STAFF PAPER

22–25 April 2014

IASB Meeting

Project	**Narrow-scope amendments to IFRS 2 *Share-based Payment***
Paper topic	Classification of share-based payments in which the manner of settlement is contingent on future events

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Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request to clarify the classification of share-based payment transactions in which the manner of settlement is contingent on a future event that is outside the control of both the entity and the counterparty.

2. The Interpretations Committee considered an equity-settled share-based payment arrangement that has a contingent cash settlement provision in which the granted equity instruments will vest immediately and be settled in cash at the fair value of the equity instruments at the date of settlement, if a specified event that is outside the control of both the entity and the employees occurs. Examples of such contingent events include (i) a successful IPO and (ii) death or disability of the employee.

3. The question considered is whether and how the contingent cash settlement condition should affect the classification of the share-based payment as equity-settled or cash-settled.

4. The Interpretations Committee learnt that there is significant diversity in practice on this issue. This is primarily because IFRS 2 *Share-based Payment* does not provide specific guidance on the classification of this type of share-based payment. Hence, the Interpretations Committee recommended to the IASB that it should clarify in a narrow-scope amendment project the classification of a share-based payment with a contingent settlement feature.

5. The Interpretations Committee recommended clarifying that:

   (a) the share-based payment should be classified as either cash-settled or equity-settled in its entirety depending on which outcome is probable (**the probable approach**); and

   (b) a change in classification of the share-based payment arising from a change in the most likely settlement method should be accounted for by recording a cumulative adjustment at the point in time that the change in classification occurs, in such a way that the cumulative cost will be the same as if the change in classification had occurred at the inception of the arrangement.

Concerns raised by the IASB

6. In the IASB meeting in February 2014, the staff proposed amendments to IFRS 2 in line with the approach recommended by the Interpretations Committee. However, two IASB members compared this issue with the accounting for a share-based payment in which the counterparty has the choice of settlement. They noted that in both circumstances the entity has a potential unavoidable obligation to pay cash. Thus, they think that the guidance in IFRS 2 for a share-based payment in which the counterparty has the choice of settlement should also be applied to a share-based payment with a contingent settlement feature. This guidance would require that a share-based payment with a contingent settlement feature should be classified as a liability and equity (**the compound financial instrument approach**).

7. They think that the requirements for financial instruments with contingent settlement provisions in IAS 32 *Financial Instruments: Presentation* should be considered. Applying the compound financial instrument approach to the share-based payment would be consistent with those requirements in IAS 32.

8. In addition, those IASB members expressed a concern over the use of the ‘probable’ threshold when deciding classification of share-based payments as cash-settled or equity-settled. They argue that, in IFRS, the ‘probable’ threshold is used for recognition but not for deciding classification.

9. Accordingly, they think that the share-based payment should be accounted for as a compound financial instrument in accordance with the requirements in paragraphs 35-40 of IFRS 2.

10. Furthermore, those IASB members expressed concern that the probable approach would add too much complexity to the accounting for a share-based payment with a contingent settlement feature.

The Interpretations Committee's considerations of the compound financial instrument approach

11. The Interpretations Committee had considered the compound financial instrument approach but dismissed it. This was primarily because of concerns over the consequences of applying the compound financial instrument approach to the share-based payment being considered.

12. Using the contingent cash settlement event of a successful IPO in paragraph 2 as an example, the Interpretations Committee noted that the approach would lead to recognising 100 per cent of the fair value of a liability in cases in which a successful IPO was remote. It did not think that this would result in useful information. However, if the probable approach is applied, a liability is recognised only when it becomes probable for a successful IPO to occur.

13. The Interpretations Committee also noted that it is common for equity-settled share-based payment arrangements to have contingent settlement provisions that require cash settlement upon the occurrence of contingent events that are unlikely to occur. Examples of those events could include, but are not limited to, death or disability of employees and liquidation of the entity. Applying the compound financial instrument approach would result in recognising a liability in full for such unlikely contingent events from the inception of the arrangement until the settlement. The Interpretations Committee thought that this accounting result would not provide useful information about the entity's obligation. At the February 2014 IASB meeting, some IASB members requested more information about how share-based payments with such unlikely contingent events are classified in practice.

Purpose of this Agenda Paper

14. In this meeting, we will present the additional analysis responding to the matters raised at the February 2014 IASB meeting. On the basis of the analysis, we will ask the IASB:

    (a) whether the IASB thinks that it should proceed with this particular amendment to IFRS 2 as part of the narrow-scope amendment project; and

    (b) if so, whether the amendment should be in line with the probable approach recommended by the Interpretations Committee.

