Exposure Draft

Financial Reporting Council

April 2015

FRED 61
Draft amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

Share-based payment transactions with cash alternatives

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries, and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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Contents

Summary

(i) With effect from 1 January 2015 the Financial Reporting Council (FRC) revised financial reporting standards in the United Kingdom and Republic of Ireland. The revisions fundamentally reformed financial reporting, replacing the extant standards with five Financial Reporting Standards:

(a) FRS 100 *Application of Financial Reporting Requirements*;

(b) FRS 101 *Reduced Disclosure Framework*;

(c) FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*;

(d) FRS 103 *Insurance Contracts*; and

(e) FRS 104 *Interim Financial Reporting*.

This Financial Reporting Exposure Draft (FRED) proposes amendments to FRS 102 that are limited to the accounting requirements applicable to share-based payment transactions with cash alternatives.

(ii) The FRC's overriding objective in setting accounting standards is to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.

(iii) In meeting this objective, the FRC aims to provide succinct financial reporting standards that:

(a) have consistency with international accounting standards through the application of an IFRS-based solution unless an alternative clearly better meets the overriding objective;

(b) reflect up-to-date thinking and developments in the way entities operate and the transactions they undertake;

(c) balance consistent principles for accounting by all UK and Republic of Ireland entities with practical solutions, based on size, complexity, public interest and users' information needs;

(d) promote efficiency within groups; and

(e) are cost-effective to apply.

Draft amendments to FRS 102 – Share-based payment transactions with cash alternatives

(iv) Since the publication of FRS 102 in March 2013, entities and their advisors have assessed in more detail the accounting consequences of applying the standard. As a result of this process the FRC was informed of potential unintended consequences. It was highlighted that the accounting requirements of FRS 102 applicable to share-based payment transactions where the entity can choose to settle in cash or equity instruments differ from those in IFRS and previous UK and Irish GAAP and, as a consequence, are more onerous to apply and may result in inappropriate accounting outcomes. The FRC is seeking to make a change to FRS 102 prior to entities preparing their first FRS 102 compliant financial statements for accounting periods beginning on or after 1 January 2015.

(v) This FRED proposes a narrow scope amendment to the accounting requirements for share-based payment transactions with cash alternatives set out in Section 26 *Share-based Payment* of FRS 102 in order to achieve greater consistency with the equivalent requirements of IFRS 2 *Share-based Payment* and previous accounting requirements applicable under FRS 20 *(IFRS 2) Share-based Payment*, with the aim of improving the quality of financial reporting and reducing the cost of compliance with FRS 102.

(vi) As part of this consultation the FRC is not seeking views on other aspects of the share-based payment accounting requirements set out in FRS 102.

Invitation to comment

1 The Financial Reporting Council (FRC) is requesting comments on FRED 61 *Draft amendments to FRS 102 – Share-based payment transactions with cash alternatives* by 1 June 2015. The FRC is committed to developing standards based on evidence from consultation with users, preparers and others. Comments are invited in writing on all aspects of the draft amendments. In particular, comments are sought in relation to the questions below.

> **Question 1**
>
> The proposed requirements for share-based payment transactions with cash alternatives:
>
> (a) align the requirements in FRS 102 with full IFRS and previous UK and Irish GAAP in cases where the entity can choose to settle in cash or equity;
>
> (b) retain the current requirements of FRS 102 to recognise a liability where the recipient can require settlement in cash; and
>
> (c) generalise the requirements to include those cases where the settlement method is dependent on an external event.
>
> Do you agree with this proposal and the draft amendments to paragraph 26.15 of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*? If not, why not?
>
> **Question 2**
>
> The amendments are proposed to be effective from 1 January 2015. Nevertheless, entities were able to apply FRS 102 to accounting periods commencing prior to 1 January 2015 and if so, may have adopted the extant requirements of paragraph 26.15 of FRS 102. Based on the assumption that this will not be an issue for many entities, if any, FRED 61 does not contain any transitional provisions. Do you agree that transitional provisions are not required for the purposes of this proposed amendment? If not, please tell us what transitional provisions you would suggest and why.

2 Information on how to submit comments and the FRC's policy in relation to responses is set out on page 12.

[Draft] Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*

Share-based payment transactions with cash alternatives

[Draft] Amendments to Section 26 *Share-based Payment*

1 The following paragraph sets out the [draft] amendments to Section 26 *Share-based Payment* (deleted text is struck through, inserted text is underlined).

2 Paragraph 26.15 is amended as follows:

Share-based payment transactions with cash alternatives

26.15 Some share-based payment transactions ~~give either the entity or the counterparty a choice of settling the transaction~~ may be settled in cash (or other assets) or by the transfer of equity instruments. In such a case, the entity shall determine whether it has a present obligation to settle in cash (or other assets) and if so, shall account for the transaction as a wholly cash-settled share-based payment transaction in accordance with paragraph 26.14. ~~unless either:~~ The entity has a present obligation to settle in cash (or other assets) if:

(a) the entity does not have an unconditional right to avoid settling in cash or other assets (eg because the counterparty has a settlement choice);

(b) the option of settlement in equity instruments has no commercial substance (eg because the entity is legally prohibited from issuing shares); or

(c) the entity has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash settlement.

