

Share-based payment (Lecture A768 – 7.23 minutes)

FRS 102 deals with share-based payment transactions in Section 26 *Share-based Payment*. The term 'share-based payment' is defined as:

*The equity instruments (including shares and **share options**), **cash** or other **assets** to which a counterparty may become entitled in a **share-based payment transaction**.*

FRS 102 Glossary
share-based payment

The term 'share-based payment arrangement' is defined as:

*An agreement between the entity (or another **group** entity or any shareholder of any group entity) and another party (including an employee) that entitles the other party to receive:*

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share-based payment arrangement

- (a) ***cash** or other **assets** of the entity 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; or*
- (b) *equity instruments (including shares or share options) of the entity or another group entity,*
- (c) *provided the specified **vesting conditions**, if any, are met.*

A 'share-based payment transaction' is defined as:

A transaction in which the entity:

- (a) *receives goods or services from the supplier of those goods or services (including an employee) in a **share-based payment arrangement**; or*
- (b) *incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another **group** entity receives those goods or services.*

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share-based payment transaction

An 'equity-settled share-based payment transaction' is defined as:

*A **share-based payment transaction** in which the entity:*

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

FRS 102 Glossary
equity-settled share-based payment transaction

A 'cash-settled share-based payment transaction' is defined as:

*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 the **equity** instruments (including shares and **share options**) of the entity or another **group** entity.*

FRS 102 Glossary
cash-settled share-based payment transaction

1.1 Cash-settled share-based payment transactions

The definition of a cash-settled share-based payment transaction is noted above. When an entity enters into a cash-settled share-based payment transaction, it will recognise a liability at fair value and this liability is then remeasured at each balance sheet date, charging the profit and loss account with the related expense until the liability is settled.

A liability is recognised if goods or services have been acquired in a cash-settled share-based payment transaction, i.e.:

Dr Profit and loss	X
Cr Liability	X

For presentational purposes, company law would require the liability to be split or classified as current and/or non-current as appropriate on the face of the balance sheet and within the notes in the same way as other current and non-current liabilities.

The cash paid to settle a share-based payment will be the cost to the entity of the goods and services received or rendered. The settlement may not take place for several years and hence in a cash-settled share-based payment arrangement, the estimated liability is remeasured until the final amount is known. Where there is a change in the liability, the change is taken to the profit and loss account.

Example – Cash-settled share-based payment arrangement

Currie Ltd awards its managing director 1,000 share options on 31 December 2020 which represents 10% of the company's share capital and on this date (the grant date) the company is valued at £750,000.

The managing director has requested that a clause be incorporated into the agreement which allows the share options to be converted into cash if he leaves the company or dies to which the owners have agreed as they want to retain the managing director due to his knowledge and expertise within the industry. The agreement states that the company will buy back the share options on retirement, death or where the cessation of employment is not due to incompetence, acting in the detriment of the company or being convicted of a criminal offence. Where such acts occur, the arrangement is forfeited for nil consideration and the directors consider the managing director committing such acts to be remote.

The buyback clause results in the arrangement being treated as a cash-settled share-based payment arrangement as eventually the company will have to settle the transaction via cash. Had there been no buyback clause, it would be equity-settled.

Hence, at each reporting date, the outstanding liability is remeasured to fair value with changes in fair value going to profit or loss. On 31 December 2020, the company recognises the share-based payment arrangement as follows:

Dr Share-based payment expense	£75,000
Cr Liabilities	£75,000

Being share-based payment expense for the year ended 31 December 2020

1.2 Equity-settled share-based payment transactions

When an entity receives goods or services in an equity-settled share-based payment transaction, it recognises a corresponding increase in equity, i.e.:

- Dr Profit and loss X
- Cr Equity X

It should be noted that the issuance of any shares would be a separate entry in the books of the entity.

In terms of presenting this transaction, some entities choose to show the credit to equity in retained earnings (P&L reserves), or they maintain a separate reserve which reflects the total charges for share-based payment arrangements which have not yet vested. There is no specific guidance in FRS 102 and, in practice, most entities simply take the credit to retained earnings, although they can maintain a separate reserve. An entity cannot, however, use a share premium account to take the credit.

