STAFF PAPER

17–21 February 2014

IASB Meeting

Project	**Narrow-scope amendments to IFRS 2 *Share-based Payment***		
Paper topic	Modification of a share-based payment transaction from cash-settled to equity-settled		
CONTACT(S)	Kenichi Yoshimura	kyoshimura@ifrs.org	+44 (0)20 7246 6905

Introduction

1. The IFRS Interpretations Committee (the 'Interpretations Committee') received a request to clarify the accounting for a modification to the terms and conditions of a cash-settled share-based payment that involves a change in the classification from cash-settled to equity-settled.

2. In March 2013, the Interpretations Committee decided to recommend to the IASB that it should amend IFRS 2 in a narrow-scope amendment to clarify this issue.

3. The objective of this agenda paper is to provide the IASB with the summary of the issue, and discussions of and recommendations made by the Interpretations Committee.

4. For the ease of understanding of the issue, we use the examples in **Appendix A** (hereinafter the '**Examples**'), which are the reproduction of the examples described in the original submission.

5. This Agenda Paper is structured as follows:

   (a) summary of the issue;

   (b) summary of the staff analysis

   (c) recommendation by the Interpretations Committee

   (d) amendment proposed by the staff

(e) staff recommendation

(f) questions for the IASB

(g) Appendix A—Illustrative examples in the original submission

Summary of the issue

6. The request received sought clarification of the accounting for a share-based payment arrangement with employees in situations in which:

   (a) a cash-settled award is cancelled and is replaced by a new equity-settled award; and

   (b) the replacement award has a higher fair value than the original award as at the replacement date.

7. The submitter of this issue states that there are currently three different views on the accounting for the share-based payment transaction. The major difference in those views concerns the measurement of the new equity-settled award (ie grant date fair value of the original cash-settled award or replacement date fair value of the new equity-settled award).

8. Throughout the paper we will illustrate the alternative views by reference to the Examples in Appendix A.

View 1: apply by analogy the modification guidance in IFRS 2

9. This approach applies, by analogy, the requirements for modifications of equity-settled awards in paragraphs 27 and B42–B44 of IFRS 2 and IG Example 9 for IFRS 2. Thus, the new equity-settled award is measured at the grant date fair value of the original cash-settled award (100 in the Examples) plus the incremental fair value measured as of the modification date (12 = 132–120).

View 2: treat the original award as having being cancelled and replaced by a new award

10. This approach considers the cash-settled award to have been cancelled and settled by an equity-settled award. Using this approach, the new equity-settled award is measured by reference to the fair value of the new equity-settled award as of the replacement date, viewing the replacement date as a grant date of the equity-settled award (132 in the Examples).

11. Furthermore, there are two sub-views in this view on how to account for the difference between the carrying amount of the liability (60 in the Examples) and the portion of the replacement date fair value of the new equity-settled award attributable to the services received before the replacement (66 in the Examples).

- View 2A: recognise it over the remaining vesting period (consistent with paragraph B43 of IFRS 2).
- View 2B: recognise it immediately in profit or loss (consistent with paragraph 43(c) of IFRS 2).

12. The submitter states that the diversity arises primarily because IFRS 2 does not have specific guidance for changes in classification from cash-settled to equity-settled. In addition, there is no general guidance in IFRS 2 for a modification of terms of cash-settled share-based payments.

13. The full staff analysis on this issue and the original submission presented to the Interpretations Committee can be found in Agenda Paper 5C[1] for the March 2013 meeting of the Interpretations Committee.

Summary of the staff analysis

14. We have summarised in the following paragraphs staff analysis presented to the Interpretations Committee on this issue.

[1] 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

Accounting for the replacement

Modification vs settlement

15. Paragraph 28(c) of IFRS 2 states that the replacement of the share-based payment should be accounted for in the same manner as a modification of the original grant of equity instruments. The rationale for this is stated in paragraph BC233 of IFRS 2, as follows:

> BC233 … In the Board's view, it is very unlikely that a share or share option grant would be cancelled without some compensation to the counterparty, either in the form of cash or replacement share options. Moreover, the Board saw no difference between a repricing of share options and a cancellation of share options followed by the granting of replacement share options at a lower exercise price, and therefore concluded that the accounting treatment should be the same.

