

STAFF PAPER

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REG IASB Meeting

Project	IFRS 2 <i>Share-based Payment</i> Research Project		
Paper topic	Approach to the research		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Objective of the project and of the paper

1. During the 2011 Agenda Consultation, mixed views were expressed on how effective IFRS 2 *Share-based Payment* (IFRS 2) had been in practice. Many respondents commented on the Standard's complexity. It has also attracted a disproportionate number of interpretation requests.
2. The objective of this project is to identify whether IFRS 2 is causing this perceived complexity, and if it is, the most common areas. To achieve this, the project will use the main application issues that arise in practice to guide the work.
3. The initial output of the Research Project is expected to be a Research Paper, which would enable respondents to the 2015 Agenda Consultation to consider whether the IASB should do more on this subject.
4. The purpose of this staff paper is to describe and to explain the approach that the staff plan to apply to the research project. This paper is primarily for planning purposes and there is a broad question for the IASB members on whether they agree with the outlined approach to the research.
5. The paper has the following sections:
 - (a) Background
 - (b) Exploratory research: objective and output

- (c) Exploratory research: steps
 - (d) Application issues
 - (e) Potential ways forward
 - (f) Appendix A—List of application issues
6. In addition, the following research material can be found on the IFRS 2 project web page:¹
- (a) History of IFRS 2 *Share-based Payment*, including interpretations and amendments
 - (b) Summary of the FASB’s project *Employee Share-Based Payment Accounting Improvements*
 - (c) Paper presented by ANC (the French standard-setter) to the IFRS Advisory Council in 2010
 - (d) Discussion with preparers at the Global Preparers’ Forum (GPF) meeting on 5 March 2015: paper and notes from the meeting

Background

7. IFRS 2 was issued in 2004. Although it was not a converged Standard, many technical decisions of IFRS 2 are consistent with FAS 123 *Share-Based Payment*. These decisions included: *grant date* fair value measurement model and the approach to cancellations and ‘negative’ modifications² for equity-settled share-based payment arrangements.
8. Please note that, although FAS 123 and IFRS 2 are similar in the main aspects of accounting for share-based payment arrangements, there are many differences at the detailed application level.
9. Since 2004 IFRS 2 has attracted a number of interpretation requests and has been amended several times.

¹ <http://www.ifrs.org/Current-Projects/IASB-Projects/Share-based-payments/Pages/Share-based-payments.aspx>

² For the purposes of this paper a modification is called “negative” when it is not beneficial to an employee, ie the fair value of a share-based payment arrangement was reduced.

10. In May 2012, as a result of the 2011 Agenda Consultation, the IASB decided to add a project on share-based payment arrangements to its Research Programme for the following reason: ‘there are mixed views on how effective IFRS 2 has been in practice. Although we have an IFRS that seems to work well, it also attracts a disproportionate number of interpretation requests’³.
11. With respect to the number of requests received by the IFRS IC, they can be broadly grouped as relating to:
- (a) group share-based payment arrangements; and
 - (b) treatment of various conditions in the measurement of equity-settled share-based payment arrangements, which depends on the classification of those conditions as vesting and non-vesting conditions (with further sub-sets; six in total).⁴
12. With respect to the mixed views received in response to the 2011 Agenda Consultation: nearly all respondents who commented on IFRS 2 agreed that it was a complex Standard. Nevertheless, views varied significantly with respect to adding the project to the IASB’s main projects agenda—depending on how strongly respondents felt about the Standard’s complexity—with:
- (a) some letters indicating that the project should be assigned a high priority, because of the undue cost and effort that its application required; and
 - (b) some letters indicating that the project should be assigned a low priority, because although the Standard was complex, it was nevertheless operational in practice.
13. Since May 2012, when the project was added to the Research Programme, the IASB has issued further amendments to IFRS 2:

³ Staff paper 13B, May 2012 *Developing the IASB’s Technical Programme*.

⁴ Vesting conditions include service and performance conditions; performance conditions in their turn have market and non-market conditions.

Non-vesting conditions have three types depending on who can choose whether to meet the condition: (1) neither the entity nor the counterparty; (2) counterparty; (3) entity.

