STAFF PAPER

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Project	**Narrow scope amendments**		
Paper topic	IFRS 2 *Share-based Payment*—accounting for cash-settled share-based payment transactions that include a performance condition		
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Introduction

1. In September 2013, the IFRS Interpretations Committee (the 'Interpretations Committee') discussed a request to clarify the accounting for cash-settled share based payment (SBP) transactions that include a performance condition under IFRS 2 *Share-based Payment* (this issue was analysed in Agenda Paper 14 of September 2013).

2. The submitter noted that IFRS 2 does not specifically address the impact of vesting conditions (including the effect of a performance condition) within the context of cash-settled SBP transactions and asked the Interpretations Committee to clarify the accounting for cash-settled awards that include a performance condition, because the guidance in IFRS 2 is leading to divergent interpretations.

3. The Interpretations Committee tentatively decided that the guidance in IFRS 2 for the measurement of equity-settled awards that include a performance condition should be applied by analogy to account for cash-settled SBP transactions that include a performance condition.

Purpose of this paper

4. The objective of this paper is to:

   (a) present background information for the issue;

(b) provide a summary of the Interpretation Committee's rationale for recommending that the IASB should amend IFRS 2.

Background information

5. Paragraphs 19–21A of IFRS 2 provide guidance on the measurement of equity-settled SBP transactions that include vesting and non-vesting conditions. In accordance with this guidance the fair value of equity-settled SBP transactions is not adjusted for the probability of satisfying non-market vesting conditions and requires adjusting that fair value for the probability of satisfying market conditions and non-vesting conditions.

6. Paragraph 33 of IFRS 2 requires that all the terms and conditions must be considered when determining the fair value of cash-settled SBP transactions, but does not specifically address the impact of vesting conditions (including the effect of a performance condition) within the context of these transactions. However, it is unclear whether:

   (a) by analogy to the guidance for the measurement of equity-settled SBP transactions that include vesting conditions, only market and non-vesting conditions should be taken into account in the measurement of the fair value of the liability in a cash-settled SBP transaction; or

   (b) all conditions, including service and non-market performance conditions should be taken into account in that fair value.

Summary of the staff analysis

7. The following is a summary of the analysis presented to the Interpretations Committee in September and November 2013. Our full analysis was set out in Agenda Paper 14 for the September 2013 Interpretations Committee meeting[1] and Agenda Paper 3 for the November 2013 Interpretations Committee meeting.

[1] Agenda Paper 14 of September 2013 includes a copy of the original submission.

Measurement of an equity-settled SBP transaction

8. The following paragraphs provide a brief description of the measurement for equity-settled SBP transactions.

The measurement date for an equity-based SBP

9. In accordance with paragraphs 11 and 16 of IFRS 2, equity-settled SBP transactions are measured at *measurement date*, which is the *grant date* (the date at which the entity and the counterparty agree to a SBP transaction).

The modified grant date method approach

10. Paragraphs 19–21A of IFRS 2 provide specific guidance on how to measure the effect of *vesting* and *non-vesting* conditions on equity-settled SBP transactions. Paragraph BC180 and BC184 in IFRS 2 further refer to this methodology as a ‘modified grant date’ method.[2]

11. We think it would helpful to view the measurement of equity-settled awards as the product of the following two components:

    (a) a ‘value’ component; and

    (b) a ‘number of awards’ component.

12. The value component reflects the fair value of the individual equity instrument granted at *grant date*. Paragraph 19 specifies that at grant date the fair value is:

    (a) adjusted for the possibility of not meeting any market condition and/or non-vesting conditions; and

    (b) is not adjusted for the probability of satisfying any service and/or non-market performance condition.

13. The number of awards component reflects the number of equity instruments for which a service or a non-market performance condition is expected to be satisfied.

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[2] The body of the Standard does not refer to a modified grant date method, but the Basis for Conclusions refers to it when it discusses the use of this method in connection with the guidance in *Statement of Financial Accounting Standards No.123*. An extract of paragraph BC180 states that (emphasis added): “… The Board decided to adopt the **modified grant date method** applied in SFAS 123. However, the Board decided that it should not permit the choice available in SFAS 123 to account for the effects of expected or actual forfeitures of share options or other equity instruments because of failure to satisfy a service condition …”.