16. We note that in the transaction analysed, the cancellation of the original cash-settled award is compensated for by the promise to issue equity instruments. In this sense, although paragraph 28 of IFRS 2 addresses modifications of equity-settled award, we think that the rationale for the requirements in paragraph 28(c) of IFRS 2 should apply to cash-settled awards.

17. Accordingly, we are of the view that the share-based payment transaction should be viewed as a modification of the award, rather than as a cancellation of the original award followed by the beginning of a new equity-settled award.

Accounting for the credit side

18. We think that the liability recognised in respect of the original cash-settled award has been settled as a result of the modification, although the share-based payment transaction itself has not been settled. This is because the entity is no longer obliged to transfer cash or other assets to the employees after the modification.

19. Hence, we think that on the modification date, the carrying amount of the liability (60 in the Examples) should be derecognised, with an amount being entered as a credit entry to equity upon the modification. Regarding the measurement of the credit entry to the equity, we discuss it further in the following paragraphs.

Measurement of the share-based payment transaction

20. The fair value of services received in an equity-settled share-based payment transaction with employees is generally measured by reference to the grant date fair value of the equity instruments (paragraph 11 of IFRS 2). Appendix A *Defined terms* to IFRS 2 defines grant date as (emphasis added):

> The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

21. We note that the entity and the employees have a shared understanding of the terms and conditions of the new equity-settled award on the modification date. The shared understanding at the original grant date was that the entity would pay cash for services to be rendered by the employees. Consequently, we are of the view that the compensation expense in respect of the new equity-settled award should be measured at the modification date fair value of the equity instruments (132 in the Examples).

Accounting for the difference in fair value

22. Using the Examples, the elapsed portion of the modification date fair value of the new equity settled award is 66. If View 2A is applied, the credit entry to equity is measured at the same value as the carrying amount of the liability (60 in the Examples). This model would result in recognising the difference (6 = 66 – 60 in the Examples) as expense over the remaining vesting period rather than recognising it as expense immediately. This accounting model follows the guidance in paragraph B43 of IFRS 2 for the accounting for incremental fair value arising from modifications of an equity-settled award.

23. The accounting model in View 2B would require the entity to recognise the difference (6 = 66 – 60 in the Examples) as expense immediately upon the modification. This model measures the credit entry to equity at the modification

date fair value of the equity-settled award to the extent that the services have been rendered.

24. We note that the liability recognised in respect of the original cash-settled award has been settled by the granting of equity instruments as a result of the modification of the cash-settled award. Paragraph 30 of IFRS 2 requires that the fair value of the liability be remeasured at the end of each reporting period until the liability is settled, with any change in fair value recognised in profit or loss for the period. When the liability is settled, the amount of the liability is ultimately measured at the amount of settlement (see paragraphs BC241 and BC249), with any change in the measurement recognised in profit or loss.

25. Consequently, we think that the liability recognised in respect of the original cash-settled award should be 'trued-up' to equal the settlement amount, with any change in the measurement being recognised in profit or loss for the period. We think that the amount of settlement should be determined on the basis of the modification date fair value of the new equity-settled award and the extent to which the services have been received (66 in the Examples).

26. We note that the approach in View 2A could result in counterintuitive accounting after the modification date, if the modification involves a reduction of fair value. Assuming that the amendment reduced the fair value of the award by 100 to 20 in Examples, 60 would be credited to equity on the modification date when using View 2A. After that, negative compensation expense would be recognised each year (-20) for the remaining two years, while also debiting the same amount to equity to arrive at the total compensation expense of 20 (= 60 – 20×2).

27. We think that the accounting model in paragraph B43 of IFRS 2 bases itself on the restriction for equity-settled awards in paragraph 27 of IFRS 2. The restriction is that the entity should recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted. This restriction applies even if the terms and conditions of the equity-settled award are subsequently modified. If this 'as a minimum' restriction were applied to the share-based payment analysed, the decrease in the fair value would not be

recognised in profit or loss; consequently, the negative expense issue would not arise.