- (a) amendments to the definitions of ‘vesting condition’ and ‘market condition’ (including adding new definitions for ‘performance condition’ and ‘service condition’) issued in December 2013 as part of *Annual Improvements to IFRSs 2010-2012 Cycle*. These amendments were issued in response to the requests to the IFRS IC mentioned in paragraph 1111(b).
 - (b) draft amendments *Classification and Measurement of Share-based Payment Transactions* issued in November 2014. The proposed amendments address three issues; two⁵ out of the three issues arise from differences in measurement models (ie grant date fair value⁶ and current fair value⁷) for equity- and cash-settled share-based payment arrangements.
14. Around 10 (out of a total of 70) respondents to the above draft amendments commented more generally on IFRS 2 and the fact that it seems to be amended continually. The sentiment can be summarised with the following extract from the comment letter by EFRAG: ‘Although EFRAG is not opposed to any of the three proposed amendments, EFRAG is concerned about the continuous changes to IFRS 2 (including exceptions to the existing principles) to address implementation issues created by specific facts, circumstances or features of share-based plans. EFRAG believes that this approach creates complexity and may result in internal inconsistencies and unintended consequences. For this reason, EFRAG would like to caution the IASB against continuing to make narrow-scope changes; the IASB should rather consider a general review of the Standard to ensure that all issues are addressed in a principle-based way. This could be achieved with a post-implementation review of the Standard.’

⁵ ie treatment of vesting conditions and a modification from a cash- to an equity-settled share-based payment arrangement.

⁶ IFRS 2 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*. Consequently, when applying IFRS 2 an entity measures fair value in accordance with this IFRS, not IFRS 13. [IFRS 2.6A]

⁷ The paper uses the term “current fair value” as opposed to simply “fair value” for cash-settled share-based payment arrangements in order to draw a stronger distinction in the existing measurement models for equity- and cash-settled share-based payment arrangements in IFRS 2. In this context “current” means that, for cash-settled share-based payment arrangements, an entity shall remeasure the fair value of the liability at the end of each reporting period and at the date of settlement. [IFRS 2.30]

Exploratory research: objective and output

15. In order to act in a more ‘principle-based’ way, the staff plan to identify and explore the main application issues that arise when entities put IFRS 2 into operation, in order to identify the most common areas of complexity. The research, therefore, will be of an exploratory nature at this stage. However, the staff also plan to indicate, whenever possible, what are the main causes of these areas of complexity such as, for example, the complexity of the requirements or inconsistency of some of the principles within the Standard.
16. Please note that it is not the intention of either this or any further planned research by the IASB to re-visit the core principle of IFRS 2, which states that ‘An entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received’.⁸
17. As an output of this exploratory research, the staff plan to issue a Research Paper describing the main application issues and most common areas of complexity of IFRS 2 as well as possible ways forward if the IASB were to undertake an active IFRS 2 project.
18. It is important to have a comprehensive picture in one document (ie a Research Paper) of the Standard’s application issues and on the views that have been expressed about this project, because it attracted mixed views from various respondents during the 2011 Agenda Consultation. It is also important to focus on the main application issues.
19. In summary, the envisaged process can be described as follows:
 - (a) staff perform research in accordance with this plan;
 - (b) staff prepare a Research Paper and present it to the IASB before making it publicly available;
 - (c) respondents use the Research Paper as reference material during the 2015 Agenda Consultation; and

⁸ Paragraph 7 of IFRS 2

- (d) on the basis of the responses received during the 2015 Agenda Consultation (and potentially from other outreach), the IASB identifies whether, and if so, how to move forward with the IFRS 2 project.
20. Please note that the planned exploratory research—although it will have some features of a Post-implementation Review (PIR)—will not be a PIR. This is because it will not fully follow the methodology for the Post-implementation Review process (including the Public Request for Information), which is described in the *Due Process Handbook*.
21. There has not been a PIR for IFRS 2 because the PIR process was introduced following the issuance of IFRS 8. The IASB can decide to perform a PIR on any ‘older’ Standard if it believes that there is a need for doing this.

Exploratory research: steps

22. With this objective in mind, the staff plan to perform the following steps in order to identify and explore the IFRS 2 application issues:

Please note that the staff have already performed some work for some of the steps during the preparation of this paper.

- (i) review of responses to the 2011 Agenda consultation

Application issues that were identified during this review are included in Appendix A of this paper.

- (ii) review of IFRS 2-related requests to the IFRS IC

They are summarised in paragraph 11.

- (iii) discussions with preparers during the GPF meeting on 5 March 2015

The minutes of the discussion are available on the IFRS 2 project web page.

- (iv) discussions with technical and, if possible, valuation specialists from audit firms and with IASB members; review of published material by audit firms
- (v) review of:
 - results from the Post-implementation Review of FAS 123(R) *Share-Based Payment* by the Financial Accounting Foundation (FAF); and
 - progress of the FASB's project Employee Share-Based Payment Accounting Improvements

Summary of the project, the PIR report by FAF and the FASB's most recent Project Update is available on the IFRS 2 project web page.