In accordance with the guidance in paragraph 19 of IFRS 2, at grant date the entity estimates the number of awards for which the service and/or a non-market performance condition is expected to be satisfied. Subsequently, the entity adjusts the number of awards to reflect the number of awards for which the service and/or performance condition is expected to be satisfied and finally for the number of awards for which the service and/or performance condition is actually satisfied.

14. Consequently, the initial estimate of the number of awards is revised throughout the vesting period (or 'trued-up'[3]) to reflect revised estimates and the actual satisfaction of the service and any non-market performance conditions. The "true-up" ends at vesting date and there is no "true-up" if vested awards such as options are not exercised.

15. In accordance with paragraph 19 of IFRS 2, if a service or non-market performance condition is not met, then no share-based payment is recognised on a cumulative basis and any previously recognised cost is reversed.

16. Paragraphs 21 and 21A refer that even if a market condition or a non-vesting condition is not met, a share-based payment would still be recognised for an equity-settled award since the value of the share-based payment is reduced at grant date to factor in the probability of these conditions not being satisfied.

Views identified

17. The Interpretations Committee analysed two alternative approaches to account for the liability incurred in a cash-settled share-based payment transaction that includes a performance condition.

    (a) **View A—apply by analogy an equity–settled measurement model.** Under this approach, an entity would measure the fair value of the liability incurred in a cash-settled SBP transaction by analogy to the guidance in for equity-settled SBP transactions, on the basis of paragraphs 19–21A of IFRS 2.

[3] Paragraph BC184 in IFRS 2 refers to the modified grant date approach in *Statement of Financial Accounting Standards No.123* and its truing-up mechanism.

(b) **<u>View B</u>—apply a 'full fair value' measurement model**. Using this approach, an entity would measure the fair value of the liability incurred by taking into account the terms and conditions on which the cash-settled awards were granted and the extent to which the employees have rendered service to date, on the basis of paragraph 33 in IFRS 2 and the probability of remaining vesting and non-vesting conditions being met.

View A—apply by analogy an equity–settled measurement model

Fair value in paragraph 6A

18. Proponents of Approach A note that on the basis of paragraph 6A of IFRS 2, an entity should measure the fair value the awards granted in accordance with IFRS 2. They observe that paragraphs 19-21A of IFRS 2 provide specific guidance for measuring the impact of vesting and non-vesting conditions and think that this guidance should be applied for measuring the value of cash-settled SBP transactions.

19. Paragraph 6A in IFRS 2 states that:

> This IFRS uses the term 'fair value' in a way that differs in some respects from the definition of fair value in IFRS 13 *Fair Value Measurement*. **Therefore, when applying IFRS 2 an entity measures fair value in accordance with this IFRS, not IFRS 13.**

20. Proponents of this view further note that paragraph 6A was included in IFRS 2 as a consequential amendment from IFRS 13 *Fair Value Measurement*, because the measurement of the fair value of share-based payments in IFRS 2 is not consistent with the fair value measurement objective in IFRS 13. In this respect paragraph BC21 of IFRS 13 explains that (emphasis added):

> BC21 The exposure draft proposed introducing a new measurement basis for IFRS 2, a market-based value. The definition of market-based value would have been similar to the exit price definition of fair value except that it would specify that the measurement does not take into account

> market participant assumptions for vesting conditions and reload features. **Respondents** pointed out that some items measured at fair value in IFRS 2 were consistent with the proposed definition of fair value, not with the proposed definition of market-based value, and **were concerned that there could be unintended consequences of moving forward with a market-based value measurement basis in IFRS 2**. **The IASB agreed with those comments and concluded that amending IFRS 2 to distinguish between measures that are fair value and those based on fair value would require new measurement guidance for measures based on fair value. The IASB concluded that such guidance might result in unintended changes in practice with regard to measuring share-based payment transactions and decided to exclude IFRS 2 from the scope of IFRS 13.**

Implementation guidance to account for a cash-settled SBP with a service condition

21. Proponents of View A note that Example 12 in IFRS 2 the accounting for the effect of the service condition is consistent with the accounting for the effect of a vesting condition (other than a market condition) in an equity-settled share-based payment in paragraphs 19–21 of IFRS 2.

