



Insights into IFRS 2

Equity-settled share-based payment arrangements with employees

Share-based payments have become increasingly popular over the years, with many entities using equity instruments or cash and other assets based on the value of equity instruments as a form of payment to directors, senior management, employees and other suppliers of goods and services.

While the general accounting principles have remained largely unchanged since the introduction of IFRS 2 'Share-based Payment' in 2004, share-based payments is an area that is not well understood 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.

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

Equity-settled share-based payment arrangements

As discussed 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).

“This article discusses the accounting for equity-settled share-based payment transactions with employees.”

Equity-settled share-based payment transaction:

A share-based payment transaction in which the entity:

- receives goods or services as consideration for its own equity instruments (including shares or share options), or
- receives goods or services but has no obligation to settle the transaction with the supplier.

The most common equity-settled share-based payment transactions are grants of shares and share options. Share options are awards where employees are granted a right (but not an obligation) to subscribe to an entity's shares at a fixed or determinable price, for a specified period of time.

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

General principles

As discussed in our article, '[Insights into IFRS 2 – Basic principles of share-based payment arrangements](#)', for equity-settled share-based payment transactions with employees, the services received are measured on the grant date at fair value. The value of the services provided by employees is measured indirectly by reference to the fair value of the equity instruments granted, rather than at the fair value of the services received, as there is a presumption that the employee services received for particular components of an employee's remuneration package cannot be measured reliably. IFRS 2 therefore assumes that the fair value of the employee services is equal to the fair value of the equity instruments on the grant date. For equity-settled share-based payments, although the services may be provided over a period of time, the fair value is measured only once at the grant date (unless the share-based payment arrangement is subsequently modified).

The entity recognises the services received (ie the share-based payment cost) as the employee provides the service (starting from when the employee commences providing the service), with a corresponding increase in equity. When the employee is required to complete a specified period of service before the equity instruments vest, the services are recognised over the vesting period. However, if the award vests immediately, it is assumed that the employee has already provided the service and the expense

is recognised immediately. These and other recognition concepts were discussed in our article '[Insights into IFRS 2 – Basic principles of share-based payment arrangements with employees](#)'.

The modified grant-date method

The modified grant-date method is a method whereby vesting conditions are taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted is based on the number of equity instruments that eventually vest.

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 modified grant-date method considers these conditions as follows:

- Non-vesting conditions and market performance conditions are taken into account when estimating the grant-date fair value of the equity-settled share-based payment. There is no subsequent true-up for a failure to meet these conditions. The share-based payment cost is recognised regardless, assuming that any service conditions and non-market performance vesting conditions are met, even though the employee will never receive the share-based payment.
- Conversely, service conditions and non-market performance vesting conditions are not taken into account when estimating the grant-date fair value of the equity-settled share-based payment. Instead, non-market vesting conditions are taken into account by adjusting the number of equity instruments (ie awards) that are expected to vest. The entity does not recognise amounts relating to awards that are not expected to and ultimately do not vest because of a failure to satisfy a non-market vesting condition.

This accounting method is called the modified grant-date method, because the number of equity instruments used to calculate the transaction amount is adjusted to reflect the outcome of service and non-market performance vesting conditions, but no change is made to the grant-date fair value. 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 • No true-up for failure to meet condition
Market performance condition (eg achieving a specified share price)	• Reflected in grant-date fair value • No true-up for failure to meet condition
Non-market performance condition (eg achieving a specified earnings before interest, taxes, depreciation, and amortization (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 3-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

Reflecting conditions in the grant-date fair value

Determining the grant-date fair value is discussed in the article, '[Insights into IFRS 2 – Basic principles of share-based payment arrangements](#)'. Reflecting the probability of meeting market performance conditions (eg achieving a specified share price) in the grant-date fair value is accomplished by using one of the valuation models discussed in that article. Reflecting the probability of meeting a non-vesting condition that does not relate to future share prices is generally not incorporated into the valuation model as these conditions can often be difficult to quantify, unless they are based on some form of market-based data. Instead, an entity needs to determine an appropriate method for incorporating the non-vesting condition into the grant-date fair value.

