DIFFERENTIAL TREATMENT OF CASH AND EQUITY SETTLED TRANSACTIONS UNDER IFRS 2 SHARE-BASED PAYMENT

Victoria Wise, Centre for International Corporate Governance Research, Victoria University, PO Box 14428 MCMC, Melbourne, VIC 8001, Australia, victoria.wise@vu.edu.au

ABSTRACT

Share and share option plans are an increasingly common means of aligning employees' interest with those of shareholders and of encouraging employee retention. Some organisations also issue equity in payment for the acquisition of property, advice or other services. As more countries begin to apply international financial reporting standards, accounting for share-based payments is drawing increased attention from the investment community and researchers. The aims in this paper are to identify an inconsistency in the international accounting requirements for cash-settled and equity-settled share-based payment transactions and the implications of recognising the fair value of share-such transactions in financial statements.

INTRODUCTION

International Financial Reporting Standard 2 *Share-based Payment* (IFRS 2) [4] is a relatively new accounting standard that deals with the recognition and measurement of share-based payment transactions. These are arrangements in which an organisation receives or acquires goods or services as consideration for its own equity instruments for amounts that are based on the price of its equity instruments. In jurisdictions electing to adopt the international financial reporting regime, IFRS 2 became effective from January 2005. Three forms of share-based payment transactions are dealt with in IFRS 2. These are (1) *equity-settled share-based payment transactions*, in which an organisation receives goods or services as consideration for its own equity instruments; (2) *cash-settled share-based payment transactions*, in which it acquires goods or services by incurring liabilities to the supplier for amounts based on the value of its equity instruments; and (3) *other transactions* in which the terms of the arrangement provide either the organisation or the supplier with a choice of whether the transaction is settled in cash or by the issue of equity instruments. The main effect of IFRS 2 is that it requires recognition in the financial statements, of the goods or services received under share-based payment arrangements, regardless of whether the settlement is cash or equity based, or whether the counterparty involved is an employee. Prior to the issue of IFRS 2 there was no international requirement to identify, measure or recognise share-based payment transactions in financial statements. While such transactions may have been accorded footnote disclosure by some organisations, they were not generally expensed in the financial statements. This lack of transparency may have resulted in a lack of awareness by investors of the existence, cost, or the potential dilutive effect of share-based payment transactions.

Although external parties may be involved, in most instances the counterparty to a share-based payment transaction is an employee, with share plans and share options being used increasingly as a means of attracting and encouraging employee retention, and of aligning employees' interests with those of the organisation. In return for its equities, an organisation may also acquire property such as land, or services such as strategic advice from other parties. In its 2004 corporate governance statement, Macquarie Bank Limited [6] rationalises that its remuneration practices including share-based payments are designed to 'attract and retain...quality staff...and to encourage long-term commitment and superior performance from its employees.' Macquarie provides details of its share-based payment transactions with employees, and of the types of vesting, performance and market conditions incorporated in its employee share plans. Share-based payment transactions often result in large gains being realised by the employees. Research by Proxy Australia [2] indicated that 'CEOs at two dozen companies received a total of 85 million (Australian dollars) from converting their options into shares in the past three years, three times the "fair value" that had been broadcast to shareholders'. Arguably, for transparency alone, there is a need for publication of the gains or losses on share-based payment transactions and details of the valuation methods used.