1.3 Recognition when there are vesting conditions

Vesting conditions are those conditions which a third party must satisfy in order to become entitled to receive cash, other assets or shares of the business in a share-based payment transaction by the 'vesting date'. The 'vesting date' is the date on which the shares or share options are able to be exercised.

Where share-based payments granted to a counterparty vest immediately, they are not required to complete a specified period of service before they become unconditionally entitled to those share-based payments. Hence, in the absence of any information to suggest otherwise, the entity presumes that services rendered by the counterparty as consideration for the share-based payments have been received and therefore on the grant date, the entity recognises the services received in full, with a corresponding increase in equity (equity-settled) or liabilities (cash-settled). The term 'grant date' is defined as:

*The date at which the entity and another party (including an employee) agree to a **share-based payment arrangement**, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to **cash**, other **assets**, or equity instruments of the entity, provided the specified **vesting conditions**, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.*

FRS 102 Glossary **grant date**

Where share-based payments do not vest until the counterparty provides a specified period of service, the entity must assume that the services to be rendered as consideration for those share-based payments will be received in the future, during the vesting period. The entity accounts for those services as they are rendered by the counterparty during the vesting period, with a corresponding increase in equity or liabilities.

For example, an employee may have to complete a certain specified period of service prior to becoming entitled to exercise the share options (or not as the case might be) which entitles the employee to purchase the shares. This would represent a vesting condition which is conditional on service.

Conditions may also be imposed in the share-based payment arrangement which are conditional on the performance of the company, such as achieving a certain profit benchmark. These conditions would be non-market vesting conditions (a term which is not defined in FRS 102) and which are taken into account when estimating the number of equity instruments which are expected to vest.

The term 'market condition' is defined in FRS 102 as:

*A condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price of the entity's equity instruments, such as attaining a specified share price or a specified amount of **intrinsic value** of a **share option**, or achieving a specified target that is based on the market price of the entity's equity instruments relative to an index of market prices of equity instruments of other entities.*

FRS 102 Glossary
market vesting condition

Market vesting conditions, such as specified increases in the entity's share price, are **not** taken into consideration when estimating the number of equity instruments expected to vest because these conditions have already been taken into consideration when fair-valuing the shares or other equity instruments. Hence, an expense is recognised regardless of whether market conditions are satisfied.

At the vesting date, the entity revises the estimated number of equity instruments expected to vest so that they equal the number of equity instruments that have actually vested.

Example – Share-based payment transaction

On 1 January 2021, Wolves PLC grants 2,000 share options to each of its three directors. The terms of the share-based payment arrangement includes a condition stating that all the directors must still be in the employment of the entity on 31 December 2023 when the share options vest. The fair value of each option as at 1 January 2021 is £11 and it is expected that all of the options will vest. A further condition in the agreement is that the options will only vest if the share price reaches £18 per share. On 31 December 2021, the share price was only £9 and, due to market conditions, it is not expected to rise in the next two years. A decline in business and continuing difficulties due to Covid-19 has meant that it is only expected that two out

of the three directors will be employed by the entity on 31 December 2023.

Changes in the share-price of an entity are a market vesting condition which is taken into account when the fair value of the share option is calculated. The change in share price is not included in the calculation of the profit and loss account charge or equity movement. However, the company must take into consideration the fact that only two directors will be employed by the business, hence the calculation for the financial statements for the year ended 31 December 2021 will be:

$$2,000 \text{ options} \times 2 \text{ directors} \times \text{£}11 \times 1/3 = \text{£}14,667$$

Dr Profit and loss account £14,667

Cr Equity £14,667

Example – Share options granted

Charnley PLC offers its ten directors a share option scheme provided they each remain in the employment of the entity for a period of three years. The number of options granted to each director was 1 million. The options are exercisable immediately after the end of the third year and those directors which are eligible would be required to pay £2 for each share of £1 par value.

The fair value of the options and the estimates of the number of options which are expected to vest are as follows:

Year	Rights expected to vest	Fair value of each share option £
Grant date	6m	0.30
1	5m	0.38
2	6m	0.42

At the end of year 3, 7 million rights actually vested.

