ED ASCG Implementation Guidance IFRS (ASCG ED IG 4)

Exposure Draft ASCG Implementation Guidance on IFRS 2

Equity-settled share-based payments with net settlement features: Accounting for cash compensation

All interested individuals and organisations are invited to submit comment letters to info@drsc.de by 11 August 2017. The comment letters will be published on our website unless expressly requested otherwise by the submitter.

Introduction

Accounting Standards Committee of Germany

The Accounting Standards Committee of Germany (ASCG) has been mandated to develop principles for financial reporting in consolidated financial statements, to advise the legislature on the development of financial reporting, to represent the Federal Republic of Germany on international accountancy bodies and to develop interpretations of international financial reporting standards within the meaning of section 315e(1) of the *Handelsgesetzbuch* (HGB – German Commercial Code).

Note on application

'ASCG Implementation Guidance (IFRS)' or the 'Implementation Guidance' differs from interpretations of the international financial reporting standards within the meaning of section 315a(1) of the HGB (ASCG Interpretations (IFRS)) in that it is not interpretative, but instead offers guidance on international accounting issues by providing descriptive guidance and clarifications on the appropriate application of IFRSs. Such pronouncements may address issues that extend beyond those of predominantly national relevance.

Implementation Guidance is adopted after careful consideration of all relevant circumstances, in particular taking account of all effective IFRSs, the IASB Framework, any Observer Notes and the deliberations of the IFRS Interpretations Committee, as well as the comments received, and after holding public hearings.

Implementation Guidance adopted by the ASCG applies unless and until other specific pronouncements to the contrary are issued by the IFRS Interpretations Committee or the IASB. It serves as guidance for the accounting treatment of the relevant issues in financial statements prepared in accordance with the applicable pronouncements of the IASB.

Entities in Germany which state that their financial statements have been prepared in accordance with IFRSs are recommended to consider the Application Advice when assessing individual cases.

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Editor

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List of Abbreviations and Terms used

ASCG	Accounting Standards Committee of Germany
vesting period	The period during which the conditions of the share-based payment arrangement (vesting conditions, ie service and/or performance conditions) are to be satisfied
CU	currency unit(s)
grant date fair value	The fair value of the promised equity instruments at the grant date
IAS(s)	International Accounting Standard(s)
IASB	International Accounting Standards Board
IFRS(s)	International Financial Reporting Standard(s)
no.	number
para.	paragraph

Equity-settled share-based payments with net settlement features: Accounting for cash compensation

Applicable IFRSs: IFRS 2 *Share-based Payment*

The general materiality thresholds also apply to this Implementation Guidance. To the extent that the disclosures in accordance with IFRS 2 are also applicable to the disclosures on the remuneration of key management personnel in accordance with IAS 24 Related Party Disclosures*, the assessment of materiality in light of IAS 24 is also relevant.*

Scope

1.
This Implementation Guidance addresses the accounting for equity-settled share-based payments with net settlement features for which an entity pays cash compensation to employees because of an excess of equity instruments withheld. It is based on IFRS 2 *Share-based Payment* and reflects the amendments to IFRS 2 issued on 20 June 2016. Entities are required to apply the amendments to IFRS 2 for for annual periods beginning on or after 1 January 2018.

Background and Issues

2.
Tax laws and regulations in many countries (including Germany) oblige entities to withhold an amount for an employee's obligation in respect of taxes and similar levies associated with the payment of cash and non-cash remuneration (eg wages and salaries, remuneration in kind, share-based payment) and to pay this amount to the tax authorities – normally in cash – on behalf of the employee.

3.
Many equity-settled remuneration arrangements therefore provide for a 'net settlement' feature: the entities agree with the employees that, when the equity instruments are transferred, a portion of the total number of vested instruments will be withheld equal to the tax prepayment to be paid by the entity for the employee.