28. However, we are of the view that the restriction is not applicable to cash-settled awards, because the liability recognised for cash-settled awards is remeasured at its fair value until the settlement, with any change in fair value being immediately recognised in profit or loss. The 'as a minimum' rule applies to the new equity-settled award from the modification date on the basis of the modification date (ie grant date) fair value of the new award.

29. In addition, we understand that the approach in View 2B is taken by US GAAP for modifications of the terms and conditions of a cash-settled award that involve reclassification of a share-based payment from a liability to equity. Accordingly, we support the accounting model in View 2B.

Assessment of the annual improvement criteria

30. The Interpretations Committee thought that the potential amendment could be developed and agreed upon by the IASB on a timely basis. However, it 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 there is no requirement in IFRS 2 that specifically addresses a modification of a cash-settled award.

31. Accordingly, the Interpretations Committee observed that the potential amendment should be exposed separately and performed in a separate narrow scope amendment of the IASB. For the details about the assessment against the annual improvement criteria, please refer to Appendix C of Agenda Paper 5C for the Interpretations Committee's meeting in March 2013[2].

[2] 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

Recommendation by the Interpretations Committee

32. The Interpretations Committee overwhelmingly agreed that the share-based payment analysed should be measured at the modification date fair value of the new equity-settled award (ie View 2).

33. Some members of the Interpretations Committee supported the model in View 2A that requires the change in the fair value to be recognised over the remainder of the vesting period. However, a majority of the members preferred the accounting model in View 2B, by which the change in fair value of the share-based payment as a result of the modification is recognised in profit or loss immediately.

34. The Interpretations Committee concluded that the diversity in practice should be resolved by adding specific guidance to IFRS 2 in a narrow-scope amendment project rather than an annual improvement project.

Amendment proposed by the staff

35. 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.

How the guidance should be provided

36. We think that the accounting model recommended by the Interpretations Committee is on the basis of the existing requirements in IFRS 2. Thus, we do not propose that the IASB amends the body of IFRS 2. We recommend that the IASB adds application guidance to Appendix B of IFRS 2, and providing an additional illustrative example in *Guidance on implementing IFRS 2*. The application guidance and illustrative example would clarify the application of the principles in IFRS 2 for modifications of cash-settled awards involving changes in classification from cash-settled to equity-settled.

Transition requirements

37. The proposed amendment does not require an entity to change the fair value that the entity estimated. Regardless of which view described in this Agenda Paper has been taken, we expect that most of the entities that would be affected have the information necessary to apply the proposed amendment retrospectively.

38. Accordingly, if the amendment in this Agenda Paper is considered alone, we think that a transition relief is unnecessary. 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

39. 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

40. 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

41. 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.

42. 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 accounting model 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 in the original submission

A1. The following illustrative examples are a reproduction of those presented in the original submission received by the Interpretations Committee.

On 1 January 2010 Company M grants 100 share appreciation rights (SARs) to its CFO, subject to a four-year service condition. The grant-date fair value of a SAR is 1; the total grant-date fair value is 100. The share price at the end of 2010 is unchanged. At the end of 2011 the original grant has a fair value of 120. M cancels the grant and in its place grants 100 share options at a fair value of 132, i.e. with an incremental fair value of 12 at that date. The new equity-settled grant is identified as a replacement of the original cash-settled grant.

If the modification example is applied by analogy then measurement of the replacement award is based on the grant date fair value of the original award plus any incremental fair value. If that guidance is not applied by analogy then two alternative approaches result in the modified award being accounted for based on the modification date fair value of the replacement award. More detailed analysis of the different vies and illustrations of the accounting are attached in Appendix A.

