

Share based payment, IFRS 2 from IASB April 2004

- **Notes based on**
 - ED2 November 2002 from IASB and
 - IFRS 2
- **Purpose of option plan is to align incentives of managers & employees with shareholders**

- **Structure of typical option plan**
- **grant date (date of agreement)**
 - agreement will normally specify conditions over a given period before options are issued. For example,
 - remaining employed with the company
 - the company performance reaching a benchmark level
- **vesting period**
 - the period after the grant date when the grant of the shares is conditional
 - options are issued after the vesting period

US GAAP

- **Accounting Principles Board 25 (1972)**
- **still in force**
- **for fixed plans (ie those not dependent on performance)**
 - expense is measured at intrinsic value, at grant date
 - intrinsic value = current share price - exercise price
 - normally zero!
- **for performance related plans**
 - treat as expense at measurement date, when it is clear how many options are going to be issued
 - that is, **measurement date is at the end of the vesting period**
- **very few plans like this in US**

- **Statement of Financial Accounting Standard 123 (1995)**
- **plans with non employees, treat as expense**
 - at fair value of options (BS or binomial)
 - or fair value of good-services provided

- **plans for employees**
 - as for non employees, but *voluntary*
 - if not adopt, must make disclosure about the expense
 - FASB make it clear that not happy with this, but "to bring closure to this divisive debate"
 - disclosure not good substitute for measurement
 - few companies have adopted SFAS 123

IFRS 2, Share based payment

Basics

- **charge fair value (fv) at the time of grant to P&L over the vesting period**
- **for non employees, normally fv is the value of good-services**
- **for employees, fv is the value of option, since can't identify the specific services provided**
- **vesting conditions taken in to account by adjusting the number of shares**
 - ie, at the end of the vesting period, no expense charged over the period unless conditions have been satisfied
 - but different from APB25 (where P&L charge is at vesting)

Deal with potential issues

- **"no cost to the entity"**
 - consumption of resources received
 - a real cost to shareholder, diluting the eps
- **"eps hit twice"**
- **once in the P&L, then through dilution when option is exercised**
 - but this is the economic substance
 - as if
 - raising cash by issue of option
 - paying cash to employees
 - having to issue shares if options are exercised

Example of non performance related plan

- 100 options granted to 500 employees
- if they work for the next 3 years
- fair value of options = 15
- company estimates that 20% will leave before 3 years

- P&L charge

- Yr1

$$50,000 \times 80\% \times 15 \times 1/3 = 200,000$$

- Yr2

$$\begin{aligned} & [50,000 \times 80\% \times 15 \times 2/3] \\ & -200,000 \qquad \qquad \qquad = 200,000 \end{aligned}$$

- Yr3

$$\begin{aligned} & [50,000 \times 80\% \times 15 \times 3/3] \\ & -400,000 \qquad \qquad \qquad = 200,000 \end{aligned}$$

If expectations are not fulfilled

- company estimates that 20% will leave before 3 years
- at end of yr1 revise to 15%
- at end of yr2 revise to 12%
- at end of yr3 57 have left (443 remain)

- P&L charge

- Yr1

$$50,000 \times 85\% \times 15 \times 1/3 = 212,500$$

- Yr2

$$\begin{aligned} & [50,000 \times 88\% \times 15 \times 2/3] \\ & -212,500 \qquad \qquad \qquad = 227,500 \end{aligned}$$

- Yr3

$$\begin{aligned} & [44,300 \times 15 \times 3/3] \\ & -[212,500 + 227,500] \qquad \qquad \qquad = 224,500 \end{aligned}$$

Options with performance conditions

- **100 options granted to 500 employees, if stay until options vest. Option value = 30**
- **Yr1**
 - vesting condition earnings growth 18%
 - actual 14%, but expects vesting in yr2
 - expects 60 employees to leave before vesting
- **Yr2**
 - vesting condition 2 yr earnings growth 13%
 - actual 1 yr growth is 10%, but expect vesting in yr3
 - expects 83 to leave before vesting
- **Yr3**
 - vesting condition 3 yr earnings growth 10%
 - actual 1 yr growth is 8%, vest
 - 419 employees left

- **P&L charge**

- **Yr1**

$$440 \times 100 \times 30 \times 1/2 = 660,000$$

- **Yr2**

$$\begin{aligned} & [417 \times 100 \times 30 \times 2/3] \\ & -660,000 \end{aligned} = 174,000$$

- **Yr3**

$$\begin{aligned} & [419 \times 100 \times 30 \times 3/3] \\ & -[660,000+174,000] \end{aligned} = 423,000$$