

Insights into IFRS 2

Classification of share-based payment transactions and vesting conditions



Share-based payments, the accounting requirements of which are set out in IFRS 2 ‘Share-based Payment’, can be difficult to understand in practice and entities often have difficulty in applying the requirements to increasingly complex and innovative share-based payment arrangements.

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. This article explains how to determine the classification of share-based payment transactions and vesting conditions, both of which significantly impact the accounting requirements to be applied under IFRS 2.

As explained in our article ‘**Insights into IFRS 2 – Objective and scope of IFRS 2**’, IFRS 2 also applies to arrangements involving other group entities or shareholders. While the concepts in this article also apply to group share-based payments, such arrangements are covered in ‘**Insights into IFRS 2 – Group share-based payments**’. This article focuses on share-based payments directly between the reporting entity and a counterparty.

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Classification of share-based payment transactions

A reminder of the definition of a share-based payment transaction:

A transaction in which the reporting entity receives goods or services from an employee or supplier in exchange for its own equity instruments (including shares or share options) or for cash or other assets based on the price of those equity instruments.

Under IFRS 2, a share-based payment transaction must be classified as either an equity-settled transaction or a cash-settled transaction. As the accounting requirements for these two classifications differ significantly, it is important to understand the differences between these two transaction types.

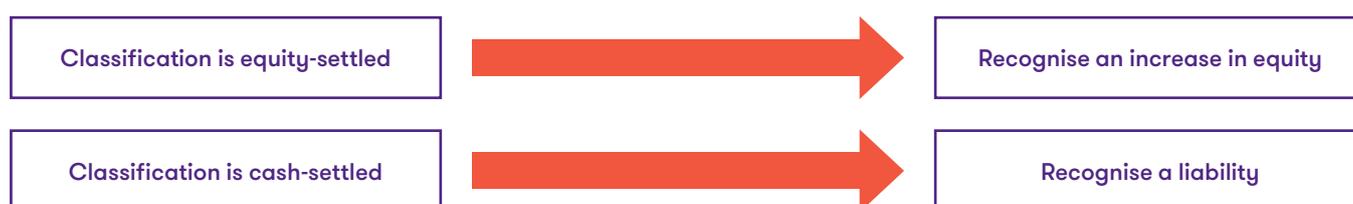
Equity-settled vs Cash-settled:

Classification	Equity-settled share-based payment transaction.	Cash-settled share-based payment transaction.
Definition	A share-based payment transaction in which the entity: a) receives goods or services as consideration for its own equity instruments, or b) receives goods or services but has no obligation to settle the 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, the amounts of which are based on the price (or value) of equity instruments of the entity (or another group entity).
Examples	Shares or options granted to employees in exchange for services rendered.	Share appreciation rights that entitle employees to cash payments based on the increase in the entity's share price.

The classification of share-based payment transactions as either equity-settled or cash-settled is based on the nature of the entity's obligation to the employee or supplier. If the entity has an obligation to deliver only its own equity instruments, then the transaction is equity-settled.

If the entity has an obligation to deliver cash or other assets, then the transaction is cash-settled. Particular care needs to be taken when transferring cash or other assets, for instance, because of the existence of a written put option granted to the employee that upon exercise (at the discretion of the beneficiary) would require the entity to transfer cash in exchange for the shares held by the employee. This type of arrangement often exists when the shares or options are issued by a non-listed parent or by a non-listed subsidiary to its own employee. When the grant of the equity instrument (shares or options) and the put option form part of the same global arrangement they should be dealt with altogether as a single cash-settled transaction as from the date the put is issued.

As noted in 'Insights into IFRS 2 – Objectives and scope of IFRS 2', a share-based payment transaction is recognised as the goods are obtained or as the services are received (a debit entry). The corresponding credit entry is determined by the classification of the transaction:



This article will now focus on the complexities that can affect the classification of share-based payment transactions. As noted above, the accounting for equity-settled and cash-settled share-based payment transactions differs significantly and is detailed in separate articles – 'Insights into IFRS 2 – Equity-settled share-based payment arrangements with employees' and 'Insights into IFRS 2 – Cash-settled share-based payment arrangements with employees'.

