Looking to create a share scheme?

Don't forget the accounting!

Share-based payments

Share-based payment arrangements can be powerful tools for companies to align the interests of their employees with the interests of their shareholders. These arrangements can represent a significant portion of the remuneration paid to employees, directors, and service providers, particularly for start-up companies. As a result, the identification, measurement, and disclosure of share-based payment arrangements can be material to the entity's financial statements.

If your organisation is creating a share-based payment arrangement, you should consider the terms and the resulting accounting treatment upfront. Different structures, such as payments made in shares or payments made in cash for amounts that are based on the price of shares, can result in significantly different impacts to profit or loss and the balance sheet.

Considering the accounting upfront will enable you to design a plan that not only provides the right incentives to employees, but will result in an accounting treatment that reflects the way the directors and management think about the business.

Early planning will also allow you to meet your financial reporting deadlines. Many share-based payment arrangements require a difficult valuation exercise, particularly for privately-held entities where it can be challenging to measure certain inputs to the valuation model, such as the current fair value of the entity's shares.

Adequate time should be allocated to perform the valuation and to draft the required financial statement disclosures, which can be extensive. In this publication we highlight a few of the key accounting considerations that should be taken into account when designing a share scheme.

Identifying share-based payments

Share-based payment arrangements can turn up in surprising places! The scope of NZ IFRS 2 *Share-based Payment* is wide and includes arrangements for the purchase of goods or services in exchange for either equity instruments or cash amounts based on the price of the entity's equity instruments (or an arrangement where one party has a choice over the manner of settlement). Consideration of the substance of the arrangement (rather than legal form) is critical to identifying the appropriate accounting treatment.

Examples of share-based payment arrangements include:

- Share appreciation rights
- Non-recourse loans to purchase shares (in-substance options)
- Restricted share plans where restrictions are only lifted upon completion of a service period
- Certain employee share purchase plans

NZ IFRS 2 is not limited to employee remuneration arrangements. Contracts with service providers (such as advisers or fund managers) may require them to apply payments to purchase equity instruments of the entity. Compensation agreements should be scrutinised carefully to determine whether they may be within the scope of the Standard.

Classification of the arrangement

A share scheme must be classified as either equity-settled or cash-settled based on the terms of the agreement. Any arrangement which could result in the entity settling the arrangement in cash would be classified as cash-settled.

Example:

A closely held company issues shares to employees under a share-based remuneration scheme. The scheme permits (or requires) employees to sell those shares back to the company when they leave or retire. Since the company will ultimately be required to pay cash, this is a cash-settled share-based payment arrangement.

The classification is important because the two types of arrangements have significantly different accounting outcomes.

Classification of an arrangement as cash-settled will result in the recognition of a liability on the balance sheet that must be remeasured to fair value each reporting period until it is settled, with any change in fair value recorded in profit or loss. Where an entity's share price is increasing, the entity may be required to record a large expense. The valuation exercise may also result in additional administrative and financial burdens, particularly for long-term arrangements.

In contrast, the fair values of equity-settled share-based payments are measured at the grant date and are not subsequently revalued.

Caution:

Terms which could significantly impact the accounting for a share scheme could be hidden in a number of different documents, including the entity's founding documents, shareholder agreements, contracts with employees, and any scheme documents. All relevant documents must be examined.

Determining the grant date

Equity-settled share-based payments to employees are measured at the grant date, which is the date when the entity and the employee have a shared understanding of the terms and conditions of the arrangement. Judgement may be required in determining the grant date, particularly where significant time elapses between the date the plan is communicated to the employee and the date any required approval process and documentation are complete. The determination of the grant date can have a significant impact on the valuation (and therefore expense) where the share price is increasing.

Timely negotiation, documentation, and approval of share plans can reduce this impact.

Determining the vesting period

Share-based payment expense is recognised over the vesting period, which is the period over which all specified vesting conditions must be met. The expense recognition for share awards which vest in tranches is accelerated compared to the expense recognition for awards which all vest at once.

Vesting Examples:
1) Employee A will receive 200 shares at the end of 2 years of service. The entity will recognise half of the expense in each year.
2) Employee B will receive 100 shares at the end of year 1 and another 100 shares at the end of year 2. The entity will recognise the entire expense for the first tranche in Year 1. The entity will recognise half of the expense for the second tranche in each year. The total expense for Employee B in Year 1 will therefore be three times the expense for Employee B in Year 2.

Evaluating the impact of performance targets

Share schemes may include performance targets that must be met in order for the employee or service provider to receive the share-based payment. The impact of a performance target depends on whether it is a market condition (related to the price of an entity's equity instruments) or a non-market condition.

Non-market conditions, such as sales or EBITDA targets, are taken into account by adjusting the expense each period based on the number of instruments expected to vest. The expense is trued up each period until vesting, which can result in volatility in profit or loss. In contrast, market conditions, such as meeting a specified share price, are included in the valuation of the share award at the grant date. As a result, the entity will recognise expense in profit or loss even where those market conditions are not met if the employee satisfies all other vesting conditions.

Modifications to share plans

A company may modify a share-based payment arrangement, for example by reducing the exercise price or changing performance conditions. The modification may arise due to changes in the circumstances of the entity or may be required to correct unintended consequences that were not considered at the time the plan was created. Accounting for modifications can be complex and can result in volatility in profit or loss.

Arrangements within a consolidated group

Employees of a subsidiary company may be eligible to receive equity instruments of the parent (which could be an overseas entity). The subsidiary company which is receiving the employee services must recognise the share-based payment expense regardless of which entity operates the compensation plan. However the classification of the transaction as equity-settled or cash-settled depends on both how it is settled (cash or equity) and which entity has the obligation to settle the arrangement with the employee (e.g. the subsidiary or the parent).

Additionally, the classification (and therefore the accounting treatment) in the financial statements of the subsidiary may be different to the treatment in the consolidated financial statements of the parent. For example, where a subsidiary has a direct obligation to acquire shares of its parent to provide to its employees, the subsidiary must account for the transaction as cash-settled even though the arrangement will be treated as equity-settled at the group level.

In practice, it may be difficult to determine which entity has the obligation to settle the arrangement. All relevant documents should be examined and significant judgement may be required.

The subsidiary must also consider the treatment of any intra-group recharge payments which may be required when the parent is responsible for settling the arrangement. This can be complex, particularly where the timing or amount of the recharge is different to the expense calculated in accordance with NZ IFRS 2.

Other matters giving rise to accounting complexity

The following matters may also give rise to accounting complexity:

- Equity instruments issued to former owners in connection with a business combination
- Cancellation, replacement, or other modification of share-based payment arrangements because of a business combination
- Instruments issued with share and option exercise prices denominated in a foreign currency
- Share plan operated through a trustee company which may need to be consolidated

Tax treatment of the share scheme

The tax treatment for employee share schemes must also be considered when determining the terms of the arrangement to ensure there aren't adverse outcomes for the company and/or the employees, especially in terms of the timing of tax payments.

How we can help

We have an experienced team of professionals who can assist you in developing a share scheme that is tailored to your entity's circumstances, including:

- accounting expertise to help you ensure the terms of the scheme will result in financial reporting outcomes that appropriately reflect the entity's goals in creating the scheme,
- tax expertise to make sure there aren't adverse taxation outcomes for the entity, its investors and its employees, and
- valuation expertise to assist you with determining the fair value of the options or shares granted.

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