15. This Agenda Paper addresses the issue of classification of the share-based payment being considered (the issue in paragraph 5(a)). If the IASB agrees with proposing the amendment to IFRS 2 in line with the probable approach, it will need to consider how a change in classification of the share-based payment that arises from a change in the probable settlement method should be accounted for (the issue in paragraph 5(b)). Agenda Paper 12D(ii) addresses that accounting issue under the probable approach.

16. This Agenda Paper is structured as follows:

    (a) summary of the results of our outreach

    (b) analysis of the requirements in IFRS

    (c) analysis of the recommendation by the Interpretations Committee

    (d) staff recommendation and question for the IASB.

Summary of the results of outreach

17. When we brought this issue to the Interpretations Committee, we had performed outreach primarily to the International Forum of Accounting Standard-Setters (IFASS) and regulators to assess whether this issue is widespread and whether there is significant diversity in practice.

18. The results of the outreach indicate that share-based payments in which the manner of settlement is contingent on uncertain future events, including a

successful IPO and a change in control, are widespread in a number of jurisdictions. We also learnt that there is significant diversity in practice within each jurisdiction and among those jurisdictions. However, in some jurisdictions, the most prevalent accounting is an approach that is similar to the probable approach.

19. In response to the requests from the IASB in the February 2014 meeting, we performed additional limited outreach to large accounting firms to ask:

    (a) in their experience, how common it is for the manner of settlement of a share-based payment to be contingent on the occurrence or non-occurrence of future events that are outside the control of both parties and that are unlikely to occur;

    (b) what types of unlikely contingent events are common; and

    (c) how these different contingent events affect the classification of the share-based payment transaction as cash-settled or equity-settled in practice.

20. We received five responses to the additional outreach request. All the respondents stated that unlikely contingent settlement features are commonly found in share-based payment arrangements. Those unlikely contingent events include death, injury, or disability of employees, and termination of employment without cause.

21. They also stated that even though there is diversity in practice, the most common approach for deciding classification of the share-based payment is an approach that is similar to the probable approach.

Analysis of the requirements in IFRS

Applicability of IAS 32 to share-based payments

22. IAS 32 provides principles for presenting financial instruments as liabilities or equity. The IASB states in paragraphs BC106-110 of IFRS 2 that it applied different considerations to the distinction between liabilities and equity when it

developed IFRS 2. We therefore expect that the requirements for distinguishing between liabilities and equity in IAS 32 to be different from those in IFRS 2.

23. However, we note that in those paragraphs of Basis for Conclusions of IFRS 2, the IASB explains the difference within the context of an entity's obligation to deliver a variable number of the entity's own equity instruments. For example, IAS 32 classifies a contract that will or may be settled in the entity's own equity instruments as a liability, if the contract is a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments (paragraph 16 of IAS 32). However, a share-based payment in which the entity is required to deliver a variable number of its equity instruments is classified as an equity-settled share-based payment in IFRS 2.

24. Accordingly, there is a view that the difference between IAS 32 and IFRS 2 is only the fact that IFRS 2 classifies a share-based payment that will be settled in a variable number of equity instruments as an equity-settled share-based payment whereas IAS 32 would classify such a contract as a financial liability. Those who support this view think that the requirements in paragraph 25 of IAS 32 that requires issuers of a financial instrument to classify that instrument as a liability if the issuer can be required to deliver cash or another financial asset still applies to share-based payment transactions.

25. Paragraph 25 of IAS 32 provides specific guidance on how to classify a financial instrument that requires an entity to transfer cash or another financial asset in the event of occurrence or non-occurrence of uncertain future events that are beyond the control of both the issuer and the holder. Paragraph 25 of IAS 32 states (emphasis added):

> **Contingent settlement provisions**
>
> 25 **A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument**, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. **The issuer of such an instrument does not have the unconditional right to avoid delivering cash or**

> **another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:**
>
> (a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine;
>
> (b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer; or
>
> (c) the instrument has all the features and meets the conditions in paragraphs 16A and 16B.

26. Those who support this view note that an entity that is a party to a share-based payment with a contingent settlement feature does not have an unconditional right to avoid delivering cash. Thus, they argue that the principle in paragraph 25 of IAS 32 should be considered when deciding classification of the share-based payment.

Classification principles in IFRS 2

27. Paragraph 34 of IFRS 2 provides a principle that the entity should account for a share-based payment, or a component of that transaction, as being cash-settled if, and to the extent that, the entity has incurred a liability to settle in cash or other assets.

28. Those who support the view in paragraph 24 above would argue that the requirement in paragraph 25 of IAS 32 should be the basis for making a determination about "if, and to the extent that, the entity has incurred a liability to settle in cash or other assets" in paragraph 34 of IFRS 2.

