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SLFRS 2 – Share based payments

Definition: SBP arrangement

An agreement between the entity and another party that entitles the other party to receive:

£$

Cash or other assets based on the value of equity instruments of the entity or another group entity

or

Equity instruments of the entity or another group entity

Definition: SBP transaction

A transaction in which the entity:

Receives goods / services from a supplier / employee in a SBP arrangement

or

Incurs obligation to settle transaction with supplier / employee when another group entity receives the goods / services

Common types of SBP transaction

Share option
A contractual right, but not an obligation, to buy an entity's shares at a fixed price for a fixed time period

Share granted
Evidences a residual interest in an entity after deducting all its liabilities

Employee share purchase plan (ESPP)
Employees pay a % of salary to the entity to buy shares at a discount

Share appreciation right (SAR)
Arrangement gives employee right to receive a cash payment typically based on increases in value of the entity's share price

3 basic types of SBP arrangement

Equity settled	Cash settled	Cash alternatives
Entity receives goods / services as consideration for entity's own equity instruments or has no obligation to settle with the supplier	**Entity receives goods / services by incurring liability to transfer cash / other assets to supplier for amounts based on entity's or another group entity's share price**	**Either entity or the counterparty has choice to settle in equity instruments or in cash / other assets**

Employees vs non-employees

Employees

Non-employees

Different accounting

In the scope of IFRS 2

Grants to employees, and others providing similar services

Grants to non-employees, e.g. consultants, suppliers

Employee share purchase plan (ESPP)

Certain SBPs settled by a group entity or an external shareholder of the same group

Outside the scope of IFRS 2

Equity instruments issued as consideration in a business combination

Contracts to acquire non-financial items in the scope of the financial instruments standards including those that meet the own-use exemption but are designated as at fair value through profit or loss

Classification

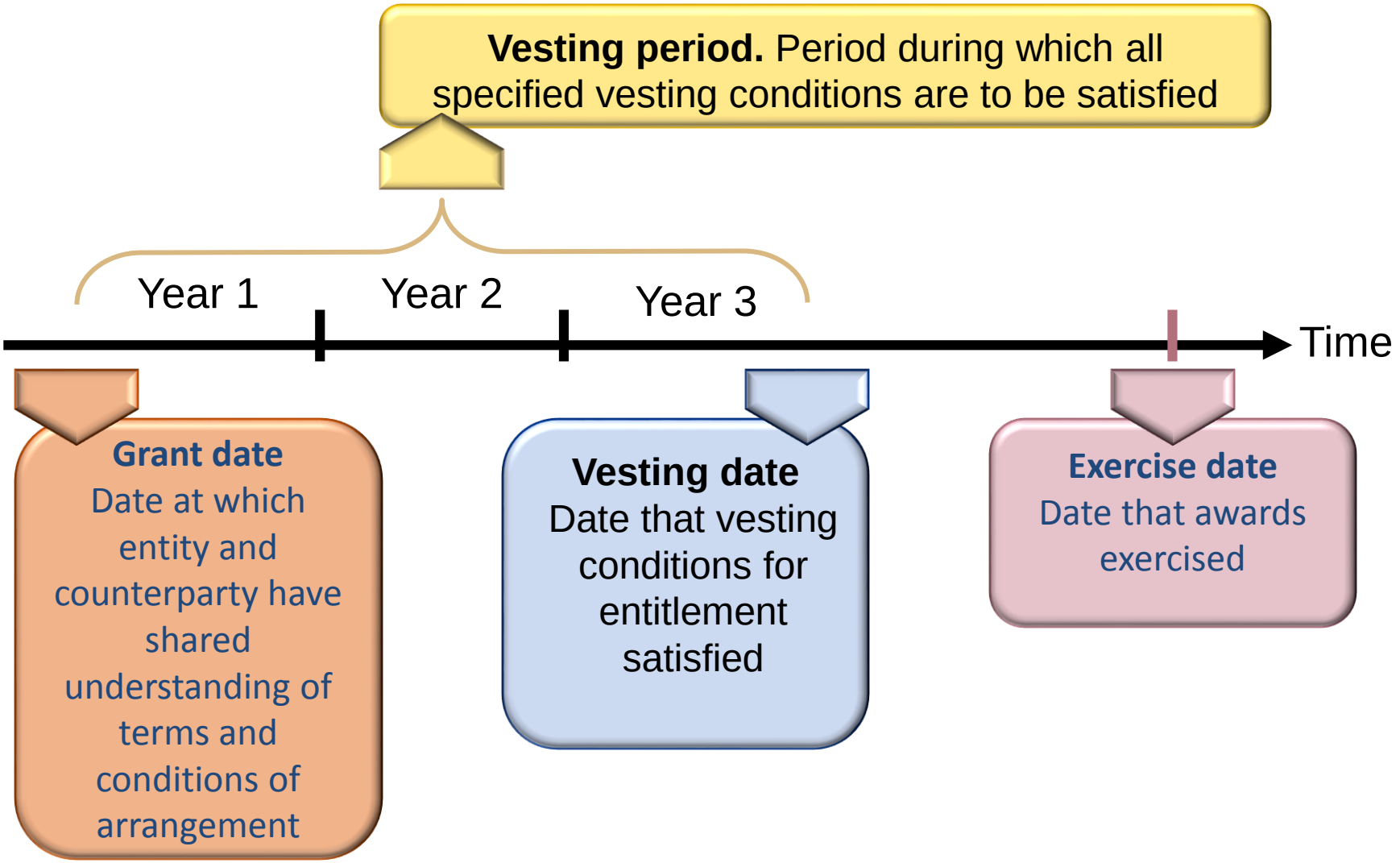
Classified as either equity settled or cash settled