4.
Following the amendments to IFRS 2 issued on 20 June 2016, the Standard now includes an exception for share-based payment arrangements with net settlement features: such arrangements are also classified and accounted for as 'equity-settled' in their entirety in cases where, on transfer of the vested equity instruments, the entity withholds a portion of these equity instruments for taxes and similar levies owed in connection with share-based payments and pays the monetary value of the withheld equity instruments to the tax authorities in cash. IFRS 2 also specifies that this relates to taxes and similar levies owed by the employee that are paid to the tax authorities by the entity on behalf of the employee. Additionally, to qualify for this accounting exception, the entity must be obliged by tax laws or regulations to withhold an amount of a share-based payment for taxes and similar levies owed by the employees in this connection (see IFRS 2.33E – 33H(a)).

5.
The payment to the tax authorities is accounted for as a repurchase of equity instruments by the entity (see IFRS 2.33G). Equity is therefore reduced at the assumed repurchase date by the amount of the fair value of the repurchased equity instruments at the hypothetical repurchase date.

6.
In countries with progressive tax rates (eg Germany), entities often use the employees' top marginal tax rate when calculating the number of equity instruments to be withheld, with the result that they may pay a very high amount of taxes or similar levies. In many cases, it emerges at the date of the

payment to the tax authorities that the top marginal tax rate assumed for the withheld equity instruments was too high, and that too many equity instruments were therefore withheld by the entity.

7.
If the entity compensates the employee for the excess of equity instruments withheld by paying a cash amount representing the difference between the value of the equity instruments withheld at the date of their transfer to the employee and amount paid to the tax authorities, the transaction contains a cash payment element that is required to be classified and accounted for as a ‘cash-settled share-based payment’ (see IFRS 2.33H(b)). A comparable scenario arises if the taxes and similar levies payable by the entity cannot be matched precisely by shares. This is the case, for example, if four shares have vested at a fair value of CU 100 each and – assuming a tax rate of 40% – CU 60 is paid to the tax authorities. In this case, the entity can withhold one or two shares, but not 1.6 shares (40% × 4 = 1.6).

8.
The requirement set out in para. 33H(b) does not specifically address the following questions, and it is the intention of this Implementation Guidance to answer them:

a) At what point is it necessary to present the cash compensation separately as a cash-settled share-based payment?
b) How is it accounted for?

At what point is it necessary to present the cash compensation separately as a cash-settled share-based payment?

9.
Payment of cash compensation for an excess of shares means that the share-based payment is implemented using two different mechanisms, which must be classified accordingly: the portion of the arrangement that is settled in equity instruments is classified as ‘equity-settled’, while the portion that is paid in cash (the cash compensation) is classified as a ‘cash-settled share-based payment’.

10.
In principle, separate accounting for both remuneration mechanisms starting on the grant date is indicated. However, IFRS 2.33H(b) addresses the exceptional case where the accounting for the entire share-based payment transaction is bifurcated into an equity-settled portion and a cash-settled portion, but only when the cash compensation is paid to the employee. Consequently, prior periods are not adjusted.

11.
The objective of bifurcating the entire transaction when the cash compensation is paid is to recognise the previously unrecognised expense through a cumulative catch-up adjustment. The total expense recognised for this payment between the grant date and the settlement date thus corresponds to the amount that would have been recognised during this period if the entity had bifurcated the recognition of the entire share-based payment transaction from the beginning of the vesting period.

How is it accounted for?

12.
The cash compensation paid to the employee is accounted for separately as a ‘cash-settled share-based payment’ by deducting the excess of equity instruments withheld from equity on the basis of the grant date fair value. The obligation to pay cash compensation to the employee is recognised as a liability (in the amount of the excess of equity instruments withheld, based on the settlement date fair value). The difference between the amount of the liability to the employee and the amount deducted from equity corresponds to the previously unrecognised change in the fair value of the equity instruments, since ‘equity-settled share-based payments’ are measured based on the grant date fair value of the equity instruments. However, because these fair value changes are to be recognised for ‘cash-settled

share-based payments', the previously unrecognised effect on profit or loss is recognised in profit or loss using a catch-up adjustment.

