STAFF PAPER

17–21 February 2014

IASB Meeting

Project	**Narrow-scope amendments to IFRS 2 *Share-based Payment***
Paper topic	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. In September 2013, the Interpretations Committee decided to propose 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; 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.

3. The objective of this Agenda Paper is to provide the IASB with the summary of the discussions in the previous meetings of the Interpretations Committee, staff

analysis of the issue, and the Interpretations Committee's recommendation to the IASB[1].

4. This Agenda Paper is structured as follows:

(a) summary of the issue;

(b) discussions with regard to the classification of the share-based payment;

(c) discussions with regard to the accounting for a change in classification;

(d) assessment against the annual improvement criteria;

(e) the Interpretations Committee's recommendations to the IASB;

(f) amendment proposed by the staff;

(g) staff recommendation;

(h) questions for the IASB;

(i) Appendix A—Illustrative Examples;

Summary of the issue

5. 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). If such an event does not occur before the date of settlement, the share-based payment is settled in the shares.

6. We note that, in addition to the situation described above, contingent cash settlement features that are seen in practice are, among other things, a change in control, the non-occurrence of a successful IPO by a particular date, and a death or disability of employees.

7. The questions to be addressed are:

[1] Refer to Agenda Paper 6 for the September 2013 Interpretations Committee meeting (http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/September/AP06%20IFRS%202%20Contingent%20settlement%20feature.pdf) for further detail.

(a) Should the share-based payment be classified as:

(i) equity-settled;

(ii) cash-settled; or

(iii) a combination of equity-settled and cash-settled?

(b) If the share-based payment should be classified as a combination of equity-settled and cash-settled, how should that bifurcation be made?

8. The Interpretations Committee noted that, on the basis of the result of the outreach performed by the staff, there is significant diversity in practice for the issue.

9. It also noted that the diversity arises primarily because 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.

10. The Interpretations Committee considered whether it would be appropriate to apply guidance in other IFRSs, by analogy, to the share-based payment transaction. The Interpretations Committee noted that paragraph 25 of IAS 32 *Financial Instruments: Presentation* addresses a financial instrument with a contingent settlement feature; however, it observed that the guidance in IAS 32 does not provide guidance for the classification of this type of share-based payment transaction, because there are differences in principles for classification between IFRS 2 and IAS 32 (see paragraph BC106-110 of IFRS 2). The Interpretations Committee further noted that paragraph 4(f) of IAS 32 states that share-based payment transactions are, for the most part, outside the scope of IAS 32[2].

11. The Interpretations Committee also observed that the requirements for recognition of a liability in IAS 37 are not applicable to a share-based payment transaction. This is because IAS 37 has different recognition requirements from those in IFRS 2 (ie there is a probability threshold in addition to an existence threshold).

[2] Some contacts to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments, and treasury shares purchased, sold, issued or cancelled in connection with share-based payments are within the scope of IAS 32.

In addition, the Interpretations Committee noted that the *Conceptual Framework* does not provide clear guidance for the distinction between a liability and equity.

12. Consequently, the Interpretations Committee observed that the existing guidance in other IFRSs and the *Conceptual Framework* does not provide guidance for the classification of the share-based payment transactions.

13. On the basis of the observations above, the Interpretations Committee decided to explore approaches to providing specific guidance to decide whether it should recommend to the IASB that IFRS 2 should be amended to solve the diversity.

Discussions with regard to the classification of the share-based payment

Alternative approaches identified by the staff

14. The Interpretations Committee analysed five alternative approaches, including three sub-approaches of one of those approaches, for additional guidance that would address the classification issue. **Example 1** in **Appendix A** presents journal entries under each alternative approach by using a simplified fact pattern.

15. A summary of each approach is presented below. The details of each one is included in Agenda Paper 6 for the Interpretations Committee meeting in September 2013[3].

Approach A—Classify the entire award as cash-settled

16. Using 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 based on the guidance in paragraph 25 of IAS 32.

[3] http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/September/AP06%20IFRS%202%20Contingent%20settlement%20feature.pdf

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

17. Using this approach, a share-based payment with a contingent settlement feature would be classified as either cash-settled or equity-settled in its entirety, depending on which settlement method is probable based on the recognition criteria for a liability in IAS 37 *Provisions, Contingent Liabilities, and Contingent Assets*.

