COMMON ISSUES IN ACCOUNTING FOR SHARE-BASED PAYMENTS

Providing share-based remuneration to senior employees and directors is a common way to incentivise, or simply "lock in" key people. It can also be an effective way for early-stage businesses to minimise cash outflow by using share-based payment to pay other key suppliers.

However, AASB 2 Share-based Payments is a challenging standard to implement, both due to its complexity, and because many entities make such transactions only relatively infrequently, and therefore may not be familiar with the detailed accounting requirements. A small change in the terms of an agreement can sometimes lead to a significantly different accounting treatment, meaning that it is easy to make inadvertent mistakes in its application.

In this article, Ralph Martin, RSM Australia's National Technical Director, takes a look at some areas that commonly cause difficulty in accounting for share-based payments.

HOW MUCH ARE THEY WORTH?

Payments to Suppliers other than Employees

Share-based payments to employees are initially valued at the grant date, and are usually valued using Black Scholes, Monte Carlo, Binomial, or similar methods. However, a common mistake is to apply these valuation techniques to payments to suppliers other than employees, such as brokers, bankers, suppliers of goods, or service providers.

AASB 2 contains a rebuttable presumption that, for transactions with parties other than employees, the share-based payment shall be valued based on the fair value of the services received, not the fair value of the shares or options issued. It is only where the fair value of the goods received cannot be reliably determined that the fair value of the equity instruments issued should be used.

So, where you have share-based payments with non-employees, such as professional advisers, don't immediately reach for your Black Scholes calculator or other valuation method. It may not be the right way to determine what expense you should recognise. Where the supplier also supplies the same or similar goods or services for a cash price, then this would represent the fair value that should be recognised as an expense.

EXAMPLE 1

Prospero Ltd acquires some IT equipment from Miranda Pty Ltd. Under the terms of the sale agreement, Prospero will pay Miranda in shares, rather than in cash. It provides Miranda with 100,000 shares, and its share price on the date that the equipment is delivered is $0.50 per share. The retail price of the IT equipment is $40,000.

Prospero should ignore the fair value of the consideration paid ($50,000) and recognise the cost of the equipment based on the fair value of the goods received. It would therefore recognise the following entry:

Dr Property Plant and Equipment	$40,000
Cr Issue Capital	$40,000

WHICH STANDARD APPLIES?

Liabilities settled using shares

Using an entity's own shares to settle liabilities can be an effective way to preserve cash, particularly in uncertain economic times. However, the accounting treatment will differ depending on when the agreement to settle a liability in shares was reached.

- Where the terms of the arrangement originally included share-based payment as an option or a requirement, then the arrangement falls under AASB 2 Share-based payments or AASB 9 Financial Instruments for contracts relating to financial instruments (for example, the issue of convertible debt)

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- Where the terms of an arrangement originally contemplated that a liability would be settled in cash, but there is a later agreement that the liability should be settled through the issue of shares, then Interpretation 19 Extinguishing Financial Liabilities with Equity Instruments applies
- However, there is a scope limitation to Interpretation 19 which excludes transactions where the creditor is a direct or indirect shareholder acting in their capacity as a shareholder. In such instances, the transaction is recorded within equity

This distinction is important, because, as noted above, AASB 2 would require only that an expense for the fair value of the goods and services received is recognised. However, under Interpretation 19, any difference between the fair value of the goods or services received and the fair value of the equity instruments issued is recognised in the income statement.

EXAMPLE 2

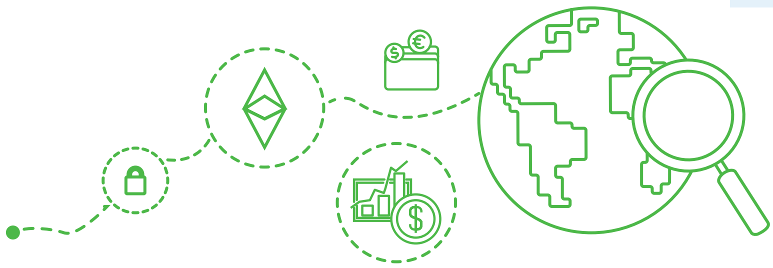
As in Example 1 above, Prospero Ltd acquires some IT equipment from Miranda Pty Ltd. However, in this scenario, no share-based payment is initially contemplated, and the terms of the contract are that the purchase will be paid for in cash. The retail price of the IT equipment is $40,000, and Prospero records a trade payable for this amount.

Dr Property Plant and Equipment	$40,000
Cr Trade Payables	$40,000

Three months later, due to cash-flow problems, Prospero approaches Miranda with an offer to settle the liability by issuing 100,000 of its own shares. The fair value of Prospero's shares is $0.50 per share.