View 1: Analogy to modification from equity-settled share-based payment to cash-settled share-based payment

The principles for modification and cancellation of equity-settled share-based payments should be applied by analogy to such changes in classification. IFRS 2 IG 2 illustrates that the requirements of IFRS 2.27 and IFRS 2 B42 - 44 apply to a modification that triggers a change from an equity-settled classification to a cash-settled classification. Under view 1 those principles should be applied by analogy to the opposite change in classification. Accordingly, a modification of an existing cash-settled arrangement in which the classification is changed from cash settled to equity settled should be accounted for as follows:

Distinguish between the grant-date fair value of the original cash-settled share-based payment arrangement (first component) and the remeasurement of that liability (second component).
At the date of modification, the liability recognised to the extent that services have been received as of that date is reclassified to equity.
The incremental fair value of the modification is calculated as:

- the fair value of the new grant, measured at the date of modification; less
- the fair value of the original grant, measured at the date of modification; and
- any payments made to the employees on cancellation of the original grant.

Recognise the remaining grant-date fair value of the original grant (unrecognised portion of the first component only) in addition to the incremental fair value, if any, over the remaining vesting period.

This is illustrated as follows:

	Liability			Equity		
	In current period			In current period		
End of:	Recognition of grant-date fair value of liability	Remeasure-ment	Cumulative	Unrecognised grant-date fair value of liability	Incremental fair value	Cumulative
2010	25	-	25	-	-	-
2011	25	10	60			60
2012	-	-	-	25	6	91
2013	-	-	-	25	6	122

M accounts for the transaction as follows:

	Debit	*Credit*
2010		
Expenses	25	
Liability		25
To recognise 1/4 of grant-date fair value of the liability, no remeasurement		
2011		
Expenses	35	
Liability		35
To recognise 1/4 of grant-date fair value of the liability of 25 and remeasurement of 10		
Liability	60	
Equity		60
To recognise reclassification from liability to equity		
2012		
Expenses	31	
Equity		31
To recognise ½ of the unrecognised grant-date fair value of the original cash settled share-based payment arrangement of 25 and ½ of the incremental fair value as of modification date of 6 ((132-120)/2) as an increase in equity		

	Debit	*Credit*
2013		
Expenses	31	

Equity		31

To recognise ½ of the unrecognised grant-date fair value of the original cash settled share-based payment arrangement of 25 and ½ of the incremental fair value as of modification date of 6 ((132-120)/2) as an increase in equity

Cumulative effects:

Expenses	122	
Equity		122
Liability		0

View 2: No analogy to modification from equity-settled share-based payment to cash-settled share-based payment

View 2 is to measure the equity-settled award at modification date. There are two sub-views as to when the incremental value should be expensed.

View 2 is that the requirements of IFRS 2 relating to cash-settled awards do not include guidance relating to modifications on the grounds that the liability is remeasured to its fair value and therefore any modifications would be reflected in the carrying value of the liability. If an entity cancelled a cash-settled award then, in contrast to the treatment of a cancellation for an equity-settled award, the expense would be reversed.

Under this view when a cash-settled award is "cancelled" and "replaced" by an equity-settled award the appropriate accounting would be to reverse the expense recognised up to the date of cancellation and then start to recognise an equity-settled award with a new grant date. However, this would not give an expense recognition in line with the receipt of services. Furthermore, reversal of the recognised expense would be appropriate only if the liability had been extinguished; in fact the liability has been "settled" by a promise to issue equity instruments; *therefore, the appropriate treatment for the accrued liability is to transfer it to equity*. The grant date for an equity-settled award is defined in IFRS 2 as:

> "The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained."

At the original grant date of the award the shared understanding was that there would be a cash payment. It is only after the "modification" date that the entity is obligated to issue equity instruments and that the shared understanding is based on issue of equity instruments. Therefore the grant date for the purpose of measuring the equity settled award is the date of modification rather than the original award date. Another way of looking at this would be in line with IFRS 2 B43(b), prior to the modification the number of equity instruments expected to vest was zero, therefore all the equity instruments are incremental and under B43(b) the incremental expense would be measured based on the fair value at the modification date[3].