Accounting requirements for each type differ significantly

Cash alternative at choice of counterparty:
compound instrument and generally cash-settled accounting applies

Cash alternative at choice of entity:
generally depends on entity's intention

Timeline of a share option award



General measurement principles

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Equity settled

Non-employees

Goods / services measured directly based on their fair value

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Employees

Goods / services measured indirectly based on fair value of equity instrument

**

Goods / services measured at intrinsic value of equity instrument

Cash settled

Goods / services measured at grant date fair value of liability. Liability is remeasured

Equity-settled general recognition principles

Debit

- Recognise goods / services received when goods obtained / services received
- When goods / services do not qualify for recognition as assets, expense is recognised

- Corresponding increase in equity recognised

Credit

Determining the grant date fair value

Measure employee services indirectly, based on fair value of equity instruments granted

Fair value of equity instruments measured at market price for instruments with similar terms and conditions (rare)

Measured at grant date

If no market exists, fair value is estimated by applying a valuation (e.g. option pricing) model

Calculating total expected charge

Total number of options × Grant date fair value of one option × Percentage expected to vest =

Total value at grant date

Management assumptions can affect the result significantly

Fact
Assumption

Accounting for conditions

Grant date fair value of options

✖

Percentage expected to vest

♦ Market conditions
♦ Non-vesting conditions

♦ Service conditions
♦ Non-market performance conditions

Do <u>not</u> true up during vesting period or on vesting date

True up estimates during vesting period and on vesting date

Measurement illustration: (1) Performance conditions

- On 1 January Year 1 Lila-Tech grants employees 100 options with a 3-year service condition and a target share price of L$ 10 at the vesting date (market condition)
- Assumptions:
  - All employees remain in service over vesting period
  - Grant date fair value of each option is L$ 3.5 excluding market condition, and L$ 3 including market condition
  - Best estimate is that market condition will be met

What compensation cost does Lila-Tech recognise over the vesting period?