Miranda accepts the offer. In this scenario, Prospero applies Interpretation 19, and therefore recognised the following entries:

Dr Trade Payables	$40,000
Dr Loss on settlement of liability	$10,000
Cr Issued Capital	$50,000



WHEN IS A LOAN NOT A LOAN?

Arrangements with Limited Recourse Loans

A common arrangement for many companies is to provide directors with a limited recourse loan to acquire shares in the entity. Typically, under such arrangements, the company makes a loan to the employee, who must then use the loan to acquire shares in that company. The shares are then held in trust for the employee until the loan has been paid. However, the loan is "limited-recourse" meaning that in the event of non-payment, the company's only recourse is to the shares issued.

A common error is to treat such an arrangement as a loan, and recognise a loan receivable on issue of the shares. However, the substance of such an arrangement is that the employee has an option to acquire the shares. If the share price has increased, they are likely to repay the loan, and therefore gain from the increase in the entity's share price. However, they have no obligation to pay the loan, as they can simply choose to return the shares instead. It would therefore be inappropriate to recognise a loan receivable, as the issuing entity has no contractual right to receive any cash.

> The correct accounting treatment is to treat the arrangement as a grant of share options, where the option is deemed to be exercised on the date that the loan is repaid.

EXAMPLE 3

Ariel Ltd, an ASX listed company, provides a limited-recourse loan of $1m to a key employee, which the employee must use to buy 200,000 shares at $5 each. The shares are to be held in trust for three years, after which the employee must either repay the loan or forfeit the shares. The shares are automatically forfeited if the employee ceases employment before this time.

Under AASB 2, this arrangement would be treated as the issue of 200,000 options with a vesting period of three years, and an exercise price of $5. The options would be fair valued on the grant date, and the fair value would be recognised as an expense over the three year vesting period.

A STING IN THE TAIL

Modifications and Cancellations

Sometimes, share-based payment awards are modified or cancelled before they vest. This may be because the company is in financial difficulty, or because the vesting conditions have become so difficult to achieve, or the share price has fallen so significantly, that there is very little chance that it will ever be "in the money" and therefore be exercised. However, the results from such changes can often be counter-intuitive, with actions which might appear favourable to the company issuing the shares resulting in accelerated recognition of expenses. In summary:

- Where equity-settled share-based payments are modified in the employee's favour, (thereby increasing the fair value of the award) the additional cost must be recognised over the period from the modification date to the vesting date
- Where equity-settled share-based payments are modified in the issuing company's favour, no change to the accounting occurs – the original expense based on the fair value on the date of the original grant continues to be recognised.
- Where equity-settled share-based payments are cancelled by the employer during the vesting period, the entire remaining expense is recognised immediately.

EXAMPLE 4

Caliban Plc issues performance rights to its employees on 1 July 2019. The performance rights have a vesting period of 3 years, and a fair value of $3 million. It therefore recognises a $1m expense in the year ended 30 June 2020.

On 1 July 2020, Caliban Plc decides that, due to very significant falls in its share price, the scheme no longer has any motivational value to employees, and cancels it with immediate effect. The result would be that Caliban Plc would recognise an immediate expense of $2m on 1 July 2020.

WHEN DO THEY VEST?

The Importance of Service Conditions

The expense of share-based payments is recognised over the vesting period. However, a common mistake in accounting for share options is to fail to differentiate between a vesting period and an exercise period. A vesting period is the period over which there is a service condition, meaning there is an obligation to complete a specific period of employment or similar service, and if that service is not completed, regardless of the reason, the share-based payment does not vest. There may be other performance conditions, but regardless of whether they exist, there must be a service condition in order for there to be a vesting period.

If there is no service condition within the terms of the grant, then there is no vesting condition and therefore and no vesting period. This means that the expense must be recognised immediately. This can lead to unexpected or unwelcome results where service conditions are not explicitly included in grant agreements.

EXAMPLE 5

Juno Ltd issues performance rights to its sales director which will vest based on the revenue growth of the company. If revenue grows by 20% or more over the next 2 years, she will receive 100,000 shares, and she will receive a further 100,000 shares if revenue grows by 40% or more over that time. However, the terms of the grant do not state that she must remain employed by Juno Ltd in order to receive the performance rights.

While there might appear to be a vesting period over which the grant accrues, the lack of any service condition means that this period cannot be treated as a vesting period. Instead, the performance rights would be fair valued at the grant date, with the fair value determination taking into account the probability of the hurdles being met. This amount would be recognised as an expense immediately, and would not be subject to any further adjustment, regardless of whether the performance hurdles are met.

For further information

For further information about accounting for share-based payments, please contact Ralph Martin, or your own local RSM adviser.