Accounting for Share-Based Payment Transactions – Part 2

(Relevant to PBE Paper I – Financial Accounting)

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Introduction

Share-based payment is one of the most essential topics in PBE Paper I: Financial Accounting. In the first article of our two-part series on this topic, we have explained the definition and classification of share-based payments and the accounting requirements for equity-settled share-based payment transactions. As mentioned in the first part, the basic principle in accounting for an entity's equity-settled share-based payment transactions is that goods and services received are recognized by the entity when the goods are obtained or when the services are received. A corresponding increase in equity is then recorded.

In this second article, we address the accounting treatment for two other types of share-based payment transactions, namely cash-settled share-based payment transactions and share-based payment transactions with cash alternatives.

Cash-settled share-based payment transactions

A cash-settled share-based payment transaction is 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 equity instruments (including shares or share options) of the entity or of another group entity. (Note: Group share-based payment transactions are beyond the scope of PBE Paper I.)

In the above definition, a cash-settled share-based payment transaction occurs when goods or services are paid for at amounts that are based on the price (or value) of the entity's shares or share options. The following are some examples of cash-settled share-based payment transactions:

- An entity may grant share appreciation rights to employees as part of their remuneration package, whereby the employees will become entitled to a future cash payment (rather than an equity instrument), based on the increase in the entity's share price from a specified level over a specified period of time.

- An entity agrees to pay its consultant a fee equal to the price of the entity's shares or share options.

For cash-settled share-based payment transactions, the entity should measure the goods or services acquired and the liability incurred at the fair value of the liability. Unlike equity-settled share-based payment transactions, the liability will continue to be re-measured at its fair value at the end of each reporting period until the full liability is settled. Any changes in the fair value of the liability should be recognized in the profit or loss for that period.

Example 1 illustrates the accounting treatment for cash-settled share-based payment transactions.

<u>Example 1</u>

On 1 January 20X4, Treasure Ltd grants an incentive scheme to each of its 200 employees. The incentive scheme includes a cash payment to be made to the employees equal to the share price of 1,000 of Treasure Ltd's shares at the end of a three-year period, subject to the following conditions:

- The share price must exceed $20.
- The employee must be with the company on 31 December 20X6.
- Vesting begins on 31 December 20X6.

The market prices of Treasure Ltd's shares are as follows:

On 1 January 20X4	$20
On 31 December 20X4	$30
On 31 December 20X5	$33
On 31 December 20X6	$40

Treasure Ltd classifies the incentive scheme as a cash-settled share-based payment transaction in accordance with HKFRS 2 "Share-based Payment".

As the incentive scheme is a cash-settled share-based payment transaction, Treasure Ltd should measure the employee services received and the liability incurred at the fair value of the liability. Further, Treasure Ltd should re-measure the liability at its fair value at the end of each reporting period and on the date of settlement, with any changes in the fair value of the liability recognized in the profit or loss for that period.

Assuming that all of the employees are expected to still remain in service with the company at 31 December 20X6, the following journal entries would be made:

	$'000	$'000
31 December 20X4		
Dr. Employee benefits expense (Staff costs)	2,000	
Cr. Liability		2,000

To recognize the staff service costs relating to the incentive scheme granted to employees for year 20X4. (200 employees x 1,000 shares x $30 x 1/3 years)

	$'000	$'000
31 December 20X5		
Dr. Employee benefits expense (Staff costs)	2,400	
Cr. Liability		2,400

To recognize the staff service costs relating to the incentive scheme granted to employees for year 20X5. (200 employees x 1,000 shares x $33 x 2/3 years – $2,000,000)

31 December 20X6	$'000	$'000
Dr. Employee benefits expense (Staff costs)	3,600	
Cr. Liability		3,600

To recognize the staff service costs relating to the incentive scheme granted to employees for year 20X6. (200 employees x 1,000 shares x $40 x 3/3 years – $2,000,000 – $2,400,000)

31 December 20X6	$'000	$'000
Dr. Liability	8,000	
Cr. Cash		8,000

To recognize cash payment to employees relating to the incentive scheme.

Share-based payment transactions with cash alternatives

Share-based payment transactions with cash alternatives are transactions in which the entity receives or acquires goods or services and in which the terms of the arrangement provide either the entity or the supplier of those goods or services with the choice of whether the entity settles the transactions in cash (or other assets) or by issuing equity instruments.