13.
This scenario was illustrated in the deliberations of the IFRS Interpretations Committee and the IASB using an example that was not, however, incorporated into IFRS 2. This example is presented in the following:

> The entity's promise relates to 100 shares in four years, provided that the employee stays with the entity until this period has expired.
> The grant date fair value of a share at the beginning of Year 1 is CU 2. The fair value has risen to CU 10 per share by the end of Year 4.
> Tax regulations covering share-based payments require the entity to withhold an amount for the taxes and similar levies owed by the employee in this connection, and the terms and conditions of the arrangement provide for net settlement in shares.
> The entity assumes a top marginal tax rate of 40% to calculate the number of shares to withhold.
>
> Because equity instruments in equity-settled share-based payment arrangements are not remeasured after the grant date, ie the grant date fair value is used to measure them at the following reporting dates, the entity recognises CU 50 both as a personnel expense and in equity for each of Years 1 to 4 (100 shares × CU 2 = CU 200; CU 200: 4 years = CU 50/year). This means that CU 200 has been recognised in equity as a share-based payment by the end of Year 4.
> Based on the assumed tax rate for the equity instruments withheld (40%), the entity transfers 60 shares to the employee and withholds 40 shares. When the taxes and similar levies are paid to the tax authorities, however, it emerges that the actual amount payable is CU 350, rather than CU 400, as the assumed top marginal tax rate was too high. Consequently, the entity withheld 5 shares too many. As a result, the entity pays cash compensation of CU 50 to the employee (5 shares at the settlement date fair value of CU 10).
>
> Accounting entries
>
> 1. Recognition of the personnel expense during the vesting period (cumulative for Years 1 to 4):
>
> | | | | | |
> |---|---|---|---|---|
> | • | Dr Personnel expense | 200 | Cr Equity | 200 |
>
> 2. Recognition of the tax liability and payment to the tax authorities:
>
> | | | | | |
> |---|---|---|---|---|
> | • | Dr Equity | 350 | Cr Liability to tax authorities | 350 |
> | • | Dr Liability to tax authorities | 350 | Cr Cash | 350 |
>
> 3. Cash in lieu paid to the employee and separation of the cash transaction:
>
> | | | | | |
> |---|---|---|---|---|
> | • | Dr Equity | 10 (5 shares × CU 2) | | |
> | | Dr Personnel expense | 40 | Cr Liability to employee | 50 |
> | • | Dr Liability to employee | 50 | Cr Cash | 50 |
>
> <u>Explanations:</u>
>
> (1) The total personnel expense recognised and the corresponding entries in equity are identical to a scenario without net settlement. During the vesting period, 100 shares with a grant date fair value of CU 2 are accounted for as an equity-settled share-based payment.
>
> (2) In accordance with IFRS 2.33G, the actual payment to the tax authorities is accounted for as a repurchase of equity instruments. Equity is therefore reduced to CU 350.

(3) The promise of 100 shares is accounted for until settlement as an ‘equity-settled share-based payment’. This also includes the 5 excess shares withheld at the date of settlement. However, because these 5 shares are actually settled in cash, the value of these shares must be deducted again from equity. The relevant value here is the grant date fair value of CU 2, because these 5 shares were previously recognised in equity at this amount. Equity is therefore reduced by CU 10. By contrast, to measure the liability in the case of cash-settled share-based payments, the fair value of the shares at each reporting date and at the settlement date must be used. The fair value at the settlement date is CU 10 per share. The value of the liability to the employee is thus CU 50 (5 shares × CU 10). The CU 40 difference is recognised as a personnel expense. As a result, the total personnel expense over the period of the grant (starting in Year 1) until settlement (end of Year 4) is CU 240. This amount corresponds to the total personnel expense that the entity would have had to recognise over the period from the grant date to the settlement date if it had bifurcated the recognition of the share-based payment transaction from the beginning of the vesting period, using the two different recognition mechanisms.