22. They have this view because they observe that during the vesting period, the fair value of the liability recognised at each reporting date is adjusted by considering the expected number of employees that will complete the specified service. They note that this calculation follows the methodology described in paragraph 19 of IFRS 2.

23. Proponents of this view think that a cash-settled SBP transaction that includes a performance condition should follow the same methodology as the accounting for a service condition in Example 12, because, service and non-market performance conditions are both vesting conditions that are accounted for in the same way in the case of equity-settled SBP transactions.

24. Consequently, they think that the accounting for a cash-settled SBP transaction that includes a performance condition would be as follows:

    (a) the initial measurement of the fair value of the liability incurred would *exclude* the effect of both a service and a non-market performance condition; and

    (b) service and non-market performance conditions would affect the measurement of the liability by adjusting (ie 'truing-up') the number of awards to receive cash, based on the best estimate of the service and non-market performance conditions that are expected to be satisfied.

25. Proponents of this approach observe that no expense would be recognised if the achievement of a service or non-market performance condition is not probable. This is consistent with the measurement of equity-settled SBP transactions.

View B—apply a 'full fair value' measurement model

26. Proponents of this view observe that paragraph 33 in IFRS 2 requires an entity to measure the fair value of the liability by including the impact of all conditions and the extent to which services have been rendered at the reporting date. Paragraph 33 is reproduced below (emphasis added):

> …initially and at the end of each reporting period until settled, **at the fair value of the share appreciation rights** by applying an **option pricing model**, **taking into account the effect of all terms and conditions** on which the share appreciation rights were granted and the extent to which the employees have rendered service to date.

27. They also note that in accordance with paragraph 30, the fair value of the liability incurred has to be remeasured at the end of each reporting period and until the liability is settled. This differs from the 'grant date' measurement model of an equity-settled SBP transaction (in paragraphs 19–21A), which measures the fair value of the equity instruments at grant date and excludes the effect of any non-market vesting conditions or changes in the intrinsic value of the award.

28. Paragraph 30 is reproduced below (emphasis added):

> **For cash-settled share-based payment transactions**, the entity shall measure the goods or services acquired and the liability incurred at the fair value of the liability. **Until the liability is settled, the entity shall remeasure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognised in profit or loss for the period**.

29. Consequently, proponents of this view think that on the basis of paragraphs 30 and 33 in IFRS 2, the fair value of the liability incurred should be constantly 'updated' to reflect the effect of all terms and conditions of the grant. In this respect, proponents of this approach think that:

    (a) the fair value of the liability would be determined, initially and at each reporting date until settled by taking into account all terms and conditions on which the cash-settled transaction was granted and the extent to which employees have rendered service; and

    (b) any change in the fair value of the recognised liability at the end of each reporting period and until the liability is settled would be considered a remeasurement (including any adjustment to the fair value of the liability due to revisions in the estimate of the outcome of vesting and non-vesting conditions).

The Interpretations Committee's view

30. At the September 2013 meeting the Interpretations Committee members observed that while they acknowledge that there are valid arguments for View B, they preferred View A because they think that:

    (a) the 'fair value' of share-based payment transactions should be measured in accordance with the specific guidance in IFRS 2 for measuring the impact of vesting and non-vesting conditions and not in accordance with IFRS 13 (on the basis of paragraph 6A); and

    (b) the accounting for a cash-settled award that includes a service condition in Example 12 of the Implementation Guidance in IFRS 2 is consistent with the accounting for the effect of a vesting condition (other than a market condition) in an equity-settled award and is not consistent with the remeasurement for all the uncertainties at each reporting date.

