Grant Thornton

Insights into IFRS 2

Cash-settled share-based payment arrangements with employees

Cash-settled share-based payment arrangements are a form of compensation where entities pay in cash or other assets based on the value of equity instruments. These arrangements differ significantly from equity-settled payments in their classification, measurement, and accounting treatment under IFRS 2.

While the accounting for both of these types of arrangements has not changed significantly in recent years, it is an area that is not well understood in practice and confusion often arises between the different types of arrangements and how to treat them.

Our '**Insights into IFRS 2**' series is aimed at demystifying IFRS 2 by explaining the fundamentals of accounting for share-based payments using relatively simple language and providing insights to help entities cut through some of the complexities associated with accounting for these types of arrangements.

As explained in our article '**Insights into IFRS 2 – Classification of share-based payment transactions and vesting conditions**', a share-based payment arrangement must be classified as either an equity-settled transaction or a cash-settled transaction. This article discusses the accounting for cash-settled share-based payment transactions. The accounting for equity-settled transactions is discussed in our article, '**Insights into IFRS 2 – Equity-settled share-based payment arrangements with employees**'. The accounting for share-based payment transactions with non-employees is discussed in our article '**Insights into IFRS 2 – Share-based payment arrangements with non-employees**'.

Cash-settled share-based payment arrangements

As explained in our article '**Insights into IFRS 2 – Classification of share-based payment transactions and vesting conditions**', share-based payment transactions that are within the scope of IFRS 2 are classified based on whether the entity's obligation is to deliver:

- its own equity instruments (equity-settled), or
- cash or other assets (cash-settled).

Cash-settled share-based payment transaction:

A share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity.

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Common forms of cash-settled share-based payment transactions include:

- Share-appreciation rights (SARs), where employees are entitled to a future cash payment equal to the increase in the entity's share price from a specified level over a specified period of time
- Phantom shares, where employees are entitled to a cash payment equal to the fair value of a specified number of shares at the date of exercise, and
- Phantom options, where employees are entitled to a cash payment equal to the gain that would have been made by exercising options at a specified price over a specified number of shares and then selling the shares at the date of exercise.

Practical insight – Classification of share-based payment transactions based on cash flows

Each situation should be assessed to determine whether a share-based payment transaction is equity-settled or cash-settled. There may be circumstances where there are cash outflows incurred by the entity or cash inflows received by the employee which may suggest that the transaction is cash-settled. For example:

- An entity may incur a cash outflow to purchase shares in the market to settle equity-settled share-based payment transactions, rather than issuing new shares from treasury. In our view, this transaction is not classified as cash-settled, as there is no liability to transfer cash or other assets to the employee. In this instance, the transaction should be accounted as two separate transactions consisting of a buy-back of treasury shares recognised in accordance with IAS 32 'Financial Instruments: Presentation' and an equity-settled share-based payment transaction accounted for in terms of the principles explained in our article '**Insights into IFRS 2 – Equity-settled share-based payment arrangements with employees**'.
- An entity may immediately repurchase shares granted to an employee, even though the entity has not committed to do so. In our view, if an entity creates an expectation by the employee that it will systematically reacquire the shares granted (for example, because of the illiquidity of the market) this could result in the arrangement being accounted for as cash-settled.

Example 1 – Repurchase arrangement at the entity's option

Entity A is an unlisted company that has issued shares to its employees as part of their compensation packages. Since it expects that not every employee will wish to become long-term investors in the company, Entity A also established an arrangement in which the employees must offer their shares for sale to Entity A upon ceasing employment.

Entity A may, but is not obligated to, repurchase the offered shares at their then-current market price. To date, Entity A has accepted all past offers to buy back the shares. This arrangement is not available to any of Entity A's non-employee shareholders.