Reflecting conditions in the awards expected to vest

Estimating the impact of service and non-market performance conditions is achieved by estimating the number of equity instruments for which the conditions are expected to be satisfied. Initially, an entity makes its best estimate of the number of awards for which the conditions are expected to be satisfied, which may be any number between zero (ie conditions will not be satisfied) and the total number of instruments granted (ie conditions will be completely satisfied). At each subsequent reporting date, the entity revises, or true-up, this estimate based on new information (eg some employees have left and therefore will not satisfy the service condition). On the vesting date, the entity revises the estimate to equal the number of equity instruments that ultimately vests.

At the end of the vesting period, this results in the cumulative share-based payment cost recognised by the entity being:

- The number of equity instruments for which service and non-market performance conditions have been satisfied, multiplied by
- The grant-date fair value of those equity instruments, which incorporated the impact of non-vesting and market performance conditions.

As noted in the summary table on page three, market conditions are reflected in the grant-date fair value and are not subsequently adjusted if the market condition is not met. Therefore, an entity recognises the services received from employees that meet all other vesting conditions, even if the market condition is not met. For example, if an employee receives a share option award and meets the required service condition, but the entity does not meet the share price target associated with the award, the entity still recognises the services received from the employee at the grant-date fair value.

A change in estimate for the likelihood of satisfying service or non-market vesting conditions is not adjusted consistently with typical changes in estimates (ie prospective application). Instead, the charge (or credit) in profit or loss for the period is the cumulative amount determined if that revised estimate had been used from the beginning of the vesting period, less the cumulative amount charged in the previous period.

Once an equity-settled share-based payment award has vested, no further accounting adjustments can be made to the cost of the award. For example, where options vest but are never exercised by the option holder, IFRS 2 requires that the cost of those options still be recognised. However, this does not preclude the entity from making a transfer between components of equity upon expiry of the award.

The following examples illustrate the above concepts.

Example 1 – Equity-settled share-based payment transaction with a service condition

On 1 January 20X1, Entity A grants five share options to each of its 100 employees. Each grant is conditional upon the employee working for the entity over the next three years. Entity A estimates that the grant-date fair value of each option is CU10.

On the basis of a weighted average probability, Entity A estimates that 10% of its employees will leave during the three-year period (and therefore forfeit their rights to the options). Entity A revises its estimate of departures over the three-year period as employees actually leave. For example, although Entity A initially estimated departures of 10% (10 employees), five employees leave during year one alone and therefore Entity A changed its estimate to 15% (15 employees).

During the three-year period, Entity A's changing estimates of the number of employees that will meet the service condition were as follows:

Period	Number of employees expected to meet service conditions	Number of employees that have left (cumulative)
1 January 20X1	90	–
End of 20X1	85	5
End of 20X2	70	17
End of 20X3	62	38

Analysis

Entity A accounts for the transaction as follows:

Year	Calculation	Expense Dr CU	Equity Cr CU
End of 20X1	5 options X 85 employees X CU10 X 1/3	1,417	1,417
End of 20X2	(5 options X 70 employees X CU10 X 2/3) – CU1,417	917	917
End of 20X3	(5 options X 62 employees X CU10 X 3/3) – CU1,417 – CU917	766	766
Cumulative Impact		3,100	3,100

Example 2 – Equity-settled share-based payment transaction with a non-market performance condition

On 1 January 20X1, Entity B grants five share options to each of its 100 employees. Each grant is conditional upon the employee working for the entity over the next three years and cumulative net earnings reaching CU25 million by the end of the third year. Entity B estimates that the grant-date fair value is CU10.

During the three-year period, Entity B's changing estimates of (a) the number of employees that will meet the service condition and (b) whether the cumulative earnings target will be met were as follows:

Period	Number of employees expected to meet service conditions	Expectation of whether cumulative earnings target will be met
1 January 20X1	90	Yes
End of 20X1	85	Yes
End of 20X2	70	Yes
End of 20X3	62	No

Analysis

Entity B accounts for the transaction as follows:

Year	Calculation	Expense Dr CU	Equity CR CU
End of 20X1	5 options X 85 employees X CU10 X 1/3	1,417	1,417
End of 20X2	(5 options X 70 employees X CU10 X 2/3) – CU1,417	917	917
End of 20X3	(0 options ¹ X 62 employees X CU10 X 3/3) – CU1,417 – CU917	(2,334)	(2,334)
Cumulative Impact		–	–

¹ Non-market performance condition (cumulative earnings) was not met.