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

18. This approach takes the view that a share-based payment transaction with a contingent cash settlement feature should be classified as both a liability and equity in accordance with paragraph 34 of IFRS 2. With regard to how to measure each component, the Interpretations Committee considered three alternative models as explained in the following paragraphs.

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

19. Using this model, a cash-settled component and equity-settled component would be measured independently at the amount of:

    (a) cash-settled component: (fair value of the cash-settled alternative) × (probability of cash settlement)

    (b) equity-settled component: (grant date fair value of the equity-settled alternative) × 100% if equity settlement is 'expected', or nil if equity settlement is not 'expected'.

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

20. This model would require an entity to measure a cash-settled component and equity-settled component at the amount of:

    (a) cash-settled component: (fair value of the cash-settled alternative) × (probability of cash settlement)

(b) equity-settled component: (grant date fair value of the equity-settled alternative) × (probability of equity settlement).

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

21. This approach employs the compound financial instrument approach described 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, a cash-settled component and equity-settled component would be measured at the amount of:

(a) cash-settled component: (fair value of the cash-settled alternative) × 100%

(b) equity-settled component: (grant date fair value of the equity-settled alternative) – (grant date fair value of the cash-settled alternative), if any.

The approach supported by the Interpretations Committee

22. Approach A (entirely cash-settled) was not supported by the Interpretations Committee, primarily because that approach does not take into consideration the likelihood of the occurrence or non-occurrence of a contingent settlement event. The Interpretations Committee admitted that Approach A 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. However, the Interpretations Committee was concerned that the approach could result in recognising a liability in full even if the probability of the occurrence of the contingent cash settlement event is remote (eg death or disability of an employee).

23. The Interpretations Committee did not support Model C-3 (compound financial instrument model) either. It acknowledged the similarity in the share-based payment transactions analysed and those described in paragraphs 35-40 of IFRS 2, which is that an entity does not have an unconditional right to avoid delivering cash. It noted however that this approach would raise the same concern as that for

Approach A because this approach assumes 100 per cent likelihood of the occurrence of cash settlement.

24. Applying Model C-1 (cash-settled at its fair value plus equity-settled if ‘expected’), the sum of a equity-settled component and cash-settled component at the initial and subsequent measurement could exceed the fair value of the entire share-based payment in a situation in which equity settlement is ‘expected’ and the probability of cash settlement is not zero. In this case, part of the share based payment would be double counted (refer to Example 1 in Appendix A for details). Accordingly, the Interpretations Committee did not prefer Model C-1.

25. The Interpretations Committee noted that Model C-2 (probability-weighted approach) would best match the principle in paragraph 34 of IFRS 2, which requires an entity to recognise a liability to the extent that the entity has incurred a liability to settle in cash or other assets. Nevertheless, the Interpretations Committee noted that the approach would cause too much complexity in the accounting for a share-based payment with a contingent settlement provision. This is because this approach would require an entity to continuously reclassify part of the share-based payment as the probability of the occurrence of cash settlement changes.

26. The Interpretations Committee admitted that, regarding Approach B (cash-settled if probable), requirements for recognition of a liability in IAS 37 are different from those in IFRS 2. However, the Interpretations Committee supported Approach B because:

   (a) The share-based payment could be viewed as representing a single share-based payment (either cash-settled or equity-settled) rather than two share-based payments (both cash-settled and equity-settled) because:

      (i) no parties to the arrangement can dictate the manner of settlement; and

      (ii) the share-based payment will be settled either in cash or equity instruments in its entirety.

(b) The manner of settlement of the single share-based payment is determined by the occurrence or non-occurrence of an uncertain future event.

27. 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 that the event will occur within the reasonable period of time. Thus, the transaction described in paragraph 5 would be classified as a liability if it is 'probable' that the cash settlement event will occur. However, we note that this guidance in US GAAP applies only to cash settlement events that meet the definition of performance conditions under US GAAP (eg an IPO and change in control) and that the meaning of the term 'probable' in US GAAP is different from that in IFRS. Accordingly, we think that the approach recommend by the Interpretations Committee is similar to that in US GAAP.

