

# HKFRS News

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## Amendment to HKFRS 2 dealing with vesting conditions and cancellations

The HKICPA published an amendment to HKFRS 2 *Share-based Payments* in March 2008. The amendment will apply for annual periods beginning on or after 1 January 2009 with earlier application permitted.

The amendment to HKFRS 2 *Share-based Payments* dealing with vesting conditions and cancellations has been issued after a long gestation period. The amendment limits vesting conditions to service conditions and performance conditions. Other features of a share-based payment are not vesting conditions. These features are included in the grant date fair value for share-based payment transactions. In other words, these features will not impact the number of awards expected to vest or their valuation subsequent to grant date, but only impact the grant date fair value.

The amendment also specifies that all cancellations, whether by the entity or by other parties, should receive the same accounting treatment, (i.e. acceleration of the expense based on the grant date fair value).

These changes will have an impact on the accounting for share-based payments which include conditions unrelated to service, especially those which an employee can choose to meet or not. Common examples will be awards which include a condition that the employee must hold a number of shares or awards linked to savings plans.

Consider an example where employees agree to invest 100 per month for 5 years in a savings vehicle. The vehicle guarantees interest of 180, payable at the end of the 5 years. The employee can take the accumulated savings at any time, but will only get the interest if he completes the full 5 years. An employee that remains with the company and continues to make investments can use the accumulated fund of 6,180  $[(100 \times 12 \times 5) + 180]$  to purchase shares at an exercise price of 80% of the share price at the start of the savings period.

Applying the amendment to HKFRS 2, the requirement to stay with the company will be a vesting condition (service condition) and the requirement to invest will be a non-vesting condition. This means that the grant date fair value for the HKFRS 2 expense must include the effect of employees choosing to give up their options by stopping their investments in the savings vehicle. This is a separate assessment from any assumption regarding employee turnover. If employees do stop investing, this will lead to an acceleration of expense recognition but there will be no truing up for any variation between actual experience and the assumptions used in calculating the grant date fair value.

This may seem relatively straightforward at first glance, even though it may lead to quite a volatile expense. If past experience indicates that 25% of employees stop saving whilst still working then why don't we just reduce the value of the option by 25%?

Unfortunately it is not that simple. Some employees will decide to stop saving for factors that are unrelated to the share price; they may have other obligations or other investment plans. This introduces an element of economically irrational behaviour that must be incorporated in the grant date fair value. Other employees may stop saving because the option is underwater and they see no value in continuing to save. If the



*HKFRS has converged with IFRS effective from 1 January 2005. Contents contained in this newsletter are relevant to both HKFRS preparers and IFRS preparers.*

only circumstance in which employees ceased saving was when the option had no value, it would have no impact on the determination of the fair value of those options.

Applying these provisions in practice will need judgement. It is important that preparers start to gather relevant data to support those judgements sooner rather than later.

## Amendment to IAS 32 dealing with puttable instruments

The IASB published an amendment to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial statements* on 14 February 2008 after a long waiting period. The corresponding amendment to HKAS 32 and HKAS 1 is expected to be published by the HKICPA in due course.

The amendment to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial statements* is the outcome of the Board's earlier commitment to improve the relevance and understandability of the current accounting treatment for these instruments. The amendment is effective for annual periods beginning on or after 1 January 2009 with earlier adoption allowed.

The impact of the changes will be most significant for entities structured as co-operatives or partnerships. Some investment funds may also be affected to a limited extent. The amendment changes the classification of certain qualifying instruments from financial liabilities to equity instruments. These instruments will no longer have to comply with the measurement requirements of financial liabilities stated in IAS 39 *Financial Instruments: Recognition and Measurement* or the disclosure requirements of IFRS 7 *Financial Instruments: Disclosure*. Constituents argued that these instruments often represent a residual interest in the entity and as such meet the definition of equity, despite the inherent obligation to pay cash. As a result, the Board was persuaded to amend IAS 32.

The amendment deals with puttable financial instruments that the holder of an instrument has the option to sell back to the entity, or those that have to be put back on an uncertain event such as death or retirement. It also deals with instruments that include a contractual obligation for the issuing entity to make a payment on liquidation, where liquidation is certain to occur (i.e. a limited life entity) or liquidation is at the option of the instrument holder.

To qualify for equity classification in the separate financial statements of the issuer, the instrument must meet a number of stringent criteria:

- It must be in the most subordinated class of instruments, and all instruments in that class must have identical features. *Preference shares* do not meet this requirement and therefore continue to be classified as liabilities. In the event of liquidation, the holder must receive a pro rata share of the entity's remaining assets once the liabilities are repaid.
- It must share in the performance of the entity, either with reference to its profits or losses, or its net assets.
- No other instrument should share in the performance of the entity in a similar way, and the puttable instrument's return should not be fixed or restricted by another instrument.
- A puttable instrument should not (apart from the put feature) have any obligation to deliver cash or another financial asset, to exchange financial assets or financial liabilities with another entity under potentially unfavourable conditions or to be settled in a variable number of shares.

Similar criteria exist for instruments issued by limited life entities.

The Board clarified that this is a narrow exception and should not be applied by analogy. Furthermore, a qualifying instrument would not be considered as an equity instrument under another standard such as IFRS 2 *Share-based payment*. The equity classification of instruments issued by a subsidiary would not flow through on consolidation as these instruments are not considered to be the most subordinated class on consolidation. This also limits accounting arbitrage and structuring opportunities.

The impact of the amendment will vary between territories and industries, depending on the specific structures in use.



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