

THE FAIR VALUE OF SHARE-BASED COSTS

IFRS 2 Share-based payment will have a major impact on company reporting, for the first time requiring costs related to share-based payments to be measured at fair value and recognised in income statements.

Share-based payments include the following:

- All executive and employee share option and share purchase plans, including Save-As-You-Earns plans.
- Share appreciation rights, where a cash payment is made, the amount depending on the share price.
- Transactions with suppliers that involve a share-based payment being made in exchange for goods or non-employee services.

Key principle

Transactions in which goods or services are received as consideration for an entity's equity instruments should be measured at the fair value of the goods or services received. If that value cannot be estimated reliably, the fair value of the equity instruments granted should be used.

Equity-settled share-based payments

For equity-settled share-based transactions with parties other than employees, the fair value of the goods or services received should be measured at the date the entity obtains them. In rare cases where the value of goods and services cannot be estimated reliably, the transaction is measured by reference to the fair value of the equity instruments granted,

measured at the date the goods or services are received.

For transactions with employees, the IASB believes that the value of employee services received cannot be estimated reliably. Therefore, equity-settled share-based payments to employees should be measured at the fair value of the equity instrument – measured at grant date. IFRS 2 requires the following:

- Fair values should be based on market prices. If these are not available, they should be based on option pricing models.
- The expense is spread over the vesting period, defined as both the performance period and any subsequent service period.
- If the vesting of the equity instrument is based on a performance condition related to market price (such as the share price being above a certain level), the likelihood of the award vesting is included in the fair value assessment at grant date.
- Performance conditions not related to the market (such as earnings per share targets) and service conditions are not included in the fair value determined at grant date. The initial charge is estimated based on the expected number of awards that will vest, and this is adjusted during the vesting period if actual experience differs.

Cash-settled share-based payments

Cash-settled share-based payments, such as share appreciation rights or phantom options, are treated as liabilities rather than equity. The fair value is estimated at grant date and

remeasured at each balance sheet date up to the settlement of the awards.

Disclosure requirements

IFRS 2 prescribes certain disclosures to enable users of accounts to understand:

- The nature and extent of share-based payment arrangements that existed during the period.
- How the fair values were determined.
- The effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

Effective date

IFRS 2 is effective for annual periods beginning on or after 1 January 2005. All equity-settled share-based payments granted after 7 November 2002 that have not yet vested at 1 January 2005 must apply IFRS 2.

Impact of IFRS 2

Under current practice, only the nature and terms of share arrangements have to be disclosed, and a charge rarely appears in the profit and loss account. IFRS 2 therefore marks a significant change in accounting policy.

In 2003, PricewaterhouseCoopers conducted a study of the impact of IFRS 2's preceding exposure draft (ED 2) on 22 listed companies in the UK. Although IFRS 2 is not exactly the same as ED 2, the results are still informative. PwC found that the effects varied widely, depending on the share schemes in place. On average, implementing ED 2 could reduce earnings from continuing operations by 3.5%, and by more than 10% for the most affected companies.

PwC suggests companies need not be overly concerned about ongoing substantial movements in

the annual charge. Peter Holgate, UK senior technical partner at PwC, says: "Major swings in the charge from year to year will be common only when there is an irregular pattern of awards, or where the awards are cash-settled. Companies will need to look carefully at their current compensation arrangements for employees and others to ensure they are using the most effective schemes." Holgate adds that implementation of IFRS 2 will be most complex for senior executives' share-option awards that contain individual performance criteria.

FRS 20

The UK's ASB plans to introduce a UK standard – FRS 20 (IFRS 2) share-based payment – based on IFRS 2. The requirements of FRS 20 will be identical to those of IFRS 2, except that implementation of the standard for unlisted entities will be deferred one year to 1 January 2006. Entities applying the Financial Reporting Standard for Smaller Entities (FRSSE) will be exempted.

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A wide range of Briefings can be found at www.financialdirector.co.uk/briefing

Useful links

- The IASB's announcement is at www.iasb.org
- Deloitte's IAS Plus website includes an analysis of IFRS 2 at www.iasplus.com/iasplus/0402sharebased.pdf
- PwC has produced a guide to the implications of IFRS 2 for share plans at www.pwcglobal.com/gx/eng/about/svcs/corporatereporting/IFRS2.pdf
- KPMG's initial summary of IFRS is at www.kpmg.co.uk/services/pubs.cfm