In this example, because the non-market performance condition was not met in 20X3, the expense recorded in the previous two years was reversed. This accounting outcome reflects the fact that ultimately, the amount recognised for goods or services received is based on the number of equity instruments that vest. As a result, on a cumulative basis, no amount is recognised as the share options do not vest because of failure to satisfy a vesting condition (that is not a market condition).





Example 3 – Equity-settled share-based payment transaction with a market performance condition

On 1 January 20X1, Entity C grants five share options to each of its 100 employees. Each grant is conditional upon the employee working for the entity over the next three years and the share price reaching CU20 by the end of the third year. Entity C estimates that the grant-date fair value is CU8 by using a valuation technique, taking into account the probability of whether the market performance condition will be met.

During the three-year period, Entity C's changing estimates of the number of employees that will meet the service condition were as follows:

Period	Number of employees expected to meet service conditions
1 January 20X1	90
End of 20X1	85
End of 20X2	70
End of 20X3	62

At the end of 20X3, the share price is CU18 and therefore the market performance condition is not met.

Analysis

Entity C accounts for the transaction as follows:

Year	Calculation	Expense Dr CU	Equity Cr CU
End of 20X1	5 options X 85 employees X CU8 X 1/3	1,133	1,133
End of 20X2	(5 options X 70 employees X CU8 X 2/3) – CU1,133	734	734
End of 20X3	(5 options X 62 employees X CU8 X 3/3) – CU1,133 – CU734	613	613
Cumulative Impact		2,480	2,480

As discussed above, the fact that the market performance condition (ie share price target) was not met does not impact the recognition of the share-based payment expense. The possibility that the target would not be met was already factored into the grant-date fair value of the option.

Example 4 – Graded vesting on an equity-settled shared-based payment transaction

On 1 January 20X1, Entity A grants 10 share awards to each of its 120 employees. To receive the awards, the employee must remain in the continued employment of Entity A. Each year, two of the shares shall vest on the anniversary of the grant date. The employee must remain in employment of Entity A for five years to receive all 10 shares. If an employee left after two years' service, they would keep the four shares vested to date but would forfeit their right to the remaining six awards.

As such, it is expected that 200 awards will fully vest by the end of each year. The grant date fair value of the awards is determined to be CU1. The vesting schedule, therefore, that Entity A will recognise is as follows:

Awards vesting in the year	Charge recognised in profit or loss during the annual reporting period ending				
	20X1 CU	20X2 CU	20X3 CU	20X4 CU	20X5 CU
20X1	240	–	–	–	–
20X2	120	120	–	–	–
20X3	80	80	80	–	–
20X4	60	60	60	60	–
20X5	48	48	48	48	48
Total share-based payment charge for the year	548	308	188	108	48

As discussed above, like market performance conditions, non-vesting conditions are reflected in the grant-date fair value of the equity instruments. There is no true-up for the failure to meet these conditions, and therefore the full share-based payment will be recognised regardless. However, if a non-vesting condition is not met because the counterparty chooses not to meet the condition during the vesting period, then an entity applies cancellation accounting. In this case, the vesting is accelerated, and any remaining expense is recognised immediately.

Example 5 – Equity-settled share-based payment transaction with a non-vesting condition that the counterparty can choose not to meet

On 1 January 20X1, Entity D grants five share options to each of its 100 employees. Each grant is conditional upon the employee working for the entity over the next three years (a service condition) and contributing to a savings plan that will be used by the employee at the end of three years to exercise the options (a non-vesting condition). Entity D estimates that the grant-date fair value, which incorporates the probability that the employees will contribute to the savings plan, is CU9.

Entity D expects that all employees will meet the service condition. However, employees may take a refund of their contributions at any point during the three-year period. During the second year, eight employees stop making contributions to the savings plan (ie they have chosen not to meet the non-vesting condition).