- (vi) review of the paper presented by the French standard-setter, Autorité des normes comptables (ANC) to the IFRS Advisory Council in November 2010 (ie before the 2011 Agenda Consultation)

Summary of the paper and its main proposals are available on the IFRS 2 project web page.

- (vii) review publicly available data on the extent of IFRS 2 disclosures by entities in practice
- (viii) perform user outreach with the objective of finding out whether there are any significant issues that analysts face when they deal with share-based payment arrangements; the staff are planning for this outreach to be performed during a discussion with a small number of CMAC members who are familiar with the topic.

Application issues

23. As stated previously, as part of the exploratory research, the staff plan to identify and explore the main application issues that exist when entities apply IFRS 2 in practice. The staff plan to include the list of main application issues in the final Research Paper. This list should provide a basis for respondents to the 2015 Agenda Consultation when they consider the most common problem areas of IFRS 2 and the best way(s) to deal with them.
24. On the basis on the research and the outreach performed *so far*, the staff have identified the following common application issues with IFRS 2 that appear to exist in practice. They are described in more detail in Appendix A of this paper:

Application issue	Underlying issue
(1) Group share-based payment plans— accounting in separate financial statements	Accounting in separate financial statements
(2) Complexity in classification of vesting and non-vesting conditions	Measurement model: grant date fair value for equity-settled arrangements
(3) Perceived counter-intuitive results in accounting for some transactions	
(4) Complexity that arises from the existence of two measurement models	
(5) Complexity in measurement of share-based payment arrangements at grant date fair value	
(6) Amount of expense does not appear to reflect entity’s results	
(7) Classification of share-based payment arrangements as equity- or cash-settled	Debt / equity classification
(8) Volume of disclosures	Principles of disclosure

25. The staff plan that these and other, if any, application issues will be explored further in the final Research Paper.

Potential ways forward

26. In terms of overall process, the staff plan to include a list of possible ways forward for the IFRS 2 project in the final Research Paper. This list is not exclusive, but it should provide a good starting point for respondents to the 2015 Agenda Consultation when they consider the best way to proceed with the IFRS 2 project. We plan to discuss the alternatives in some detail in the final Research Paper.
27. *So far* the staff have identified the following possible ways forward for the IFRS 2 project after the 2015 Agenda Consultation:
- (a) Perform a comprehensive Post-implementation Review of IFRS 2, including a Request for Information, as a first step and decide on the next step(s) later.
 - (b) Revise IFRS 2 if there is a valid reason for doing so. Whether there is a valid reason for revising the Standard will emerge from the responses and other feedback to the 2015 Agenda Consultation and to the Research Paper.

For example, on the basis of the analysis of the application issues in the Research Paper, respondents might believe that both counter-intuitive accounting results and the complexity of the Standard stem from the use of the grant date fair value measurement model for equity-settled share-based payment arrangements.

Consequently, respondents might further suggest that:

- a) In order to remove the counter-intuitive results and the complexity, IFRS 2 should be revised so that measurement models for equity- and cash-settled share-based payment arrangements are aligned, ie both types of arrangements are measured using the 'current fair value / payment' measurement approach. This would also eliminate classification of vesting and non-vesting conditions.
- b) In order to remove complexity even further, IFRS 2 should be revised so that it would require that share-based payment arrangements are measured at their intrinsic value (ie the value of the underlying share less any exercise price) rather than at fair value; this would remove the need for professional valuations.

- (c) Amend IFRS 2 in some narrow-scope areas (which at this stage have not been identified).
- (d) No further action is required, because IFRS 2 is operational overall.

Question for the IASB

Does the IASB agree with the suggested approach to the exploratory research on IFRS 2? Do you think any changes are needed and why?

Appendix

Application issues (*identified so far*)

Group share-based payment plans—accounting in separate financial statements

1. The IFRS IC has received in the past a number of interpretation requests about accounting for group share-based payment arrangements in separate financial statements of group entities. As a result of these requests, the IASB has issued two amendments to IFRS 2:
 - clarifying the application of IFRS 2 to arrangements involving the entity's own equity instruments and to arrangements involving equity instruments of the entity's parent (originally issued as IFRIC 11 *IFRS 2—Group and Treasury Share Transactions* issued in 2006); and
 - clarifying the scope of IFRS 2, as well as the accounting for group cash-settled share-based payment transactions in the separate (or individual) financial statements of an entity receiving the goods or services when another group entity or shareholder has the obligation to settle the award (amendments *Group Cash-settled Share-based Payment Transactions* issued in 2009).