The financial statements for each year will show the following:

Year	Calculation	Equity £'000	Expense £'000
1	5m x £0.30 x 1/3	500	500
2	6m x £0.30 x 2/3	1,200	700

3	7m x £0.30	2,100	900
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Assuming that all eligible directors exercised their options, the entries in the financial statements are:

	£m
Dr Cash	14
Cr Share capital (7m x £1)	7
Cr Share premium	7

A transfer may be made from the share-based payment reserve to retained earnings to clear the reserve out, but this is not required.

Where share-based payments are used with employees, the share premium account will not include any element of the 'value' of those share-based payments which have been recognised as an expense and in equity. This is because in law, the services of an employee cannot be recognised as part of the consideration for shares. The situation can vary somewhat if share-based payments are used to pay a supplier, for example, as the fair value of the goods purchased with shares will be the value of the consideration for the shares.

1.4 Measurement principle for equity-settled share-based payment transactions

The general measurement principles in respect of an equity-settled share-based payment transaction are outlined in FRS 102, paras 26.7 to 26.9. FRS 105 does not allow a micro-entity to account for equity-settled share-based payment transaction until the shares are issued. Once they are issued, FRS 105 requires the micro-entity to apply the requirements of FRS 105, Section 17 *Liabilities and Equity*.

Under FRS 102, equity-settled share-based payment transactions are measured at the fair value of the goods or services received with a corresponding increase in equity. Where fair value cannot be determined reliably, FRS 102, para 26.7 cross-references to paras 26.10 and 26.11 which relate to shares, share options and equity-settled share appreciation rights. FRS 102, para 26.7 also clarifies that the fair value is in respect of the fair value of equity instruments granted to employees and others providing similar services and *not* to the fair value of services received because usually it is not possible to fair value the latter.

In respect of transactions with employees (including others providing similar services), the fair value of equity instruments is measured at grant date. In respect of transactions with parties other than employees, the measurement date is the date when the entity obtains the goods or the counterparty renders the service.

When dealing with the accounting treatment for a share-based payment transaction, the first thing to do is to split the conditions into 'market' and 'non-market' conditions.

Example – Market and non-market conditions

Hill PLC has a share-based payment arrangement in place. The terms of the arrangement are as follows:

- there has to be a minimum 7.5% increase in the company's share price;
- employees must remain in the company's employment for a minimum of three years; and
- revenue in year 2 has to be at least 20% higher than in year 1.

7.5% increase in the company's share price

The 7.5% increase in the share price is a market condition. At the grant date it is included in the measurement of the fair value of the share option based on an assessment of the outcome but is not reflected in the revised number of shares on 'true up' (the term 'true up' refers to the ability of the entity to revise its estimates of likely vesting at the grant date to reflect the actual level of vesting). The share-based payment expense continues regardless of whether, or not, the market condition is met.

Employees remain in employment for a minimum three-year period

This is a non-market condition and hence is excluded from measurement of the grant date fair value. It is, however, reflected in the revised number of shares and the share-based payment expense is reversed if the condition is not met.

Revenue in year 2 has to be at least 20% higher than in year 1

This is a non-market condition and hence is excluded from measurement of the grant date fair value. It is, however, reflected in the revised number of shares and the share-based payment expense is reversed if the condition is not met.

1.5 Modifications

Any modification to a share-based payment arrangement could be beneficial or not beneficial to the employee.

FRS 102, para 26.12(a) states:

The entity shall take the modified vesting conditions into account in accounting for the share-based payment transaction, as follows:

If the modification increases the fair value of the equity instruments granted (or increases the number of equity instruments granted) measured immediately before and after the modification, the entity shall include the incremental fair value granted in the measurement of the amount recognised for services received as consideration for the equity instruments granted. The incremental fair value granted is the difference between the fair value of the modified equity instrument and that of the original equity instrument, both estimated as at the date of the

FRS 102, para 25.12(a)

modification. If the modification occurs during the vesting period, the incremental fair value granted is included in the measurement of the amount recognised for services received over the period from the modification date until the date when the modified equity instruments vest, in addition to the amount based on the grant date fair value of the original equity instruments, which is recognised over the remainder of the original vesting period.