31. The Interpretations Committee also thought that measuring the fair value of the liability by analogy to the guidance for equity-settled SBP transactions would be easier to apply in practice and referred to some explanations in the Basis for Conclusions of IFRS 2, which explain why a distinction has been drawn in the accounting for different types of conditions affecting equity-settled awards. In this respect it referred to paragraph BC184 of IFRS 2. An extract of this paragraph is presented below (emphasis added)

> BC184…. Furthermore, **the practical difficulties that led the Board to conclude that non-market performance conditions should be dealt with via the modified grant date method rather than being included in the grant date valuation do not apply to market conditions, because market conditions can be incorporated into option pricing models**. **Moreover, it is difficult to distinguish between market conditions, such as a target share price, and the market condition that is inherent in the option itself**, ie that the option will be exercised only if the share price on the date of exercise exceeds the exercise price. For these reasons, the Board concluded that the IFRS should apply the same approach as is applied in SFAS 123.

32. The Interpretations Committee further observed that applying View A as opposed to View B only results in a difference in the timing of recognition of the expense at each reporting date, but ultimately, the cumulative expense recognised under either View A or View B would be the same because a cash-settled SBP is remeasured to its actual settlement amount (ie the cumulative amount recognised in profit or loss will equal the cash paid to the counterparty).

33. Some other members noted that the guidance in paragraph 37 of IFRS 2 also encourages the application by analogy of the guidance for measuring the effect of vesting conditions on equity-settled SBP transactions. This is because on the

basis of paragraph 37 of IFRS 2, equity-settled SBP transactions in which the counterparty has the right to choose the manner of settlement (ie cash or equity instruments) are often structured in such a way that the fair value of one settlement alternative is the same as the other. Consequently, this guidance might suggest that a performance condition should have the *same* impact on the fair value of a cash-settled SBP transaction and on an equity-settled SBP transaction. Paragraph 37 is reproduced below:

> To apply paragraph 36, the entity shall first measure the fair value of the debt component, and then measure the fair value of the equity component—taking into account that the counterparty must forfeit the right to receive cash in order to receive the equity instrument. **The fair value of the compound financial instrument is the sum of the fair values of the two components. However, 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.** For example, the counterparty might have the choice of receiving share options or cash-settled share appreciation rights. In such cases, the fair value of the equity component is zero, and hence the fair value of the compound financial instrument is the same as the fair value of the debt component. Conversely, if the fair values of the settlement alternatives differ, the fair value of the equity component usually will be greater than zero, in which case the fair value of the compound financial instrument will be greater than the fair value of the debt component

Drafting a proposal

34. The Interpretations Committee suggests that:

(a) further guidance is added to IFRS 2 to account for a cash-settled share-based payment transaction that includes a performance condition.

This guidance should describe how vesting and/or non-vesting conditions have a different impact in the measurement of the liability; and

(b) an example is included in the Implementation Guidance of IFRS 2 to address the impact of a performance condition on the measurement of a cash-settled share-based payment transaction.

Adding specific guidance

35. The following paragraphs describe how a cash-settled SBP would be measured based on the Interpretations Committee's recommended approach.

During the vesting period (at each reporting date)

Market and non-vesting conditions

36. Market conditions and non-vesting conditions should be taken into account when initially measuring and subsequently, when remeasuring (or 'truing-up') the fair value component of the instruments granted.

Vesting conditions (other than market conditions)

37. Non-market vesting conditions:

(a) should not be taken into account in the initial measurement or subsequent remeasurement of the 'value' component of the instruments granted;

(b) will affect the 'number of awards' component in the measurement of the liability initially and at each reporting date by:

(i) estimating the number of employees that are expected to meet the service condition; and

(ii) reflecting the probability that a non-market performance target will be attained.

38. If it is not probable that a service or a non-market performance condition will be satisfied, no expense would be recognised.

At vesting date

39. The Interpretations Committee noted that a failure to satisfy *any* condition should trigger a remeasurement of the liability to zero and a reversal of the cumulative expense. Consequently, the cumulative expense recognised for the cash-settled liability is reversed for the failure to satisfy:

(a) a service and/or a non-market performance; **and also**

(b) a market and a non-vesting condition.

At settlement date

40. The liability is remeasured through settlement to reflect the amount of cash ultimately paid.

Adding Implementation Guidance (Example 12A)

41. The Interpretations Committee proposes adding Example 12A to the Implementation Guidance in IFRS 2 to illustrate the accounting for the impact of a performance condition in the measurement of a cash-settled SBP transaction, following View A in this paper (measuring the fair value of the liability incurred in a cash-settled SBP by analogy to the equity).