The recognition and measurement of such transactions depends on whether the entity or the counterparty has the choice of settlement:

(a) If the counterparty has the choice of the settlement, the entity has, in fact, issued a compound financial instrument, which includes a debt component (i.e. the counterparty's right to demand payment in cash) and an equity component (i.e. the counterparty's right to demand settlement in equity instruments rather than in cash). These two components should be separately measured and recognized as follows:
  - (i) The debt component should be accounted for under the requirements of cash-settled share-based payment transactions.
  - (ii) The equity component should be accounted for under the requirements of equity-settled share-based payment transactions.

(b) If the entity has the choice of the settlement, the entity should determine whether it has a present obligation to settle in cash. If such obligation exists, the transaction should be accounted for as a cash-settled share-based payment transaction. Otherwise, it should be accounted for as an equity-settled share-based payment transaction.

Example 2 is modified from "Guidance on Implementing HKFRS 2 Share-Based Payment", Example 13 and illustrates the accounting treatment for share-based payment transactions with cash alternatives where the counterparty has the choice of settlement.

Example 2

On 1 January 20X4, Golden Ltd grants to a managing director the right to choose either 15,000 shares or a cash payment equal to the value of 10,500 shares. The grant is conditional upon the completion of three years' service.

The fair values of Golden Ltd's shares are as follows:

On 1 January 20X4	$100
On 31 December 20X4	$110
On 31 December 20X5	$120
On 31 December 20X6	$125

Golden Ltd estimates that the fair value of the share alternative is $90 per share at the grant date.

Scenario 1: Assume the managing director chooses to receive 15,000 shares at 31 December 20X6.

As the managing director has the choice of the settlement, the transaction is regarded as Golden Ltd's being issuing a compound financial instrument. The fair value of the compound financial instrument is measured as $1,350,000 (15,000 shares x $90), which is split into:

- Debt component: $1,050,000 (10,500 shares x $100)
- Equity component: $300,000 ($1,350,000 – $1,050,000)

The relevant journal entries are as follows:

	$	$
31 December 20X4		
Dr. Employee benefits expense (Staff costs)	485,000	
Cr. Liability (10,500 shares x $110 x 1/3 years)		385,000
Cr. Equity – share capital ($300,000 x 1/3 years)		100,000

To recognize the staff service costs relating to the share alternative granted to the managing director for year 20X4.

31 December 20X5	$	$
Dr. Employee benefits expense (Staff costs)	555,000	
Cr. Liability (10,500 shares x $120 x 2/3 years – $385,000)		455,000
Cr. Equity – share capital ($300,000 x 2/3 years – $100,000		100,000

To recognize the staff service costs relating to the share alternative granted to the managing director for year 20X5.

31 December 20X6	$	$
Dr. Employee benefits expense (Staff costs)	572,500	
Cr. Liability (10,500 shares x $125 x 3/3 years – $385,000 – $455,000)		472,500
Cr. Equity – share capital ($300,000 x 3/3 years – $100,000 – $100,000)		100,000

To recognize the staff service costs relating to the share alternative granted to the managing director for year 20X6.

31 December 20X6	$	$
Dr. Liability	1,312,500	
Cr. Equity – share capital		1,312,500

To recognize the transfer of the debt component to the share capital account.

Scenario 2: Assume the managing director chooses to receive a cash payment equal to 10,500 shares at 31 December 20X6.

If the settlement is in cash rather than equity instruments, the payment made is applied to settle the liability in full. The relevant journal entry is as follows:

31 December 20X6	$	$
Dr. Liability (10,500 shares x $125)	1,312,500	
Cr. Cash		1,312,500

To recognize cash payment to the managing director relating to the share alternative.

Conclusion

Students sitting for PBE Paper I: Financial Accounting must possess the general knowledge of accounting for share-based payment transactions. In this article, we have explained the nature and accounting treatments of cash-settled share-based payment transactions and share-based payment transactions with cash alternatives. Together with the accounting treatments for equity-settled share-based payment transactions as discussed in Part 1 (http://www.hkiaat.org/e-newsletter/Oct-14/technical_article/PBEI.pdf), we believe that students should now possess the knowledge of accounting treatments for different types of share-based payment transactions.