Discussions with regard to the accounting for a change in classification

28. If Approach B is taken, the share based payment would be reclassified from cash-settled to equity-settled or vice versa if the probable settlement method changes before the settlement date. The Interpretations Committee therefore discussed how changes in classification of the share-based payment under Approach B should be accounted for. The Interpretations Committee analysed two alternative methods for the accounting for the classification changes. We have prepared illustrative examples in **Example 2** in **Appendix A** to show journal entries for each method using a slightly modified fact pattern from that in **Example 1**.

Alternative methods identified by the staff

Method 1—account for the change in classification by reference to the guidance for a failure to satisfy a non-market vesting condition (the single measurement method)

29. Using this method, the entity accounts for a change in the classification as if an original settlement alternative had 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 derecognise the amount recorded in equity for the equity-settled share-based payment with a credit to profit or loss (paragraph 19 of IFRS 2), and record a liability with a 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 from the inception of the arrangement and record catch-up adjustments in the period in which the classification change occurs. This method results in no restatements of comparative periods, consistently with the requirements in paragraph 19 of IFRS 2.

30. Those who support this method also think that a change in the estimate for the most probable settlement method is a change in an accounting estimate. The change in the estimate would give rise to changes in liabilities and equity. Thus, they think that the effects of the change attributable to the period before the change should be recognised in the period of the change (rather than over the remainder of the vesting period) in accordance with paragraph 37 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

31. The total amount of expense recognised in this method would represent the measurement determined in accordance with the requirements for either a cash-settled share-based payment or equity-settled share-based payment, depending on whether it is settled in cash or equity instruments.

Method 2—account for the change in classification by reference to the guidance for a modification of the terms and conditions of the share-based payment (the multiple measurement method)

32. Using this method, a change in the classification of the share-based payment with a contingent settlement provision would be accounted for as if a modification of the terms and conditions of a share-based payment transaction had occurred (paragraphs 26-29 and B42-B44 of IFRS 2). For example, if the share-based payment is reclassified from equity-settled to cash-settled, the cumulative amount of compensation expenses recognised for the equity-settled share-based payment would not be adjusted.

33. After the reclassification date, an amount of compensation expense is determined in accordance with the requirements for cash-settled share-based payments in paragraphs 30-33 of IFRS 2 and with the requirements for modifications to terms and conditions of equity-settled share-based payments in paragraphs 26-29 and B42-B44. Thus, if the modification date fair value of the cash-settled alternative is greater than that of the equity-settled alternative, the incremental fair value would be recognised as an expense over the remainder of the service period (paragraph B43 of IFRS 2). If not, there would be no adjustment to expenses recognised for the equity-settled alternative before the reclassification (paragraph B44 of IFRS 2).

34. Using this method, the total amount of expense recognised would represent a mix of measurements determined in accordance with the requirements for both cash-settled share-based payments and equity-settled share-based payments.

35. We understand that US GAAP provides guidance that the specific share-based payments described in paragraph 27 that is classified as equity, but subsequently becomes a liability because the contingent cash settlement event is probable of occurring, are accounted for similar to modifications of the terms and conditions of the share-based payments. Thus, this model would result in consistent accounting with that under US GAAP for specific transactions with contingent cash settlement features (eg an IPO). We note however that the guidance in US GAAP does not address changes in classification of share-based payments with other cash settlement features such as death or disability of employees that do not meet the definition of performance conditions under US GAAP.

A method preferred by the Interpretations Committee

36. The Interpretations Committee noted that neither approach can be directly derived from the existing guidance in IFRS 2. This is because in this fact pattern, the changes in classification are not caused by a failure to meet the vesting conditions or a modification to the terms and conditions of the arrangement. The classification of the share-based payment changes because of a change in the most likely settlement method.