~~(a) the entity has a past practice of settling by issuing equity instruments; or~~

~~(b) the option has no commercial substance because the cash settlement amount bears no relationship to, and is likely to be lower in value than, the fair value of the equity instrument.~~

~~In circumstances (a) and (b),~~If the entity determines that it does not have a present obligation to settle in cash (or other assets), the entity shall account for the transaction as ~~an~~ wholly equity-settled share-based payment transaction in accordance with paragraphs 26.7 to 26.13.

The Accounting Council's Advice to the FRC to issue FRED 61: Draft amendments to FRS 102 – Share-based payment transactions with cash alternatives

Introduction

1 This report provides an overview of the main issues that have been considered by the Accounting Council in advising the Financial Reporting Council (FRC) to issue FRED 61 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Share-based payment transactions with cash alternatives*.

2 The FRC, in accordance with the *Statutory Auditors (Amendment of Companies Act 2006 and Delegation of Functions etc) Order 2012* (SI 2012/1741), is a prescribed body for issuing accounting standards in the UK. The *Foreword to Accounting Standards* sets out the application of accounting standards in the Republic of Ireland.

3 In accordance with the *FRC Codes and Standards: procedures*, any proposal to issue, amend or withdraw a code or standard is put to the FRC Board with the full advice of the relevant Councils and/or the Codes & Standards Committee. Ordinarily, the FRC Board will only reject the advice put to it where:

(a) it is apparent that a significant group of stakeholders has not been adequately consulted;

(b) the necessary assessment of the impact of the proposal has not been completed, including an analysis of costs and benefits;

(c) insufficient consideration has been given to the timing or cost of implementation; or

(d) the cumulative impact of a number of proposals would make the adoption of an otherwise satisfactory proposal inappropriate.

4 The FRC has established the Accounting Council as the relevant Council to assist it in the setting of accounting standards.

Advice

5 The Accounting Council is advising the FRC to issue FRED 61 *Draft amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Share-based payment transactions with cash alternatives.*

6 The amendments proposed in FRED 61 converge to a greater extent the requirements in FRS 102 with those in International Financial Reporting Standards (IFRS) with the aim of improving the quality of financial reporting and reducing the cost of compliance with FRS 102.

7 The Accounting Council's Advice to the FRC to issue FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* was set out in that standard. When these amendments are finalised, the Accounting Council's Advice to the FRC on these amendments will be included in the revised FRS 102.

Background

8 FRS 102 contains specific accounting requirements applicable to share-based payment transactions with a cash-settlement option in Section 26 *Share-based Payment*. These requirements are identical to those in the IFRS for SMEs on which FRS 102 is based.

9 With the introduction of FRS 102, it was the FRC's intention to simplify, to an extent, the accounting requirements for share-based payment arrangements in comparison to those in FRS 20 *(IFRS 2) Share-based Payment,* whilst retaining similar recognition and measurement principles. It has only recently been brought to the FRC's attention that the required accounting for share-based payment transactions that give the reporting entity an option to settle in cash or equity could result in cash-settlement accounting under FRS 102 when the same transactions would be accounted for as equity-settled under FRS 20 and IFRS 2 *Share-based Payment.* As a consequence, the application of FRS 102 could result in the recognition of a liability even though the recognition requirements set out in FRS 102 are not clearly met. Cash-settlement accounting is also more onerous than equity-settled accounting since it requires the measurement of the obligation at fair value at each reporting date.

Objective

10 The FRC gives careful consideration to its objective and the intended effects when developing new financial reporting standards or requirements for the UK and the Republic of Ireland. In developing financial reporting standards the overriding objective of the FRC is to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.

11 In meeting this objective, the FRC aims to provide succinct financial reporting standards that:

(a) have consistency with international accounting standards through the application of an IFRS-based solution unless an alternative clearly better meets the overriding objective;

(b) reflect up-to-date thinking and developments in the way entities operate and the transactions they undertake;

(c) balance consistent principles for accounting by all UK and Republic of Ireland entities with practical solutions, based on size, complexity, public interest and users' information needs;

(d) promote efficiency within groups; and

(e) are cost-effective to apply.

12 FRED 61 proposes to amend the requirements of FRS 102 relating to share-based payment transactions with cash alternatives. The proposed amendments achieve greater consistency with the equivalent requirements of IFRS 2 and previous UK and Irish GAAP in FRS 20 with the aim of improving the quality of financial reporting and reducing the cost of compliance with FRS 102.

Cash-settled vs equity-settled accounting for share-based payment transactions with cash alternatives

13 A number of private entities in the UK and in the Republic of Ireland offer their employees share-based payment awards. To allow a degree of flexibility the entity frequently has an option to settle its obligation by issuing equity instruments or by paying cash equal to the value of the shares.

14 Under FRS 102 obligations arising from awards that contain a cash-settlement option are accounted for as a liability unless there is evidence of a past practice of settling in equity instruments or the cash-settlement option has no commercial substance. In other words, in the absence of counter-evidence the default treatment is that of a cash-settled scheme and the recognition of a liability which is remeasured at each reporting date.