Measurement illustration: (2) Performance conditions

- **Market conditions** accounted for in calculation of grant date fair value
- Estimated discount for market condition is L$ 0.50
- Therefore grant date fair value = L$ 3.00 (3.50 - 0.50)
- Total compensation cost = L$ 300 (3 x 100)

	Expense
Year 1	L$ 100
Year 2	L$ 100
Year 3	L$ 100

Measurement illustration: (3) Performance conditions

- At the end of Year 2 Lila-Tech estimates that the market condition will not be met (i.e. share price target of L$ 10 will not be reached at vesting date)
- All service conditions expected to be met

Measurement illustration: (4) Performance conditions

- On 1 January Year 1 Lila-Tech grants employees 100 options with a 3-year service condition and revenue target of L$ 100,000 per employee at the vesting date (non-market condition)

- Assumptions:
  - All employees remain in service over vesting period
  - Grant date fair value of each option is L$ 3.5
  - Non-market performance condition expected to be met by all employees

What compensation cost does Lila-Tech recognise over the vesting period?

Measurement illustration: (5) Performance conditions

- Non-market conditions accounted for in calculating number of options expected to vest
- Grant date fair value = L$ 3.50
- Therefore total compensation cost = L$ 350 (3.50 x 100)

	Expected compensation cost (total)	Accumulated attribution*	Expensed in prior periods	Expense in current year
Year 1	L$ 350	L$ 117	0	117
Year 2	L$ 350	L$ 233	-117	116

*** (350 / 3) x (number of periods lapsed)**

Measurement illustration: (6) Performance conditions

- At the end of Year 2 Lila-Tech estimates that only 50% of employees will meet the non-market condition
- All service conditions are expected to be met
- This is also the actual outcome

	Expected compensation cost (total)	Accumulated attribution	Expensed in prior periods	Expense in current year
Year 1	350	117*	0	117
Year 2	~~350~~ 175	117**	-117	0
Year 3	175	175**	-117	58
Total				175

** (350 / 3) x (number of periods lapsed)

** (175 / 3) x (number of periods lapsed)

Measurement illustration: (7) Performance conditions

- A change in the expectation of whether or not a performance condition will be met:
  - is ignored for market conditions (accounted for through valuation model)
  - but recognised for non-market conditions

Expense:	Market condition	Non-market condition
Year 1	100	117
Year 2	100	0
Year 3	100	58
Total	300	175

Cash-settled general recognition principles

Debit

- Recognise goods / services received when goods obtained or services received
- When the goods / services do not qualify for recognition as assets, expense is recognised

- Corresponding liability recognised for obligation to pay cash / other assets
- Liability remeasured to fair value at each reporting date (in profit or loss)

Credit

Calculating total expected charge

Total number of SARs × Fair value of one SAR × Percentage expected to vest =

Total value at grant date

Requirement to remeasure overrides no true up for market and non-vesting conditions

Fact
Assumption

SAR = share appreciation right

Measurement illustration: (1) Cash-settled transaction

- On 1 January Year 1 Lila-Tech grants employees 100 SARs with a 3-year service condition and target share price of L$ 10 at vesting date (market condition)
- Assumptions:
  - Transaction will be settled in cash not shares
  - Employees remain in service over vesting period
  - Grant date fair value of each SAR is L$ 3 (including market condition)
  - Best estimate is that service condition will be met by all employees

Measurement illustration: (2) Cash-settled transaction

- Assumptions (continued):
  - Subsequent estimates of fair value of each SAR:

	Fair value	Intrinsic value
End Year 1	4.00	1.50
End Year 2	4.25	3.00
End Year 3	4.50	4.25
Settlement date	4.00	4.00

  - All service conditions fulfilled and vested SARs settled on 31 December Year 4

What compensation cost does Lila-Tech recognise at each reporting date over the vesting period?