37. However, a majority of the members of the Interpretations Committee supported Method 1 (the single measurement method) for various reasons, including:

    (a) Applying a new classification from the inception of the arrangement better matches a share-based payment that is a single share-based payment but with two settlement alternatives from the inception of the arrangement.

    (b) The effects of a change in an accounting estimate for the probable settlement method should be recognised in the period of the change rather than prospectively (consistently with paragraph 19 of IFRS 2 and paragraph 37 of IAS 8).

    (c) Method 1 is more straight-forward to implement.

Assessment against annual improvement criteria

38. The Interpretations Committee thought 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, the Interpretations Committee noted that the amendment would be perceived as being beyond a clarification and correction of minor unintended consequences, oversights or conflict of existing requirements in IFRS 2. This is because the potential amendment would add guidance on specific types of share-based payment transactions for the purpose of resolving the diversity in practice. The amendment would not necessarily be derived from a consensus on an interpretation of principles in IFRS 2 or other IFRSs.

39. Accordingly, the Interpretations Committee observed that the potential amendment should be proposed in a separate narrow-scope amendment project by the IASB. For details about the assessment against the annual improvements criteria, please refer to Appendix A of Agenda Paper 6 for the Interpretations Committee meeting in September 2013[4].

[4] http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/September/AP06%20IFRS%202%20Contingent%20settlement%20feature.pdf

Interpretations Committee's recommendations to the IASB

40. On the basis of the discussions above, the Interpretations Committee decided to recommend to the IASB that it should amend IFRS 2 in a narrow-scope amendment project by adding guidance in line with the following approaches:

    (a) A share-based payment in which the manner of settlement is contingent on a future event that is outside the control of both the entity and the counterparty should be classified as either cash-settled or equity-settled in its entirety depending on which outcome is probable.

    (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 for the effects of the reclassification in a period in which the reclassification occurs, without restating comparatives.

Amendment proposed by the staff

41. The draft wording of the proposed amendments to IFRS 2 is included in Agenda Paper 12G, together with the draft amendments arising from other IFRS 2 issues.

Transition requirements

42. We considered whether the amendments should be applied retrospectively in accordance with the requirements in IAS 8. We note that it would be difficult for most entities to decide the classification of the share-based payment with contingent cash settlement features in the past without using hindsight. This is because the classification depends on the entity's estimates for the manner of settlement in the future.

43. Accordingly, if the amendment in this Agenda Paper is considered alone, we think that the proposed amendment should be applied prospectively to avoid the use of hindsight.. Notwithstanding the above, we collectively analyse the transition requirements in Agenda Paper 12G for all the amendments proposed in Agenda Paper 12C-12F.

First-time adopters

44. 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 share-based payments in Appendix D of IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

Consequential amendments

45. 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.

Staff recommendation

46. We recommend to the IASB that it should propose to amend IFRS 2 in a narrow-scope amendment project by adding guidance in line with the approach recommended by the Interpretations Committee.

47. If the IASB agrees with the proposals in this Agenda Paper, a ballot draft will be prepared for IASB members to approve. We propose that the IASB publishes an Exposure Draft with a 120-day comment period.

Questions for the IASB

Question 1
Does the IASB agree with the staff recommendation that the IASB should amend IFRS 2 in a narrow-scope amendment project by adding guidance in line with the approach recommended by the Interpretations Committee?

Question 2
If the answer to Question 1 is 'yes', does the IASB agree to publish an Exposure Draft with a 120-day comment period based on the wording of the proposed amendment in Agenda Paper 12G?

Appendix A—Illustrative examples

Example 1

In 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[5] per share from the grant date to the settlement date.

Journal entries

	Approach A (Cash-settled entirely)		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	

[5] 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(Cash)	-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

Example 2

This example illustrates how the reclassification should be accounted for on the basis of the assumption that Approach B is taken for deciding the classification of the share-based payment.

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 Single measurement method		Method 2 Multiple measurement method	
20X1				
Employee expense	25		25	
Liability	0		0	
Equity	-25	(a)	-25	(a)

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

20X2

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

*(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 (CU10*10*2/4 - CU6*10*2/4)*

20X3

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

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

Total

Employee expense	60	100
Liability	-60	-60
Equity	0	-40