Where a change reduces the total fair value of the arrangement, FRS 102, para 26.12(b) is relevant, which states:

*If the modification reduces the total fair value of the **share-based payment arrangement**, or apparently is not otherwise beneficial to the employee, the entity shall nevertheless continue to account for the services received as consideration for the equity instruments granted as if that modification had not occurred.*

FRS 102, para 26.12(b)

During a vesting period, an entity could alter the terms and conditions of a share option scheme and there are a number of reasons why this could be the case, for example it may increase or decrease the exercise price of the share options which would make the scheme more or less favourable to the employees.

Where there is no change to the vesting period, the steps to follow for the modification are as follows:

1. Calculate the fair value of the award immediately prior to the modification
2. Calculate the fair value of the award immediately after the modification
3. If the value in 2 is less than 1 there is no incremental fair value. The original grant date fair value continues to be charged over the remaining vesting period
4. If the value in 2 is more than 1 the difference is the incremental value. The original grant date fair value continues to be charged over the remaining vesting period plus the additional incremental fair value over the remaining vesting period

If the vesting date is changed, the incremental fair value is charged over the period to the new vesting date, but the original grant date fair value must continue to be charged over the period ending on the original vesting date.

Example – Modifications to a share-based payment arrangement

On 1 January 2021, Harrison PLC, which has an accounting reference date of 31 December, introduced a share-based payment arrangement for its employees in which they have the option to buy 20,000 shares provided they stay in the company's employment for three years. On 1 January 2021 (grant date) the fair value of the share options is £7.

Due to changes in legislation, the company has seen a significant decline in activity which has reduced the value of the company's shares significantly. This means that the fair value of the options is now only £2.80 per option. On 1 July 2021, the

company took the decision to change the arrangement so that those employees in the scheme who are still in the employment of the company at the date the options vest have the option to buy 40,000 shares rather than the original 20,000 (i.e. 100% more). The date of the modification is 1 July 2021. The directors expect that 80% of the employees will remain in the company's employment at the date the share options vest.

The fair value of each additional equity instrument granted is determined to be the share price at the date of the grant. Hence, the incremental fair value granted is 20,000 additional shares at £2.80 per share.

This modification is accounted for in the same way that a new grant of equity instruments would be. At the year end 31 December 2021, the company is one-third of the way through the original tranche of share options and one-fifth of the way through the second tranche of shares issues (6 months / 30 months).

The charge to P&L for the year ended 31 December 2021 is calculated as follows:

$$(16,000 * x £7 x 1/3) + (16,000 * x £2.80 x 1/5) = £46,293$$

*The number of shares is 16,000 based on the fact that the directors only expect 80% of the employees to remain in the company's employment once the options vest (20,000 originally granted x 80%).

1.6 Cancellations

FRS 102, para 26.13 states that an entity accounts for a cancellation or settlement of an equity-settled share-based payment arrangement as an acceleration of vesting, and hence shall recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

FRS 102 is unclear as to whether the amount which would have been recognised is the expense that would have been recognised had all of the awards outstanding at the cancellation or settlement date vested, or whether it is the entity's estimate of the number of awards which would have vested had the cancellation or settlement not occurred. Hence, an accounting policy should be developed and this should be disclosed in the financial statements.

On 1 January 2020, Walker PLC granted 100 share options to its sales director. The terms of the agreement are that the sales director must remain in the employment of the business for three years. At the grant date, the fair value of the share options was £1,500 and it was expected that the employee would remain in the employment of the company for a three-year period.

On 1 January 2021, changes in the business resulted in the cancellation of the award and the company agreed to settle the award in cash on a pro-rata basis. The sales director received £500 (£1,500 x 1/3) and this amount was recognised in the financial

statements.

The application of FRS 102, para 26.13 states that a cancellation must be accounted for as an acceleration of vesting and the entity should immediately recognise the amount which would otherwise have been recognised for services received over the remaining vesting period. To comply with FRS 102, para 26.13, the entity should also recognise an additional £1,000 (£1,500 less £500) to reflect the acceleration of vesting.