29. They also think that a share-based payment with a contingent settlement feature is similar to a share-based payment in which the counterparty has the choice of settlement, because the entity does not have an unconditional right to avoid paying cash.

30. Thus, they argue that both types of share-based payments should be accounted for consistently using the compound financial instrument approach. They think that this is consistent with the requirements in IAS 32 and IFRS 2.

Summary of the analysis of the requirements in IFRS

31. Although IFRS 2 does not specifically address the classification of a share-based payment with a contingent settlement feature, the technical analysis above could lead us to a conclusion that the compound financial instrument approach should be applied. This was the original conclusion by the staff when this issue was first presented to the Interpretations Committee.

Analysis of the recommendation by the Interpretations Committee

32. Notwithstanding the analysis above, the Interpretations Committee recommended that the probable approach should be applied for a share-based payment in which the manner of settlement is contingent on uncertain future events. This was primarily because of concerns over the consequences of applying the compound financial instrument approach to such a share-based payment.

The differences in rights and obligations

33. The Interpretations Committee acknowledged that the share-based payment is similar to a share-based payment 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.

34. Nevertheless, the Interpretations Committee noted a difference between the two transactions, which is that in a share-based payment transaction in which the counterparty has a choice of settlement, the counterparty has a unilateral right to force the entity to pay cash for the share-based payment. On the other hand, in a share-based payment transaction with a contingent cash settlement feature, the counterparty does not have such a right. In other words, no party to the arrangement can dictate the manner of settlement.

35. The Interpretations Committee also noted that in share-based payments in which the counterparty has the choice of settlement, some holders of the share-based payments may choose cash settlement while other holders may choose equity settlement. When considering share-based payments with contingent settlement

features, we think that the contingent cash settlement events could be divided into two groups on the basis of their characteristics:

(a) for some types of contingent settlement features, such as a successful IPO or a change in control, all of the share-based payments with the same contingent settlement feature are settled in the same manner depending on the occurrence or non-occurrence of the contingent event.

(b) for other types of contingent settlement features, such as death or disability of employees, the contingent event is specific to each employee. Consequently, such share-based payments could be settled in a different manner even though the contingent settlement feature is the same.

36. The Interpretations Committee discussed the characteristics of the type of contingent settlement features in paragraph 35(a) above when it compared a share-based payment with a contingent settlement feature with a share-based payment in which the counterparty has the choice of settlement. As a result of the discussions, the Interpretations Committee observed that a share-based payment with a contingent settlement feature and a share-based payment in which the counterparty has the choice of settlement are different in terms of whether all the share-based payments with the same settlement features are settled in the same manner.

37. We acknowledge that the Interpretations Committee's observation may not apply to share-based payments with the type of contingent settlement features in paragraph 35(b). This is because a share-based payment with such a contingent settlement feature could be settled in a different manner similar to a share-based payment in which the counterparty has the choice of settlement.

38. However, we observe that the occurrence of the contingent events given as examples in paragraph 35(b), such as death or disability of employees, would be rare. Thus, we expect that the type of contingent settlement features in paragraph 35(a) will be more likely to occur and therefore affect more frequently the classification of share-based payments with contingent settlement features than the type of contingent settlement features in paragraph 35(b). We therefore think that the Interpretations Committee's observation that is based on the

characteristics of the type of contingent settlement features in paragraph 35(a) would be appropriate.

39. Furthermore, the Interpretations Committee also thought that the classification of share-based payments is not necessarily bound by the requirements in IAS 32. This is because of the existing differences in classification requirements between IAS 32 and IFRS 2. The IASB states in paragraph BC266 of IFRS 2 that the classification of arrangements in which the entity has the choice of settlement differs from the classification under IAS 32.

40. On the basis of the discussions above, the Interpretations Committee concluded that the classification of a share-based payment with a contingent settlement feature should be different from share-based payments in which the counterparty has the choice of settlement. It thought that classifying a share-based payment with a contingent settlement feature as cash-settled or equity-settled in its entirety would better reflect the consequences of the share-based payment. This is because the share-based payment will generally be settled entirely in cash or in equity instruments. In contrast, the manner in which bifurcation is applied would result in all or virtually all of the value of the share-based payment being classified as cash-settled irrespective of how remote is the possibility that the continent event would occur. The Interpretations Committee thought that this would not be a fair presentation when cash settlement is not probable, and especially when cash settlement is unlikely as further described below.