Complexity in classification of vesting and non-vesting conditions

2. The IFRS IC had received in the past a number of interpretation requests about how various conditions in equity-settled share-based payment arrangements should be classified. As a result of these requests the IASB has issued the following amendments to IFRS 2:
 - clarifying the definition of vesting conditions and the accounting treatment of cancellations by the counterparty to a share-based arrangement (amendment *Vesting Conditions and Cancellations* issued in 2008);
 - amending the definitions of 'vesting condition' and 'market condition' and adding definitions for 'performance condition' and 'service condition' (which were previously part of the definition of 'vesting condition') (*Annual Improvements to IFRSs 2010–2012 Cycle* issued in 2013); and

- the IASB has made a proposal to clarify how vesting conditions affect the fair value of liabilities for cash-settled share-based payments: the accounting in the case of cash-settled share-based payments should follow the same approach as used for equity-settled share-based payments in order to estimate the number of instruments that will vest (draft amendment *Classification and Measurement of Share-based Payment Transactions* issued in 2014).
3. Although the IASB has issued a significant amount of guidance to clarify IFRS 2 and thus to assist entities with its practical application, this guidance seems instead to have actually added complexity to the Standard.

Perceived counter-intuitive results in accounting for some transactions

4. Accounting outcomes that some consider counterintuitive and that are frequently commented upon arise in the following situations for equity-settled share-based payment arrangements:
- cancellations—expense is recognised (vs forfeitures—expense is not recognised or, in other words, it is reversed);
 - ‘negative’ modifications—reversal of expense (ie gain) is not recognised (vs ‘positive’ modifications—additional expense is recognised);
 - ‘under-water’ share options (ie with negative intrinsic value when the share option’s exercise price exceeds fair value of the shares) —expense is still recognised; and
 - awards vesting in instalments (graded vesting, eg one quarter of the total number of options vests each year)—each instalment is treated as a separate award with a different vesting period, with the total expense being frontloaded (vs one award with proportionate allocation over the vesting period).

Complexity that arises from the existence of two measurement models

5. It appears that people simply struggle to understand the *grant date* fair value measurement model intuitively, because *grant date* fair value does not represent a value of the consideration that an entity will ultimately give. This is especially apparent when

compared to the *current* fair value model that exists in IFRS 2 for cash-settled share-based payment arrangements.

6. It was mentioned during the GPF meeting on 5 March 2015 that it could be difficult to explain the accounting outcome to users in situations in which the amount of expense in later periods does not reflect the entity's results (and share prices) during those periods because the amount was determined at the grant date of the arrangement.

Complexity in measurement of share-based payment arrangements at fair value

7. Practical complexity in measurement of share options at grant date fair value in practice arises because entities need to make several assumptions (eg about the expected volatility of share prices and life expectancy of arrangements); they also need to use complex option pricing models (eg Black-Scholes-Merton or Monte Carlo).

Amount of expense does not appear to reflect entity's results

8. The accounting outcome of the IFRS 2 requirements could be difficult to explain to users. For example, in a share-based payment arrangement that is settled in shares and recognised over a period of time, the amount of expense in later periods sometimes appears not to reflect the entity's results (and share prices) during those later periods. This is because the amount of the expense was determined at the grant date of the arrangement, ie in an earlier period.

Classification of share-based payment arrangements as equity- or cash-settled

9. Classification of share-based payment arrangements based on the expected manner of settlement has not been identified as an application issue by respondents. However, there have been two quite specific instances for which there was a need for further guidance in this application area:
 - group share-based payment arrangements, which were addressed in paragraph 1; and

- the IFRS IC issue *Accounting for a share-based payment in which the manner of settlement is contingent on future events*. The issue was closed in April 2014 because some IASB members were concerned that the proposed amendment (by the IFRS IC) might overlap with another research project *Financial instruments with characteristics of equity*, which deals with the distinction between a liability and equity.

Volume of disclosures

10. IFRS 2 requires the disclosure of information that enables users to understand: (a) the nature and extent of share-based payment arrangements; (b) how the fair value was determined and (c) the effect of the share-based payment arrangements on the entity's profit or loss and its financial position. IFRS 2 is sometimes criticised for leading entities to disclose excessive information in their financial statements. There two questions here:

- Are disclosures in recent practice lengthy?
- If so, what is the reason for this? In other words, is the cause that IFRS 2 is requiring too many disclosures, or is it that entities provide too much detail on their own initiative?