Accounting for Share-Based Payment Transactions – Part 1
(Relevant to PBE Paper I – Financial Accounting)

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Introduction

Many listed companies may provide share-based payment to their employees as part of their remuneration package. Under share-based payment schemes, employees are granted shares or share options for their services provided or performance achieved.

Share-based payment is one of the essential topics in PBE Paper I: Financial Accounting. As the increasing use of share-based payment has raised questions about the accounting treatment of such transactions in company's financial statements, HKFRS 2 "Share-Based Payment" requires an entity to reflect the effects of share-based payment transactions in its profit or loss and financial position.

Our articles are divided into two parts. This first part addresses the definition and classification of share-based payments and accounting requirements for equity-settled share-based payments transactions. The second part will focus on accounting for cash-settled share-based payments transactions and share-based payments with cash alternatives.

Definitions

HKFRS 2 defines a share-based payment 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. (Note: Group share-based payment transactions are beyond the syllabus of PBE paper I.)

In the above definition (a), the transaction is a share-based payment if the entity receives goods from suppliers or services renders from employees by giving equity instruments (e.g. shares or share options) in the entity.

Classification of share-based payments

HKFRS 2 classifies share-based payment transactions into three types:

(a) Equity-settled share-based payment transactions
(b) Cash-settled share-based payment transactions
(c) Share-based payment transactions with cash alternatives

An equity-settled share-based payment transaction is 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 there is no obligation to settle the transaction with the supplier. Examples of such transactions include:

- An entity issues shares or share options to its supplier for the purchase of goods.
- An entity issues shares or share options to its consultant for the settlement of professional services provided.
- An entity issues shares or share options to its employees for their services provided.

The definition and accounting treatment of cash-settled share-based payment transactions and share-based payment transactions with cash alternatives will be discussed in the second article.

Equity-settled share-based payment transactions

The basic principle in accounting for an entity's equity-settled share-based payment transaction is that goods or services received are recognized by the entity when the goods are obtained or when the services are received. A corresponding increase in equity is recognized.

For the purpose of PBE Paper I, we will only discuss share-based payment transactions with employees. When employees provide services to the entity, the entity should recognize the costs as an expense in profit or loss.

Equity-settled share-based payment transactions with employees

When equity instruments (e.g. shares or share options) are granted to employees as part of their remuneration package, HKFRS 2 requires the entity to measure employee's services at the fair value of services received. However, it is not normally possible to directly measure the services received. For this reason, the entity should measure the fair value of the employee services received by reference to the fair value of the equity instruments given at the grant date. The grant date is the date at which the entity and employees agree to a share-based payment arrangement.

Normally, employees are granted shares or share options based on the satisfaction of certain vesting conditions. Vesting conditions are the conditions that determine whether the entity receives services that entitle the counterparty to receive cash or equity instruments in the entity under a share-based payment arrangement. Vesting conditions are either:

(a) service conditions, or
(b) performance conditions.

(a) Service conditions

Service conditions require the employees to complete a specified period of service. For example, the share options granted to the employees vest upon the completion of three years of service by the employees. The employees are not entitled to the share options until they work for three years in the entity. The three-year service period is the vesting condition.

If the equity instruments are vested based on the satisfaction of service conditions, the entity should account for those service costs over the vesting period. The vesting period is the period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

Example 1 is modified from the HKIAAT PBE June 2012 examination paper. It demonstrates the determination of staff service costs under service conditions.

<u>Example 1</u>

AXE Ltd granted 200 share options to each of its 500 employees on 1 January 20X2. The fair value of each share option on 1 January 20X2 is $15. The exercise price of each option is $20. The grant is conditional upon each employee working for AXE Ltd for the next three years. During 20X2, 8 employees left AXE Ltd. At 31 December 20X2, AXE Ltd estimates that another 20 employees will leave during the next two years to 31 December 20X4. During 20X3, 20 employees left AXE Ltd. At 31 December 20X3, AXE Ltd estimates that another 13 employees will leave during the year to 31 December 20X4. During 20X4, 25 employees left AXE Ltd.