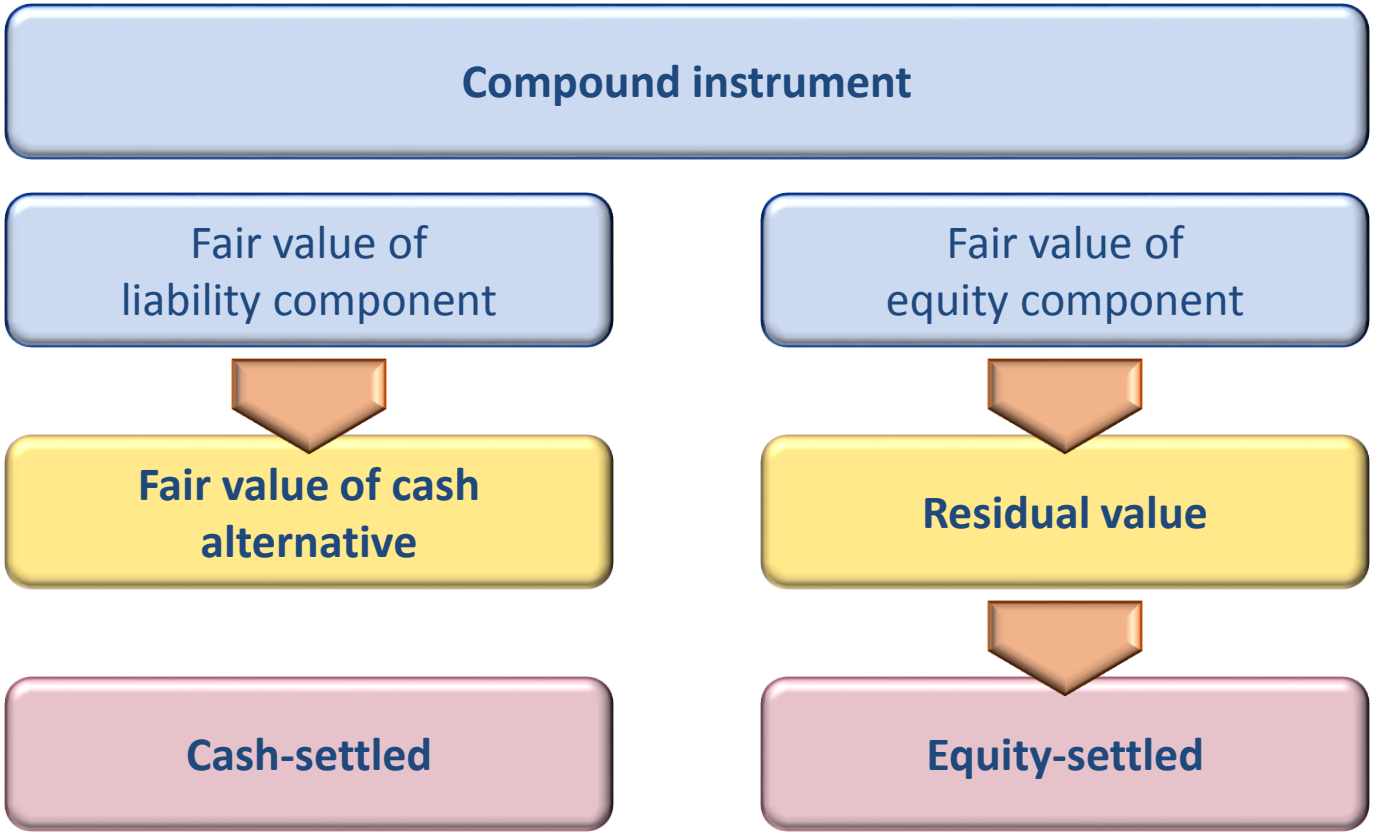
What does Lila-Tech record at settlement date?