What complexities can affect the classification of share-based payment transactions?

If the entity has an obligation to settle the transaction with its own equity instruments, then classification of the transaction is unaffected by how it obtains the equity instruments that will be used to settle the obligation, (ie the arrangement will be treated as an equity-settled transaction). In other words, whether the entity chooses, or is required, to buy its own equity instruments from another party in order to settle its obligation to deliver an instrument to the beneficiary of the share-based payment transaction does not impact the classification of the transaction.

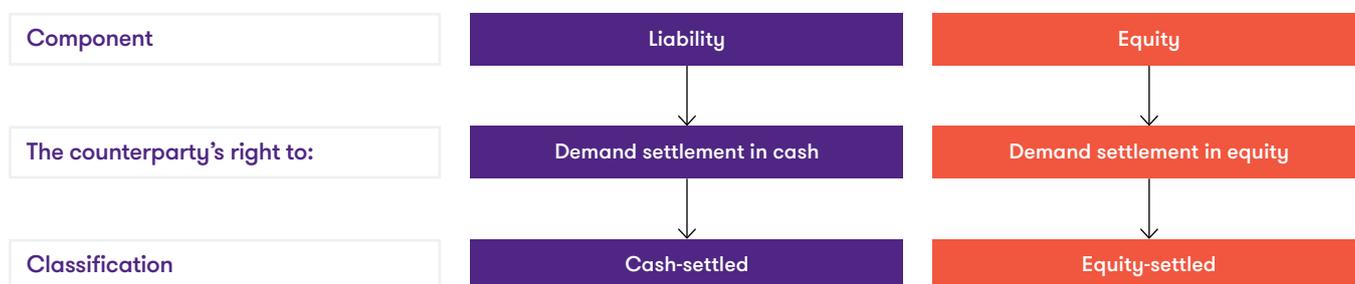
Certain share-based payment arrangements require additional consideration to determine their classification as equity-settled or cash-settled, as follows:

Share-based payment transactions with cash alternatives

Some share-based payment transactions provide either the entity or the counterparty with the choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments. This is often referred to as a share-based payment with a 'cash alternative'.

When the entity has the choice of settlement, then the transaction is classified entirely as cash-settled if the entity has a present obligation to settle in cash. An entity has a present obligation to settle in cash if the choice to settle in equity instruments has no commercial substance. For example because the entity is legally prohibited from issuing shares, the entity has a past practice or stated policy of settling in cash, the entity is a non-listed entity and the equity instrument granted is not a quoted instrument (which it is likely to reacquire for cash upon employee request), or it generally settles in cash whenever the counterparty asks for cash settlement. Otherwise, the transaction is classified entirely as equity-settled.

On the other hand, when the counterparty has the choice of settlement, then the entity is considered to have granted a compound financial instrument that includes both:



Once split, an entity accounts for each component separately. Accounting for this type of agreement is discussed in '**Insights into IFRS 2 – Employee share-based payment agreements with settlement alternatives**'.

Share-based payment transactions with contingent cash settlement features

In some share-based payments, the obligation is equity-settled except that cash settlement would be required upon the occurrence or non-occurrence of a contingent event that is not within the control of either the entity or the counterparty. While IFRS 2 provides guidance for classifying a share-based payment with a cash alternative when it can be chosen by the entity or the counterparty (see above), it does not include guidance for when the cash alternative depends on circumstances outside the control of both the entity and the counterparty (eg an initial public offering (IPO) or change in control of the entity).