IMPACT OF SHARE-BASED PAYMENT TRANSACTIONS

An important feature of IFRS 2 is the view that all share-based payment transactions ultimately lead to expense recognition and that the effects of such transactions must be recognised in profit and loss. The Financial Accounting Standards Board argued on its issue of a final statement on accounting for share-based payments (FASB Statement No. 123 *Share-Based Payment*), that 'recognizing the cost of share-based payments in the financial statements improves the relevance, reliability, and comparability of that financial information and helps users of financial information to understand better the economic transactions affecting an enterprise' [3]. The expense recognition view applies to all share-based payment transactions whether with employees or others thus it is generally expected that the application of IFRS 2 will lower the earnings of organisations that are significant users of these transactions. Because the new international accounting standard also requires share options to be fully expensed, thus lowering profit, Newman [7] suggested that companies may begin to drop the use of share options and revert to cash bonuses as a means to reward executive performance. Cash bonuses also commonly have the benefit of being fully tax deductible. Other action taken by companies exposed to share-based payment earnings volatility include accelerating the vesting of share-based payment transactions to avoid recognising associated expenses in their financial statements. In 2005 Gentex Corporation [3] accelerated the vesting of its 'under-water' share options, purportedly to avoid recognition of the compensation expense associated with these options in future financial statements upon the adoption of FASB No.123. Another significant feature of IFRS 2 is the differential accounting treatment it applies to transactions settled in cash relative to transactions that are equity settled. When goods or services are received in a share-based payment transaction they are recognised when they are received. If they were received under an equity-settled transaction, the corresponding increase is to equity. This reflects the view that employees (or others) holding outstanding share options 'are future equity holders' [5, p.154]. In contrast, if the transaction is cash-settled, the corresponding increase is recognised as a liability (debt). Thus a share-based payment transaction would, depending on the principles for asset or liability recognition, be recognised in the following journal entries.

Asset or Expense	Dr $XX	Asset or Expense	Dr $XX
Equity	Cr $XX	Liability (Debt)	Cr $XX
(Recognition of an equity-settled payment)		(Recognition of a cash-settled payment)	

If a share-based payment transaction is settled in cash, the general principle employed is that the transaction is measured at the fair value of the liability. Until it is settled, the fair value of the liability is remeasured at each reporting date and at the date of settlement, and any changes in fair value are recognised in profit or loss. In contrast, for transactions that are equity-settled, the general principle is that the goods or services received and the corresponding increase in equity are measured at the grant date, and at the fair value of the goods or services received. Remeasurement of the granted equity instruments at subsequent reporting dates and settlement date does not occur. Effectively, the fair value of a transaction classified as equity is measured at grant date and subsequent value changes are ignored. In contrast the fair value of transactions classified as liabilities (debt) are adjusted to fair value at each reporting date and the resulting profit or loss is included in the measurement of income. In the view of the AAA Committee [1] this differential accounting treatment based on the form of settlement, is a case of ‘form over substance’. The Committee expressed a concern that this has the potential to bring with it several undesirable consequences ranging from ‘transaction structuring to meet reporting goals’ to ‘estimate manipulation that goes uncorrected due to a lack of truing up’ [1, p.66]. The Committee argued that items that are economically identical, such as the outflow of an organisation’s resources through share-based payment transactions, should be accounted for in the same way. A further complication arises because it is normally considered that the fair value of services received in transactions with employees cannot be measured reliably. Thus, the fair value of the services received from employees is measured by reference to the equity instruments granted, at grant date. However, for transactions with other counterparties, there is a presumption in IFRS 2 that the fair value of goods or services can (except in rare cases) be estimated reliably.

SUMMARY

Two significant outcomes of IFRS 2 when using share-based payment transactions to reward employee performance have been discussed. These include that the cost of such transactions must be fully recognised in profit and loss. The predicted impact is the lowering of reported profits. Second, the remeasurement of share-based payment transactions for financial statement reporting purposes is likely to increase the volatility of reported earnings. The effect of such outcomes may encourage sub-optimal behaviour by mangers and investors including actions as diverse as returning to a cash bonuses reward approach, and, engaging in income-smoothing techniques to manage the impact of IFRS 2 on reported earnings. There is, as yet, little research directed towards understanding the impact of IFRS 2 on the attitudes of managers and investors and the factors influencing those attitudes. The production of financial statements in 2005 by organisations in countries that have adopted international financial reporting standards, presents an opportunity for research to be conducted in this important area.

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