Analysis

In practice different approaches may be acceptable, depending on the facts and circumstances. For example:

- Some entities may determine that the arrangement should be classified as cash-settled so long as the entity has created a valid expectation that the awards will be settled in cash. Due to Entity A's past practice of repurchasing the shares, the employees may have an expectation that the awards will be settled in cash. Entity A could also have a stated policy to accept repurchase offers from its employees.
- Other entities may also consider whether the repurchase arrangement is limited to employees:
  - When the repurchase arrangement only relates to employees who receive shares in their role as employees, the entity may determine that the repurchase arrangement is part of the terms and conditions of the share-based payment. When there is also a valid expectation that such awards (ie where the terms include the repurchase arrangement) will be settled in cash, then the entity may determine that they should be classified as cash-settled.
  - In contrast, if the repurchase arrangement was available to all of an entity's shareholders (ie not just its employees), the entity may determine that the repurchase arrangement is a shareholder condition, rather than part of the share-based payment arrangement with its employees. If so, the entity may consider it appropriate to ignore the repurchase arrangement when classifying the awards, and thus classify them as equity-settled. For equity-settled awards, any payment made to the employee should be accounted for as the repurchase of an equity interest (ie as a deduction from equity), except to the extent that the payment exceeds the fair value of the equity instruments measured at the repurchase date. Any excess would be an expense.

Transactions where either the entity or the counterparty has the choice of settlement in equity instruments or in cash or other assets are discussed in our article, '**Insights into IFRS 2 – Employee share-based payment agreements with settlement alternatives**'.

Accounting for cash-settled share-based payment arrangements with employees

For cash-settled share-based payment transactions with employees, the services received are initially measured on the grant date at fair value. The entity also recognises a corresponding liability that represents its obligation to make a payment of cash or other assets. At each reporting date and until the final settlement date, the liability for a cash-settled share-based payment transaction is remeasured at its fair value (which is equal to the fair value of the award). Any differences in the fair value of the liability are recognised in profit or loss.

The entity recognises the services received (ie the share-based payment cost), along with the corresponding liability, as the employee provides the service. Where the employee is required to complete a specified period of service, the services and the corresponding liability are recognised over the vesting period. Where the award vests immediately, the service is recognised immediately. For further information on determining the vesting period, refer to our article '**Insights into IFRS 2 – Basic principles of share-based payment arrangements with employees**'.

As discussed in our article '**Insights into IFRS 2 – Classification of share-based payment transactions and vesting conditions**', share-based payment awards may include conditions that determine whether an employee is entitled to receive the payment (ie vesting and non-vesting conditions). The entity accounts for the effects of these conditions at the end of each reporting period and upon settlement as follows:

- Market and non-vesting conditions are taken into account when estimating the fair value of the cash-settled share-based payment.
- Conversely, service and non-market performance vesting conditions are not taken into account when estimating the fair value of the cash-settled share-based payment. Instead, service and non-market performance vesting conditions are taken into account by adjusting the number of awards that are expected to vest – that is, the entity shall not recognise amounts relating to awards that are not expected to and ultimately do not vest because of a failure to satisfy a service or non-market performance vesting condition.

In summary:

Type of Condition	Impact on fair value and expense
Non-vesting condition (eg non-compete restriction, requirement to hold shares for a specified period)	• Reflected in grant date fair value • Fair value remeasured at the end of each reporting period • (True-up reflected in fair value remeasurement)
Market performance condition (eg achieving a specified share price)	• Reflected in grant date fair value • Fair value remeasured at the end of each reporting period • (True-up reflected in fair value remeasurement)
Non-market performance condition (eg achieving a specified earnings before interest, taxes, depreciation, and amortisation (EBITDA) level)	• Not reflected in grant date fair value • Reflected in number of awards expected to vest • True-up for failure to meet condition
Service condition (eg vesting after three year service period)	• Not reflected in grant date fair value • Reflected in number of awards expected to vest • True-up for failure to meet condition

Ultimately, the cumulative amount recognised for goods or services received for a cash-settled share-based award is equal to the cash paid. Accordingly, if at the end of the vesting period, a vesting condition is not met, the award is forfeited due to the failure to vest, and any amounts previously recognised in profit or loss are reversed.