[3] Also ASC 718-20-55sets out the US GAAP treatment which measures the expense based on the fair value at the time that the award is modified to equity settled. View 2 would be converged with this whilst View 1 would lead to a GAAP difference.

<u>View 2A:</u> Consider the original cash-settled liability to be settled by conversion (reclassification to equity) and account for the difference between the modification date fair value of the replacement equity-settled share-based payment arrangement and the amount reclassified to equity over the remaining vesting period.

Under this sub-view when a modification changes the classification of a share-based payment arrangement from cash-settled to equity-settled, the entity immediately reclassifies the carrying amount of the liability at the date of modification to equity. The expense recognised over the remaining vesting period is based on the modification date fair value of the replacement equity-settled share-based payment arrangement and not the grant date fair value of the original arrangement.

Taking the same fact as outline above the example below illustrates the accounting entries that arise under this view.

	Liability			Equity		
	In current period			In current period		
End of:	Recognition of grant-date fair value of liability	Remeasure-ment	Cumulative	Reclassification from liability	Unrecognised modification-date fair value of equity replacement	Cumulative
2010	25	-	25	-	-	-
2011	25	10	60	→ 60		60
2012	-	-	-	-	36	96
2013	-	-	-	-	36	132

M accounts for the transaction as follows:

	Debit	*Credit*
2010		
Expenses	25	
Liability		25
To recognise 1/4 of grant-date fair value of the liability, no remeasurement		
2011		
Expenses	35	
Liability		35
To recognise 1/4 of grant-date fair value of the liability of 25 and remeasurement of 10		
Liability	60	
Equity		60
To recognise reclassification from liability to equity		
2012		
Expenses	36	
Equity		36
To recognise 1/2 of the unrecognised modification-date fair value of the replacement equity settled share-based payment arrangement of 36 as an increase in equity (132-60)/2		
2013		
Expenses	36	
Equity		36
To recognise 1/2 of the unrecognised modification-date fair value of the replacement equity settled share-based payment arrangement of 36 as an increase in equity		
Cumulative effects:		
Expenses	132	
Equity		132
Liability		0

<u>View 2B:</u> Account for settlement of the cash-settled share-based payment on date of modification

Under this view, the change from cash-settled award to equity-settled is viewed as a settlement of the cash-settled award and any excess of the fair value of the equity instruments used to settle the liability over the amount reclassified is recognised immediately in profit or loss. That is, the fair value of the modification award is compared to the fair value of the original award, and any positive difference is expensed immediately to the extent that services have been received.

This is consistent with what is required by IFRS 2.43 (c) when an entity elects the settlement alternative with a higher fair value.

	Liability			Equity		
	In current period			In current period		
End of:	Recognition of grant-date fair value of liability	Remeasure-ment	Cumulative	Settlement of cash-settled award	Unrecognised modification-date fair value of equity replacement	Cumulative
2010	25	-	25	-	-	-
2011	25	10	60	6	-	66
2012	-	-	-	-	33	99
2013	-	-	-	-	33	132

M accounts for the transaction as follows:

	Debit	*Credit*
2010		
Expenses	25	
Liability		25
To recognise 1/4 of grant-date fair value of the liability, no remeasurement		
2011		
Expenses	35	
Liability		35
To recognise 1/4 of grant-date fair value of the liability of 25 and remeasurement of 10		

Debit

		Credit
Employee costs	6	
Liability	60	
Equity		60

To recognise reclassification from liability to equity plus the effect of settlement of the cash-settled award (6=((132-120)/2) to the extent of services provided as an increase in equity

2012

Expenses	33	
Equity		33

To recognise 1/2 of the unrecognised modification-date fair value of the replacement equity settled share-based payment arrangement of 33

2013

Expenses	33	
Equity		33

To recognise 1/2 of the unrecognised modification-date fair value of the replacement equity settled share-based payment arrangement of 33 as an increase in equity

Cumulative effects:

Expenses	132	
Equity		132
Liability		0

The total expense reflects the settlement of the original cash-settled award (66), plus the expense related to the modification equity-settled award (66).