How to convey the proposed amendments: annual improvement or narrow-scope amendment?

42. The Interpretations Committee observed that the proposed amendment to IFRS 2, to clarify the impact of vesting and non-vesting conditions in the measurement of the fair value of the liability, could be considered for an annual improvement to IFRS 2 because it would clarify a requirement that is *already* in IFRS 2 (ie how to measure the liability incurred at fair value) and would provide missing guidance that is required for the measurement of cash-settled SBP.

43. However, the Interpretations Committee has decided to recommend that the IASB exposes other amendments to IFRS 2 separately, as narrow-scope amendments. More specifically, these are proposed amendments to account for:

(a) 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; and

(b) SBP 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, which the Interpretations Committee decided to recommend to the IASB in the September 2013 meeting.

44. The Interpretations Committee observed that the amendment to IFRS 2 proposed in this paper could be exposed together with the other proposed narrow-scope amendments to IFRS 2 that the Interpretations Committee has tentatively approved at previous meetings.

Staff recommendation

45. On the basis of the assessment against the Interpretations Committee's agenda criteria (refer to **Appendix A** in this paper), the Interpretations Committee recommends to the IASB that it should expose the proposed amendment together with other proposed narrow-scope amendments to IFRS 2 (as recommended by the Interpretations Committee to the IASB).

Proposed amendment

46. The proposal for the amendment to IFRS 2 is exposed together with other proposed narrow-scope amendments to IFRS 2 in **Agenda Paper 12G** of February 2014.

Transition provisions

47. The Interpretations Committee observed that the proposed amendments may result only in changes to the timing and amount of the expense recognised at each reporting date but will not result in changes to the cumulative expense because this amount is ultimately remeasured to the amount of cash paid at settlement date. On this basis the Interpretations Committee recommends to the IASB that for new awards and outstanding awards, the proposed amendments should be applied on a prospective basis.

48. Earlier application of the proposed amendments should be also permitted.

First-time adopters

49. The Interpretations Committee recommends to the IASB that no specific guidance is proposed for first-time adopters in the application of the proposed amendments, because appropriate relief is already given through the exemptions for SBP transactions in Appendix D of IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

Consequential amendments

50. We have reviewed other IFRSs for potential consequential amendments triggered by this proposed amendment. As a result of this review, we do not propose any consequential amendments.

Questions for the IASB

Questions for the IASB
1. Does the IASB agree with the Interpretations Committee's analysis and recommendation to amend IFRS 2?

Appendix A

Agenda criteria assessment

B1 The staff's assessment of the agenda criteria for the proposed amendment is as follows:[4]

Agenda criteria	
We should address issues (see paragraph 5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected.	**Met.** On the basis of our analysis of the outreach results received from national standard-setters and regulators (refer to paragraphs 12 –20 of Agenda Paper 14 of September 2013), we can show that this issue is considered to be widespread and diversity in practice exists.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods.	**Met.** We think that clarifying the guidance for measuring the effect of a performance condition in cash-settled SBP transactions and the Implementation Guidance in IFRS 2 would improve financial reporting.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	**Met.** We think that further guidance is needed to clarify the measurement of the fair value of the liability incurred in a cash-settled SBP transaction when such payment is conditional upon satisfying specified conditions. We also think that clarity could be provided if another example is included in the Implementation Guidance in IFRS 2 to address the impact of a performance condition in the measurement of a cash-settled SBP transaction. This why we suggest adding Implementation Guidance Example 12A.
In addition:	
Is the issue sufficiently narrow in scope so that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs (see paragraph 5.17)?	**Met.** This issue is sufficiently narrow and well defined because the potential amendments would be limited to clarify the measurement of the fair value of the liability in a cash-settled SBP transaction when such payment is conditional upon satisfying specified conditions.
Will the solution that was developed by the Interpretations Committee be effective for a reasonable time period (see paragraph 5.21)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified.)	**Met.** The proposed amendment will be effective for a reasonable time period. As previously explained, the proposed amendment is justified.

[4] These criteria can be found in the *IFRS Foundation Due Process Handbook* .