Analysis

Entity D accounts for the transaction as follows:

Year	Calculation	Expense Dr CU	Equity Cr CU
End of 20X1	5 options X 100 employees X CU9 X 1/3	1,500	1,500
End of 20X2	(5 options X 92 employees X CU9 X 2/3) + (5 options X 8 employees X CU9) – CU1,500	1,620	1,620
End of 20X3	(5 options X 100 employees X CU9 X 3/3) – CU1,500 – CU1,620	1,380	1,380
Cumulative Impact		4,500	4,500

As discussed above, the fact that the non-vesting condition (ie savings plan contribution) was not met does not impact the overall expense recognised. Instead, the expense is accelerated in the second year for the eight employees that stop contributing to the savings plan. That is, the expense in 20X2 for those eight employees includes the expense that would otherwise have been recognised in the third year (20X1: 5 options X 8 employees X CU9 X 1/3 = CU120; 20X2: 5 options X 8 employees X CU9 X 3/3 = CU360 less expense recognised in 20X1 of CU120 = CU240).

What happens if the fair value of equity instruments cannot be measured reliably?

As mentioned earlier, IFRS 2 assumes that the fair value of equity instruments in equity-settled share-based transactions with employees can be measured reliably. However, the standard does acknowledge that there may be rare cases where the fair value cannot be measured reliably. In these instances, the entity should use the intrinsic value method to value the instruments (1) initially, on the grant date, (2) subsequently, at the end of each reporting period, and (3) finally, at the settlement date (ie the options are exercised, forfeited or expire). Changes in the intrinsic value are recognised in profit or loss. The intrinsic value method is generally preferable because the alternative approach is much more burdensome for preparers and requires the use of the market value of the equity instrument not only at inception but also at each reporting date.

IFRS 2 defines 'intrinsic value' as:

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, for a share option, if the grant-date share price is CU20 and the exercise price is CU15, then the intrinsic value at the grant date is CU5.

How do 'good leaver' clauses impact the accounting for share-based payment transactions?

Share-based payment arrangements usually contain clauses that indicate that the award is forfeited if an employee leaves before the service condition is met. These arrangements may also contain 'good leaver' clauses, which describe the circumstances under which some or all of the share-based payment award granted to an employee is not forfeited for leaving the entity prior to completing the service condition. This is often the case when an employee leaves due to circumstances beyond their control, such as retirement, death, or disability. An employee that leaves under these circumstances may be treated like an employee that has fulfilled the service condition, either in full or on a pro rata basis (ie up to the date they leave the entity). As a result, their service period ends on the date that they are entitled to receive the share-based payment, thereby impacting the vesting period and potentially the grant-date fair value (ie if the expected exercise date differs as a result of the shorter vesting period).



Example 6 – Good leaver clauses

On 1 March 20X1, Entity E grants 100,000 share options to each of the six members of its senior executive team, subject to a three-year service condition. The options expire after five years and can therefore be exercised at any time after vesting, up to 1 May 20X6.

The share option agreement contains a clause that if the executive leaves prior to the award vesting as a result of retirement, death or disability, a pro-rata portion of the share options will vest and can be exercised up to the original expiry date.

On the grant date, Entity E estimates the following:

- five executives will remain employed until the end of the third year
- one executive (the CFO) will leave effective 31 December 20X2 as they have indicated they plan to retire on that date

The grant-date fair value of the options is CU20. The grant-date fair value of the CFO's options is CU12, as Entity E expects that the CFO will exercise their options earlier due to the earlier vesting date.

Ultimately, the five executives remain employed during the three-year service period, and the CFO retires as expected.

Analysis

Entity E accounts for the five executives that remain employed as usual by recognising the grant-date fair value (CU20) over the three-year vesting period. The entity recognises the grant-date fair value of the CFO's options (CU12) over the shorter service period and adjusts the number of options expected to vest on a pro-rata basis (100,000 share options x 20 months / 36 months = 55,556 share options expected to vest).

How we can help

If you would like to discuss any of the points raised, please contact:

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