In our view, when the cash alternative depends on a contingent event that is outside the control of both the entity and the counterparty, there are two possible approaches to consider, as follows:

- One potential approach is to consider the guidance in IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'. In doing so, a transaction would be classified as cash-settled only if the contingent event that would result in cash settlement is probable. Otherwise, the transaction would be classified as equity-settled. In line with IAS 37, the entity would also reassess the probabilities at each reporting date.
- Another potential approach is to classify the transaction as cash-settled regardless of the probability of cash-settlement, because the entity cannot unilaterally avoid the cash-settlement (IAS 32 'Financial Instruments: Presentation' approach).

Accounting for share-based payment arrangements with contingent cash settlement features is discussed further in '**Insights into IFRS 2 – Employee share-based payment agreements with settlement alternatives**'.

Grants of a variable number of equity instruments

In some arrangements, a variable number of equity instruments may be issued in a share-based payment transaction. For example, an entity may issue shares to the value of CU10,000 in exchange for services, where the number of shares depends on the entity's current share price at that time. Despite the transaction being settled in a variable number of shares, such a transaction is generally classified as equity-settled because the obligation is to deliver the entity's own equity instruments (instead of cash or other assets).

It is important to note that this classification differs from the classification of debt vs equity under IAS 32. For example, if no goods or services (including some unidentifiable goods or services) are received in the transaction, then the transaction would not be within the scope of IFRS 2. If IFRS 2 is not applicable, an arrangement that requires a variable number of shares to be delivered for a fixed amount of cash would be classified as a financial liability under IAS 32. This is discussed in '**Insights into IFRS 2 – What is IFRS 2?**'.

Grants of equity instruments that include redemption features

In some circumstances an entity may issue equity instruments which include a redemption feature. If the entity is incurring an obligation to pay cash in the future (when the redemption occurs), then the transaction would be classified as cash-settled. This assessment depends on whether the redemption feature is:

- a mandatory redemption feature
- a redemption feature at the option of the employee or supplier, or
- a redemption feature at the option of the entity.



The following examples illustrate the impact of such features on the classification of share-based payment transactions:

Example 1 – Mandatory redemption feature

Entity A grants shares to its employees as part of the remuneration for their services. When an employee ceases employment with Entity A, Entity A must purchase the employee's shares at fair value on that date.

Even though Entity A initially issues the equity instruments as part of a share-based payment transaction, it has an obligation to pay cash to the employees at a future date. As such, the transaction is classified as a cash-settled share-based payment. In this case, the award remains within the scope of IFRS 2 even if the employee ceases employment after the service period is complete.

Example 2 – A redemption feature at the option of the employee or supplier

Entity B grants shares to its employees as part of the remuneration for their services. The share plan indicates that an employee has the right to redeem the shares at any point in time within a period of six years after receiving the shares.

Even though Entity B initially issues equity instruments as part of the share-based payment, it can be obligated to pay cash within six years of granting the shares. As such, the transaction is classified as a cash-settled share-based payment. The probability of the entity having to pay cash is not considered when classifying this type of arrangement.

Example 3 – A redemption feature at the option of the entity

Entity C grants shares to its employees as part of the remuneration for their services. When an employee ceases employment with Entity C, Entity C has the option (but not the obligation) to buy back the employee's shares at fair value on that date.

Since the buy-back is at the option of Entity C, such a feature would be classified in the same manner as a share-based payment with cash alternatives where the entity has the choice of settlement (as discussed above). As such, the transaction is classified entirely as cash-settled if the entity has a present obligation to settle in cash, based on its stated policy and/or its past practice of buying back shares. Otherwise, the transaction would be classified entirely as equity-settled.

Group share-based payments

As we explain in '[Insights into IFRS 2 – What is IFRS 2?](#)', the Standard also applies to arrangements involving other group entities or shareholders. Share-based payment transactions are classified from the perspective of each reporting entity, instead of on a group basis. In other words, a group share-based payment can result in separate and different classifications for each group entity that is involved.

Furthermore, when classifying group share-based payments, each reporting entity must consider which group entity's equity instruments are being granted and which group entity has the obligation to settle the transaction. Complexities related to group share-based payments, including classification, are addressed in '[Insights into IFRS 2 – Group share-based payments](#)'.