Measurement illustration: (3) Cash-settled transaction

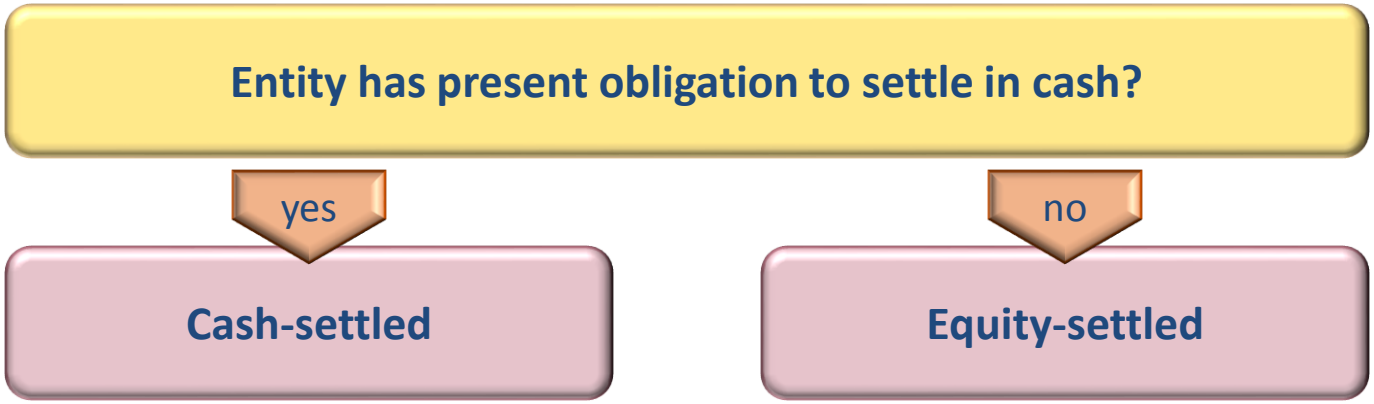
	Original grant date fair value	Remeasure-ment	Current year total	Cumulative
Year 1	100	33	133	133
Year 2	100	50	150	283
Year 3 Vesting date	100	67	167	450
Year 4 Settlement	0	-50	-50	-50
Total	300	100	400	400

Grant date: (100 x 3.00) / 3 = 100 per year
Year 1: (100 x (4.00 - 3.00)) / 3 = 33 per year
Year 2: ((100 x (4.25 - 3.00)) * 2/3) - 33 = 50 per year
Year 3: (100 x (4.50 - 3.00)) * 3/3) - 83 = 67 per year
Year 4: 100 x 4.00 = 400 - 450 = -50

Employee has settlement choice



Employer has settlement choice



Equity-settled SBP with non-employees

Measured directly at fair value of goods / services received

- If fair value of goods / services cannot be estimated reliably, measure fair value of SBP
- Use of intrinsic value very rare

Measured at date goods / services obtained

- As opposed to the grant date
- Means daily if services are rendered
- Simplification method: regular intervals

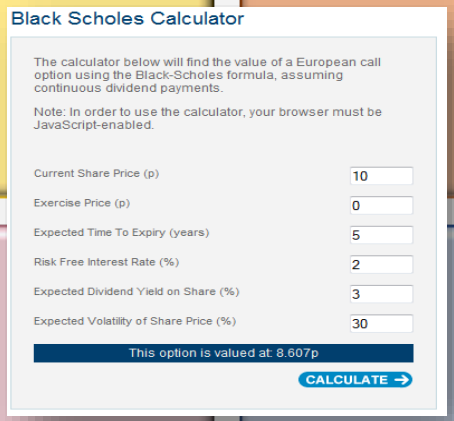
Expense immediately unless

- Goods or services qualify for capitalisation as asset (e.g. inventory); or
- Vesting conditions exist; expense when services are rendered over the vesting period

Introduction to option pricing models

Objective to estimate the amount a buyer would pay at the valuation date to obtain the option to participate in any future gains

NOT to estimate future share prices



Black-Scholes and binomial models commonly used

Option pricing models use financial theory, mathematical formulas and option-specific inputs

Introduction to option pricing models

Actual share price returns are function of volatility
Share price returns are continuous
Markets are perfectly liquid
No transaction costs or taxes
Interest rates constant throughout option's life
Dividends per share reduce share price on a one-for-one basis at the exact moment they are paid
Option may only be exercised at end of its contractual life (binomial model can be extended to allow additional flexibility)

Introduction to option pricing models

Black-Scholes and standard binomial models rely on many of the same inputs:
Exercise Price
Share Price
Term
Dividend Yield
Risk-free Rate
Volatility