As the share options granted are conditional upon the employee's remaining in AXE Ltd for the next three years, the total staff service costs will be recognized as an expense in profit or loss over the three years' vesting period as follows:

Year	Calculation	Expenses for the year	Cumulative expenses
20X2	200 options x 472 (500-8-20) employees x $15 x 1/3 years	$472,000	$472,000
20X3	200 options x 459 (500-8-20-13) employees x $15 x 2/3 years	$446,000	$918,000
20X4	200 options x 447 (500-8-20-25) employees x $15 x 3/3 years	$423,000	$1,341,000

The journal entries to record the effect of share options are as follows:

		$'000	$'000
31 December 20X2			
Dr.	Employee benefits expense (Staff costs)	472	
	Cr. Equity		472

To recognize the staff service costs relating to share options granted to employees for 20X2.

		$'000	$'000
31 December 20X3			
Dr.	Employee benefits expense (Staff costs)	446	
	Cr. Equity		446

To recognize the staff service costs relating to share options granted to employees for 20X3.

		$'000	$'000
31 December 20X4			
Dr.	Employee benefits expense (Staff costs)	423	
	Cr. Equity		423

To recognize the staff service costs relating to share options granted to employees for 20X4.

(b) Performance conditions

Performance conditions require the employees to complete a specified period of service and to meet specified performance targets. For example, the share options granted to the employees might vest upon the completion of three years' service by employees and the entity achieving a 10% gross profit target.

These performance conditions can be further classified into the following categories:

(i) Non-market performance conditions

This is a target that is defined by reference to the entity's own operations or activities: for example, profit targets and sales targets. The principles discussed above in the service conditions also apply to transactions with non-market conditions with employees. However, non-market performance conditions may affect the vesting period or the number of shares (or share options) that will vest. As a result, it may affect the amount of staff service costs to be recognized in each reporting period.

Example 2 demonstrates the determination of staff service costs under non-market performance conditions.

<u>Example 2</u>

ABA Ltd grants share options to each of its 200 employees working in the sales department on 1 January 20X2. The share options will vest on 31 December 20X4 and the employees will have to remain in the company. Other terms are as follows:

(a) if sales increase by an annual average of not less than 8% per year, 200 share options will be granted.

(b) if sales increase by an annual average of 15% or more per year, 300 share options will be granted.

On the grant date, ABA Ltd estimates that the share options had a fair value of $10 per option.

Under non-market performance conditions, the number of share options granted depends on the level of sales achieved. Assume that, on 31 December 20X2, ABA Ltd projected that the sales would increase by an average of 10% per year and 180 employees would remain in the company at 31 December 20X4. The journal entry will be:

31 December 20X2	$'000	$'000
Dr. Employee benefits expense (Staff costs)	120	
Cr. Equity		120

To recognize the staff service costs relating to share options granted to employees for 20X2 (180 employees x 200 share options x $10 x 1/3)

During 20X3, the sales increased sharply and ABA Ltd now estimated that sales would increase by an average of 16% per year and a total of 170 employees would remain in service at 31 December 20X4. The journal entry will be:

31 December 20X3	$'000	$'000
Dr. Employee benefits expense (Staff costs)	220	
Cr. Equity		220

To recognize the staff service costs relating to share options granted to employees for 20X3 (170 employees x 300 share options x $10 x 2/3 - $120,000)

During 20X4, the sales increased sharply and ABA Ltd achieved an average increase of sales of 18% per year. At 31 December 20X4, a total of 160 employees remained in service.

31 December 20X4	$'000	$'000
Dr. Employee benefits expense (Staff costs)	140	
Cr. Equity		140

To recognize the staff service costs relating to share options granted to employees for 20X4 (160 employees x 300 share options x $10 x 3/3 – $120,000 – $220,000)

If the sales had dropped during 20X4 causing the average increase in sales to be less than 8%, the staff service cost previously recognized should be reversed.

(ii) Market performance conditions

This is a target that is based on the market price (or value) of the entity's equity instruments: for example, achieving a specified share price target. Unlike non-market performance conditions, market performance conditions should be included in the determination of the fair value of the equity instrument at the grant date.

Conclusion

Students sitting PBE Paper I: Financial Accounting must possess a general knowledge of accounting for share-based payment transactions. In this article, we have explained the nature of share-based payment transactions and the accounting treatment of equity-settled share-based payment transactions. The next article in this series will look at the other two types of share-based payment transactions: cash-settled share-based payment transactions and share-based payment transactions with cash alternatives.