Classification of vesting and non-vesting conditions

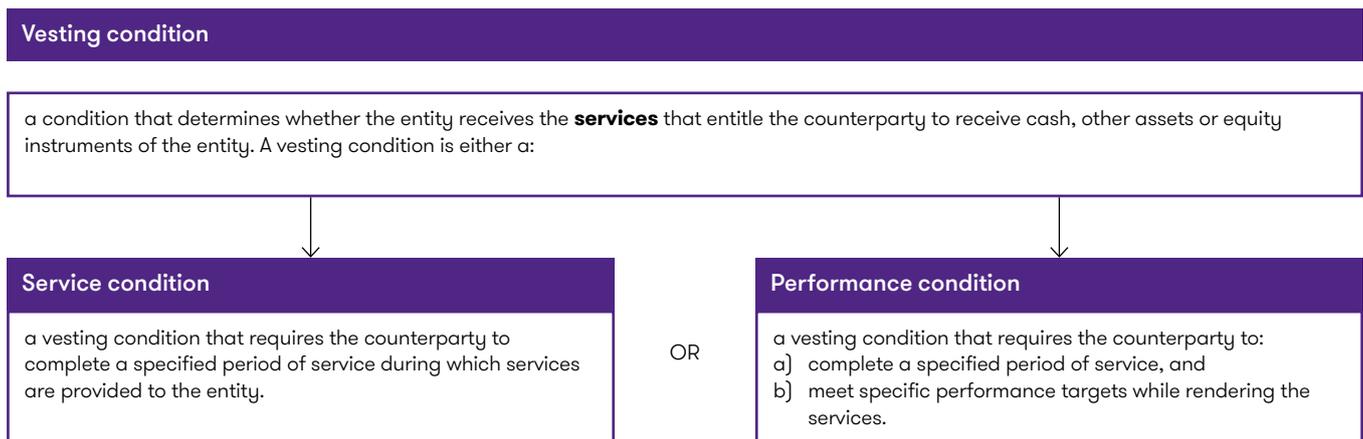
In many cases, share-based payments are conditional upon satisfying specific conditions. These conditions are typically designed to motivate employees and suppliers to act towards certain outcomes or to align their interests with those of the entity's shareholders. For example, grants of shares or share options to an employee are often conditional on the employee remaining in the entity's employment for a specified period of time or achieving a specified level of growth in the entity's profit or share price.

Different types of conditions can affect the accounting for share-based payments in different ways, and therefore it is important to appropriately determine the classification of any conditions.



Vesting conditions

As we note in 'Insights into IFRS 2 – What is IFRS 2?', the general recognition principle is that an entity recognises the cost of a share-based payment at the time when the goods are acquired or as the services are received (often referred to as the 'service-date model'). Under IFRS 2, the period over which the cost is allocated depends on the concept of 'vesting'. A share-based payment is said to 'vest' when the counterparty's right to receive cash, other assets or equity instruments of the entity no longer depends on satisfying any 'vesting conditions'.



While every condition attached to a share-based payment factors into whether and when a **counterparty** (such as an employee) receives a share-based payment, vesting conditions focus on whether the **entity** has received the services required from the counterparty to **pay** the share-based consideration the entity is issuing. Therefore, all vesting conditions must include a service requirement.

Service conditions

An example of a service condition is one in which employees are granted share options that vest after a three-year service period. This condition ensures the employees provide three years of employment before they are entitled to the share-based payment.

Service conditions do not require a performance target to be met. Furthermore, if a counterparty stops providing service during the required period for any reason (including termination of an employee by the entity), then the counterparty is considered to have failed the service condition.

Performance conditions

A performance condition is further defined as either:

- a market condition, or
- a non-market condition.

A **market condition** is a performance condition where the performance target relates to the price (or value) of the entity's or group entity's equity instruments. An example of a market target is attaining a specified share price or achieving an increase in the share price in excess of a market share price index.

