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NZ IFRS 2 – the differential treatment of cash and equity settled transactions

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New Zealand Equivalent to IFRS 2 *Share-based Payment* (NZ IFRS 2) became effective on a voluntary basis from 1 January 2005.

NZ IFRS 2 deals with the recognition and measurement of share-based payment transactions. These are arrangements in which an organisation receives goods or services as consideration for its own equity instruments (shares, share options or other equities), or acquires goods or services for amounts that are based on the price of its equity instruments.

The main effect of this standard is that it requires recognition in the financial statements of the goods or services acquired or received under share-based payment arrangements, regardless of whether the form of settlement is cash or equity and regardless of whether the counterparty involved is an employee or other party.

Most commonly the counterparty to a share-based payment transaction is an employee, with share plans and share option plans being increasingly used as a means of attracting and retaining employees, and of aligning employees' interests with those of the organisation. The corporate governance statement provided by Macquarie Bank Ltd in its 2004 annual review provides an example of the rationale for engaging in share-based payment transactions with employees, and of the types of vesting, performance and market conditions that might be incorporated into some employee share plans (see http://www.macquarie.com.au/au/about_macquarie/investor_information/ar2004/corporate_governance4.htm). In return for its own equities, an organisation may also acquire goods or property (such as land) or services such as financial or strategic advice from parties other than employees.

Prior to the issue of this accounting standard there was no requirement to identify, measure or recognise share-based payment transactions in an organisation's financial statements. As a result, shareholders may not have been aware of the existence, cost or the potential dilutive effect of share-based payment transactions. NZ IFRS 2 adopts the view that all share-based payment transactions ultimately lead to expense recognition, and it requires organisations to reflect the effects of such transactions in profit and loss. This treatment applies to all share-based payment transactions, whether with employees or others and whether settled in cash or in equity instruments. Thus it is generally expected that the introduction of NZ IFRS 2 will lower the reported earnings of organisations which are significant users of share-based payment transactions.

NZ IFRS 2 deals with three forms of share-based payment transactions:

- equity-settled share-based payment transactions, in which an organisation receives goods or services as consideration for its own equity instruments (such as shares or share options)
- cash-settled share-based payment transactions, in which an organisation acquires goods or services by incurring liabilities to the supplier for amounts that are based on the value of its own equity instruments
- other transactions in which an organisation receives or acquires goods or services and the terms of the arrangement allow either the organisation or the supplier to choose whether the transaction is settled in cash or by the issue of equity instruments.

NZ IFRS 2 applies differential treatment to transactions settled in cash and transactions that are equity settled. While goods or services received in a share-based payment transaction must be recognised when they are received, if they were received under an equity-settled transaction, the corresponding increase is to equity, whereas if the transaction is cash-settled, the corresponding increase is recognised as a liability.

Recognition of an equity-settled share-based payment:

Asset or Expense	Dr	$XX
Equity	Cr	$XX

Recognition of a cash-settled share-based payment:

Asset or Expense	Dr	$XX
Liability	Cr	$XX

If a share-based payment transaction is settled in cash, the general principle employed is that the transaction is measured at the fair value of the liability. Until it is settled, the fair value of the liability is remeasured at each reporting date and at the date of settlement, and any changes in fair value are recognised in profit or loss. In contrast, for transactions that are equity-settled, the general principle is that the goods or services received and the corresponding increase in equity are measured at the fair value of the goods or services received. Remeasurement of the granted equity instruments at subsequent reporting dates and settlement date does not occur.

Effectively, the fair value of a transaction classified as equity is measured at grant date or at the date of receipt of the goods or services, and subsequent value changes are ignored. In contrast, the fair value of transactions classified as liabilities (debt) are adjusted to fair value at each reporting date and the resulting profit or loss is included in the measurement of income.

This differential treatment has the potential to bring with it some undesirable consequences ranging from "transaction structuring to meet reporting goals" to "estimate manipulation that goes uncorrected due to a lack of truing up" (AAA 2004, p66). Arguably, items that are economically identical, such as the outflow of an organisation's resources through share-based payment transactions, should be accounted for in an identical way.

It is normally considered that the fair value of services received in transactions with employees cannot be measured reliably. Thus, the fair value of the services received from employees is measured by reference to the equity instruments granted, at grant date. However, for transactions with other counterparties, there is a presumption in NZ IFRS 2 that the fair value of goods or services can (except in rare cases) be estimated reliably. Where the fair value cannot be estimated reliably, the transaction must be measured indirectly by reference to the fair value of the equity instruments granted at the date the goods or services are obtained. In summary, the value of equity-settled share-based payments are measured and recognised as follows.

Recognition of an equity-settled share-based payment in which fair value of goods or services can be reliably estimated:

Asset or Expense	Dr	Fair value of goods or
Equity	Cr	services received or acquired

Recognition of transactions with employees, and transactions where fair value of goods or services cannot be reliably estimated:

Asset or Expense	Dr	Fair value of the equity
Equity	Cr	instruments granted

Another important feature of NZ IFRS 2 is that it allows an organisation to choose the valuation model it considers to be most appropriate in determining fair values. The valuation technique must be consistent with generally accepted valuation methodologies for pricing financial instruments. It must also account for the terms and conditions of the equity instruments such as whether or not an employee is entitled to receive dividends during a vesting period, and any other factors and assumptions that knowledgeable, willing market participants would consider in setting the price.

If market prices are not available or if the equity instruments are subject to terms and conditions that do not apply to traded equity instruments, then a valuation technique such as the Black-Scholes-Merton formula, or a binomial model, might be used to estimate the price of the options. Binomial models are "more versatile than the Black-Scholes model in incorporating early exercise" (Saly, Jagannathan and Huddart 1999, p223). It should be noted that determining the fair value of equities where various models are in use and where various estimates are required to be made under those models will do little to reduce ambiguity in valuation of share-based payment transactions.

NZ IFRS 2 includes a lengthy set of disclosure requirements designed to enable financial statement users to understand the nature, extent and effect of share-based payment arrangements and to reveal how the fair value of goods or services received or equity instruments granted was determined. For instance, if the fair value of goods or services received has been measured directly, the organisation must disclose how that fair value was determined (for example, at market price). However, if it has been measured indirectly by reference to the fair value of the equity instruments granted, an extensive set of detailed disclosures must be made including a description of each type of share-based payment arrangement and the general terms and conditions and methods of settlement.

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