Considerations on the likelihood of cash settlement

41. Paragraph 37 of IFRS 2 states that if the compound financial instrument approach is taken, the entity first measures the liability component at the fair value of the cash settlement alternative. The equity component is recognised as residual if the fair value of the compound instrument is higher than that of the cash settlement alternative (eg in a case in which an exercise price of an option for equity settlement alternative is lower than that of the cash settlement alternative). Consequently, the fair value of the cash settlement alternative and equity settlement alternative is calculated on the basis of the assumption that the likelihood of the occurrence of cash settlement is 100 per cent. This is supported

by that fact that paragraph 37 of IFRS 2 states that the fair value of the equity settlement alternative is zero if both alternatives have the same fair value.

42. It is the occurrence or non-occurrence of uncertain future events that decides the manner of settlement in a share-based payment with a contingent settlement feature. However, as stated above, the likelihood of the occurrence of cash settlement is not reflected in measuring the equity component and the liability component under the compound financial instrument approach in IFRS 2.

43. The Interpretations Committee was concerned that applying the compound financial instrument approach in IFRS 2 could result in recognising a liability in full even if the likelihood of the occurrence of the uncertain contingent cash settlement event is remote. The Interpretations Committee observed that this would not provide useful information about the entity's obligation.

44. An approach that requires a bifurcation into an equity component and a liability component on the basis of probability of cash settlement (the probability-weighted approach) might best meet the purpose of reflecting the likelihood of each settlement alternative. However, the Interpretations Committee dismissed the probability-weighted approach because it thought that it would cause too much complexity in the accounting for the share-based payment. This is because the approach would require continuous reclassification of part of the share-based payment as the probability of cash settlement changes.

45. The Interpretations Committee also noted the criticism that if the probable approach is taken, no part of the share-based payment would be classified as a liability until the occurrence of a contingent event becomes probable. This would result in a delay in disclosing the information about the entity's obligation to pay cash.

46. In addition, we acknowledge that 'probable' threshold is not used for distinction between a liability (or an asset) and equity in IFRS.

47. However, after reflecting on the discussions above, the Interpretations Committee preferred the probable approach because it thought that it would better represent the entity's obligation than the compound financial instrument approach would do when contingent cash settlement events are unlikely to occur, and is also much less complex than the probability-weighted approach.

Implementation issue

48. We note the concern raised by some IASB members that requiring assessment of probability of cash settlement would add too much complexity to the accounting for a share-based payment with a contingent settlement feature (see paragraph 10). However, the results of our outreach indicate that, although there is significant diversity in practice, many entities currently use approaches similar to the probable approach when deciding the classification of the share-based payments.

49. In addition, we note that US GAAP specifies that 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 IPO) would not by itself give rise to a liability until it becomes 'probable'[1] that the event will occur within a reasonable period of time. However, this guidance in US GAAP applies only to cash settlement events that meet the definition of performance conditions under US GAAP (eg an IPO or a change in control) and that the meaning of the term 'probable' in US GAAP is different from that in IFRS. However, the probable approach recommended by the Interpretations Committee is similar to the approach in US GAAP, albeit with a different threshold for 'probable'.

50. Consequently, we think that providing guidance in line with the probable approach would not add undue complexity to the accounting for the share-based payment.

Summary of the Interpretations Committee's recommendation

51. We acknowledge that applying the compound financial instrument approach would be consistent with the principles in IAS 32 and IFRS 2. In other words, applying the probable approach would be viewed as being conflicting with the existing requirements in IAS 32 and IFRS 2.

52. However, the Interpretations Committee concluded that guidance in line with the probable approach should be added to IFRS 2. This is primarily because, as far as a share-based payment with a contingent settlement feature is concerned, it thought that the probable approach would provide useful information about the

[1] The term 'probable' under US GAAP represents a higher probability than the term used in IFRS does.

entity's obligations in the financial statement without adding complexities that would be associated with the probability-weighted approach.

53. We note that the probable approach is different from the other approaches used in IFRS 2 for other types of transactions because it uses a probable notion to determine the classification of the share-based payment. We therefore think that any amendment made to IFRS 2 in line with the Interpretations Committee's recommendation should be clearly described as relating only to this type of share-based payment. In other words, the amendment should make it clear that the probable approach should not be used, by analogy, to account for other types of share-based payment.

Staff recommendation and question for the IASB

54. We recommend to the IASB that it should proceed with this particular amendment in line with the probable approach. This is because there is significant diversity in practice, and because the probable approach is the approach recommended by the Interpretations Committee as described above.

Question
Does the IASB agree with the staff and Interpretations Committee's recommendation that the IASB should amend IFRS 2 in a narrow-scope amendment project by adding guidance for the classification of share-based payments with contingent settlement features in line with the approach recommended by the Interpretations Committee?