A **non-market condition** is a performance condition where the performance target relates to the entity's own operations (or activities of another group entity). Non-market performance conditions are unrelated to the market price of the entity's equity instruments. An example of a non-market performance condition is achieving a specified EBITDA or profit target, or non-financial performance conditions such as a reduction in manufacturing errors or a target market share. Practical issues associated with non-market performance conditions are discussed in '**Insights into IFRS 2 – Basic principles of share-based payment arrangements with employees**'.

As noted above, and by virtue of its definition, a performance condition always includes a service condition in addition to the performance target. IFRS 2 also specifies that the performance target must be met while the counterparty is rendering services. In other words, the period for achieving the performance target cannot extend beyond the end of the service period.

Example 4 – Period of achieving performance target

Entity D issues share-based payments to its employees, subject to the employees remaining in service for three years and achieving a cumulative revenue target of CU500,000 over those three years.

As the performance assessment period (ie three years) coincides with the three-year service period, this condition meets the definition of a non-market performance condition.

Example 5 – Period of achieving performance target

Entity E issues share-based payments to its employees, subject to the entity achieving a cumulative revenue target of CU500,000 over three years. However, employees can leave the entity after two years of service without losing entitlement to the award (in other words, there is only a two-year service period).

The performance target does not meet the definition of a performance condition because the performance assessment period extends beyond the service period. The performance target does not determine whether Entity E receives the services that entitle the employees to receive the award, because the employees can leave after two-years without losing their entitlement to the award (ie regardless of whether the revenue target is met in the future). As a result, the performance condition is a non-vesting condition.

The period of achieving the performance target may begin before the service period, as long as the commencement date of the performance target is not substantially before the start of the service period. For instance, the service period may start at the grant date, however the share-based payment arrangement may refer to multi-year performance objectives that are measured starting from the beginning of the year. In that case, it would likely be considered that the performance target commencement date is not substantially before the start of the service period, and therefore the performance objectives would still be treated as vesting conditions.

Non-vesting conditions

A **non-vesting condition** refers to any condition that does not meet the definition of a vesting condition. While non-vesting conditions factor into whether the counterparty will receive a share-based payment, unlike vesting conditions, non-vesting conditions do not determine whether the entity receives the services that will entitle the counterparty to the share-based payment. Even when all vesting conditions have been satisfied and the share-based payment has vested, the counterparty would not receive the share-based payment if any non-vesting conditions have not been met. Recognition of these awards with non-vesting conditions are discussed in ‘**Insights into IFRS 2 – Basic principles of share-based payment arrangements with employees**’.