15 Under IFRS 2 an obligation arising from awards where the entity has a cash-settlement option is accounted for as a liability only if the entity has a present obligation to settle the awards in cash. The entity is presumed not to have a present obligation to settle in cash, unless there is historical evidence of cash-settlement or the equity-settlement option has no commercial substance. Contrary to FRS 102, in the absence of counter-evidence the default treatment is that of an equity-settled scheme and an adjustment to equity which is measured only at initial recognition. The same requirements applied under FRS 20.

16 The Accounting Council notes that the accounting requirements in IFRS 2 and FRS 20 are consistent with the definition of a liability set out in Section 2 *Concepts and Pervasive Principles* of FRS 102, in that a liability should only be recognised when an entity has an obligation to transfer resources embodying economic benefits. The Accounting Council therefore advises that FRS 102 should be amended in line with the requirements of IFRS 2 and FRS 20.

17 In some schemes the recipient may have an option to require settlement in cash or equity instruments. The Accounting Council advises that if an entity cannot avoid settling in cash should the recipient ask for it, the entity has a present obligation and should account for the transaction in its entirety as cash-settled. The Accounting Council notes that this requirement is different to IFRS 2 and FRS 20 which require such an obligation to be separated into its debt and equity components. The Accounting Council continues to believe that this departure provides a practical and proportionate solution for UK and Irish entities and notes that this simplification is generally consistent with the requirements in the IFRS for SMEs and FRS 102 as it currently stands.

18 In addition, the Accounting Council advises that the scope of paragraph 26.15 of FRS 102 should be amended, so that all share-based payment transactions with uncertain settlement methods are included. This is to provide greater clarity to entities on the accounting for these types of arrangements.

19 The Accounting Council is mindful that FRS 102 is already effective. The Accounting Council therefore carefully considered whether an amendment should be delayed until the three-yearly review cycle of FRS 102. The Accounting Council believes an amendment to FRS 102 outside the three-yearly review cycle is warranted in this situation because the revised accounting requirements align FRS 102 more closely with the equivalent requirements in IFRS and better meet the FRC's objective of high quality and understandable reporting. Making an amendment to FRS 102 before entities have to prepare their first set of FRS 102 compliant annual financial statements will also enable entities to continue with their historical accounting practices under FRS 20.

20 Some entities will have already commenced their preparation for the application of FRS 102 and others will soon start. It is therefore important to finalise these amendments as quickly as possible in order to minimise disruption to this process. Given that this is a narrow scope amendment affecting a single paragraph in FRS 102, the Accounting Council advises that the consultation period should be reduced.

Effective date

21 The Accounting Council advises that, consistently with FRS 102, the proposed amendments should apply to accounting periods beginning on or after 1 January 2015 with earlier adoption permitted. This will allow entities to apply the revised requirements in their first FRS 102 financial statements.

Consultation Stage Impact Assessment

Introduction

1 The Financial Reporting Council (FRC) is committed to a proportionate approach to the use of its powers, making effective use of impact assessments and having regard to the impact of regulation on small enterprises, where appropriate.

2 The draft amendments to FRS 102 proposed in FRED 61 *Draft Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Share-based payment transactions with cash alternatives* are intended to align FRS 102 with the equivalent requirements in FRS 20 *(IFRS 2) Share-based Payment* and IFRS 2 *Share-based Payment* and make compliance with FRS 102 less onerous through:

(a) not requiring a change in accounting following transition to FRS 102; and

(b) fewer share-based payment transactions requiring ongoing remeasurement at fair value.

The FRC therefore expects that the proposed amendments will have the positive effect of reduced compliance costs.

3 The FRC is mindful that some entities will have already commenced their assessment of the application of FRS 102. A late change to FRS 102, especially subsequent to the effective date, is therefore generally not desirable. However, the FRC believes that the negative consequences of a late change are outweighed by the following benefits:

(a) entities are able to continue with their past accounting practice for existing and new share-based payment awards where the entity has a cash-settlement option;

(b) the proposed accounting requirements are less onerous to apply and hence reduce the cost of compliance with FRS 102;

(c) the proposed amendments provide greater clarity for entities on how to account for transactions where the settlement method is uncertain; and

(d) the proposed accounting requirements result in better quality financial reporting.

This draft is issued by the Financial Reporting Council for comment. It should be noted that the draft may be modified in the light of comments received before being issued in final form.

For ease of handling, we prefer comments to be sent by e-mail to:

ukfrs@frc.org.uk

Comments may also be sent in hard copy to:

Susanne Pust Shah
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

Comments should be despatched so as to be received no later than 1 June 2015.

The FRC's policy is to publish on its website all responses to formal consultations issued by the FRC unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. The FRC does not edit personal information (such as telephone numbers or postal or e-mail addresses) from submissions; therefore, only information that you wish to be published should be submitted.

The FRC aims to publish responses within 10 working days of receipt.

The FRC will publish a summary of the consultation responses, either as part of, or alongside, its final decision.

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