Key difference with accounting for equity-settled share-based payment arrangements with employees

This treatment differs from an equity-settled award where an entity recognises, at a minimum, the grant date fair-value of the equity instruments, unless they fail to vest because a service or non-market performance vesting condition is not satisfied.

This difference occurs because a cash-settled award is remeasured at the end of each reporting period at its fair value, and therefore continues to incorporate the effects of market and non-vesting conditions at each remeasurement date. In contrast, the fair value of equity-settled awards, including the effects of market and non-vesting conditions, is determined at the grant date and then is not subsequently remeasured.

As a result, an IFRS 2 expense would be recognised for an equity-settled share-based payment even though the market condition is not met (to the extent that the services condition and any other non-market performance conditions are satisfied). In the case of a cash-settled award, there would be no IFRS 2 expense recognised in that situation.

Fair value versus intrinsic value

As discussed above, an entity is required to remeasure a cash-settled share-based payment award to its fair value at the end of each reporting period. A cash-settled award, however, is sometimes settled at its intrinsic value.

Intrinsic value:
The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or to which it has the right to receive, and the price (if any) the counterparty is (or will be) required to pay for those shares.

For example, a share appreciation right (SAR) gives the holder the right to receive the increase in value of a share between two dates. If the grant date share price is CU15 and the settlement date share price is CU20, then the intrinsic value is CU5.

While the fair value and intrinsic value of a SAR are equal upon settlement, disparities between the two values exist on dates prior to settlement because the fair value is determined by applying an option pricing model and takes into account the current intrinsic value and a premium for the possibility of future increases in intrinsic value (ie time value). This is illustrated in the example below, where the fair value of the SARs are different from the intrinsic values.

Example 2 – Cash-settled share-based arrangements

On 1 January 20X2, Entity C grants five SARs to each of its 100 employees, on the condition that the employees remain in its employ for the next three years.

- During year one, 10 employees leave. The entity estimates that, in total, a further 25 will leave during years two and three.
- During year two, 15 employees leave. The entity estimates that a further 20 will leave during year three.
- During year three, 25 employees leave. Following the end of year three, the remaining 50 employees exercise their SARs, and receive their intrinsic value on the settlement date of 31 January 20X5.

Entity C estimates the fair value of the SARs as follows:

Analysis

Entity C estimates the fair value of the SARs as follows:

Year	Fair value (CU)	Intrinsic value (CU)
Grant date	10	
1	12	
2	14	
3	16	
Settlement date		15

Entity C recognises the following:

Year	Calculation of liability	Liability (ending balance) (CU)	Expense (CU)
1 – 31 December 20X2	5 SARs X (100-35) employees X CU12 X 1/3	1,300	1,300
2 – 31 December 20X3	5 SARs X (100-45) employees X CU14 X 2/3	2,567	1,267
3 – 31 December 20X4	5 SARs X (100-50) employees X CU16 X 3/3	4,000	1,433
31 January 20X5	5 SARs X (100-50) employees X CU15 X 3/3	3,750	(250)
Total			**3,750**

Note: the expense is calculated as the change in the liability balance between reporting periods.

Summary of differences in accounting for equity-settled and cash-settled share-based payment arrangements

Below are the key differences in accounting for equity-settled and cash-settled share-based payment arrangements:

	Equity-settled	Cash-settled:
Accounting entry	The credit in the transaction entry is recorded in equity.	The credit in the transaction entry is recorded as a liability.
Remeasurement of fair value	The grant date fair value is never remeasured.	Until the liability is settled, the fair value is remeasured at each reporting period and at the settlement date.
Cumulative net cost	The cumulative net cost is trued-up only for changes in the estimates regarding service and non-market performance conditions.	The cumulative net cost is equal to the settlement amount (ie the cash that is paid).
Period accounted for	The expense and corresponding equity adjustment are recognised over the vesting period.	The expense and corresponding liability are recognised until settlement.

How we can help

We hope you find the information in this article helpful in giving you insight into aspects of IFRS 2. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.

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