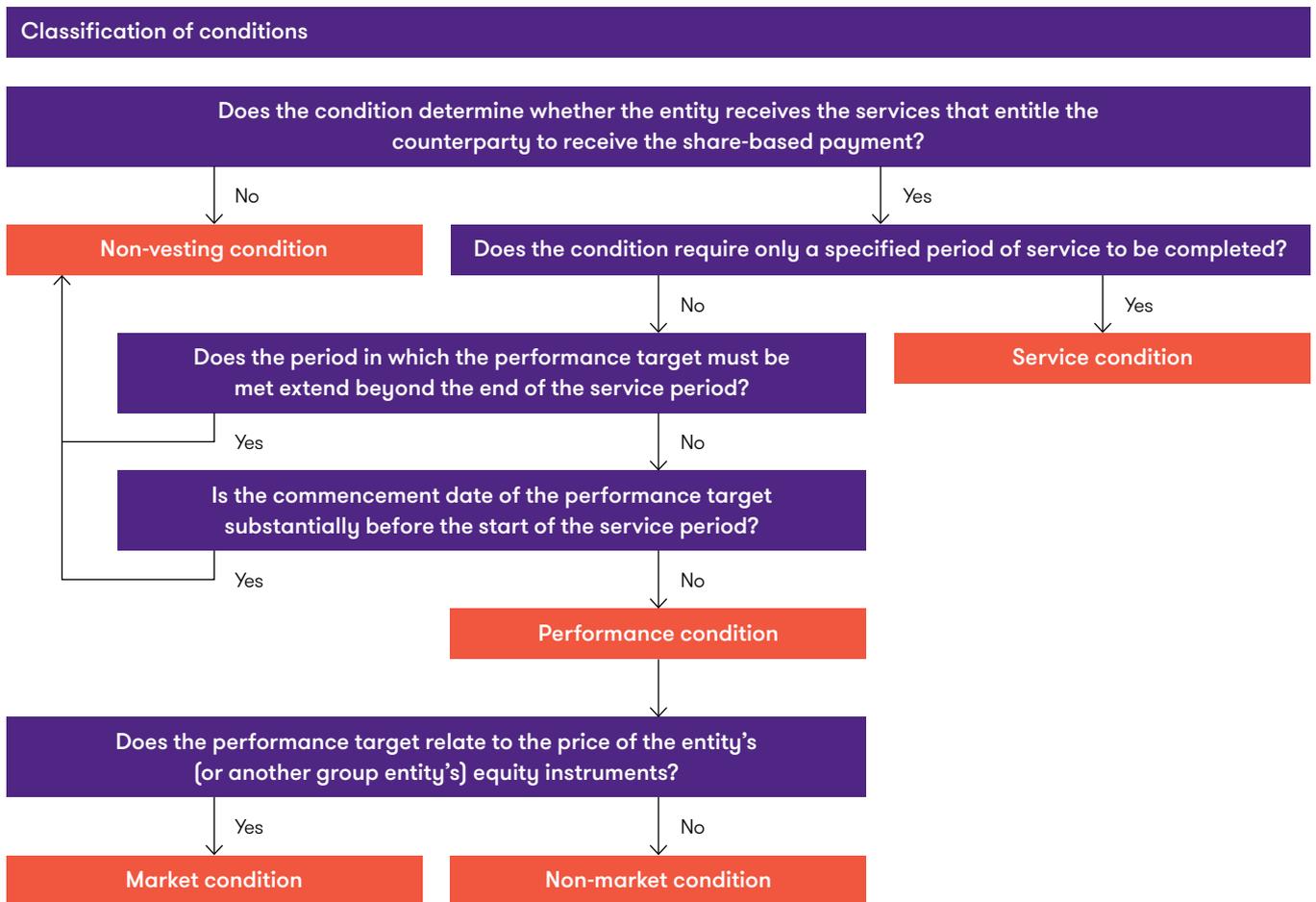
For example, an entity may issue to an employee a right to 50 shares in two years’ time, so long as the employee does not work with a competing entity during that time. Such a non-compete restriction does not determine whether the entity will receive services, because the employee could provide no further service to the entity for the next two years and still be entitled to the award.

Examples of non-vesting conditions:

- Non-compete restrictions
- Restrictions on the transfer of vested equity instruments (employee is required to hold a share after the vesting date for a specified period)
- Employees are required to pay monthly contributions into a savings plan in order to participate in an employee share purchase plan
- A requirement for a commodity index to reach a specified level



This decision tree summarises the guidance noted above for the classification of conditions under IFRS 2:



Vesting conditions and non-vesting conditions affect when a counterparty is entitled to a share-based payment as well as the amount and timing of recognition in the entity's financial statements. While we have provided guidance on the classification of share-based payments as equity-settled or cash-settled as well as the classification of conditions as vesting or non-vesting, how these classifications impact the accounting under IFRS 2 is outside the scope of this article and is therefore discussed in '**Insights into IFRS 2 – Equity-settled share-based payment arrangements with employees**' and '**Insights into IFRS 2 – Cash-settled share-based payment arrangements with employees**'.

How we can help

We hope you find the information in this article helpful in giving you some detail 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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