KPMG

IFRS Practice Issues: Replacement of a share-based payment in a business combination

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Foreword

IFRS 3 *Business Combinations* as revised in 2008 and the amendments made to IFRS 2 *Share-based Payment* by IFRS 3 are effective for annual periods beginning on or after 1 July 2009, so entities with calendar year-ends began applying IFRS 3 from 1 January 2010. Previously there was no specific guidance about the accounting for replacements of share-based payment awards in a business combination. Therefore, there may have been diversity in practice in terms of attributing the acquisition-date market-based measure of replacement awards to consideration transferred and post-combination cost. IFRS 3 includes specific requirements and guidance in respect of the accounting for mandatory replacements of share-based payment awards in a business combination. The *Improvements to IFRSs* issued by the International Accounting Standards Board (IASB) on 6 May 2010 expanded the requirements for mandatorily replaced share-based payment awards to those that are replaced voluntarily and introduced accounting requirements for non-replaced awards.

Consequently, International Financial Reporting Standards (IFRSs) now address the three major types of situations (mandatory replacement, voluntary replacement and no replacement) that an acquirer could face when the target entity has share-based payments outstanding at the time of the acquisition. An understanding of the accounting requirements and awareness of the financial impact of each type could be key in an entity's determination of the remuneration policy that it will apply to its employees. Current and forthcoming governance rules in its jurisdiction and best practice also may be part of that consideration.

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About this publication

Acknowledgements

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We would like to acknowledge the principal authors of this publication. They are Annie Mersereau, Mary Tokar, Emmanuel Lahouste and Johan Schrumpf of the KPMG International Standards Group. In addition we would like to acknowledge the efforts of Paul Munter and the other authors of the *IFRS Handbook: Business combinations and non-controlling interests* that forms the basis for this publication.

Content

Our *IFRS Practice Issues* publications address practical application issues that an entity may encounter when applying a specific IFRS or applying IFRSs in a specific industry. They may include discussion of the key requirements, interpretative guidance and illustrative examples to elaborate and clarify the practical application of the requirements.

This edition of *IFRS Practice Issues* considers the requirements of IFRS 3 in respect of share-based payment awards that are replaced in a business combination. In addition, this publication addresses the guidance in respect of share-based payments that are replaced voluntarily or not replaced as part of a business combination, included in the *Improvements to IFRSs* issued by the IASB on 6 May 2010. This publication discusses the accounting for share-based payment replacement awards (hereafter referred to as replacement awards) and unreplaced awards from the perspective of the acquirer's consolidated financial statements. Accounting in the separate financial statements of the acquirer and the acquiree is outside the scope of this publication.

The text of this publication is referenced to IFRS 2 and IFRS 3 in issue at 30 April 2010. References in the left-hand margin identify the relevant paragraphs of the IFRSs. This publication also contains references to *Insights into IFRS* (6th edition, 2009/2010), our practical guide to IFRSs.

IFRSs and their interpretation change over time. Accordingly, neither this publication nor any of our other publications should be used as a substitute for referring to the standards and interpretations themselves. In many cases further interpretation will be needed in order for an entity to apply IFRSs to its own facts, circumstances and individual transactions. Further, some of the information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change as practice develops.

Other ways KPMG member firms' professionals can help

A more detailed discussion of the general accounting issues that arise from the application of IFRSs can be found in our publication *Insights into IFRS*.

In addition to *Insights into IFRS*, we have a range of publications that can assist you further, including:

- IFRS compared to US GAAP
- Illustrative financial statements for interim and annual periods
- IFRS Handbooks, which include extensive interpretative guidance and illustrative examples to elaborate or clarify the practical application of a standard
- New on the Horizon publications, which discuss consultation papers
- Newsletters, which highlight recent developments
- IFRS Practice Issue publications, which discuss specific requirements and pronouncements
- First Impressions publications, which discuss new pronouncements
- Disclosure checklist.

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Contents

1. Overview of accounting requirements

- IFRS 3 *Business Combinations* (2008) provides guidance about the accounting for replacements of awards held by the acquiree's employees (acquiree awards) in a business combination when the acquirer:
  - is *obliged* to issue share-based payment replacement awards (replacement awards); or
  - *chooses* to replace awards that expire as a result of the business combination.

- To the extent that the replacement awards relate to past services, they are included in the consideration transferred; to the extent that they require future services, they are not part of the consideration transferred and instead are treated as post-combination remuneration cost. If they relate to both past and future services, then the market-based measure of the replacement awards is allocated between consideration transferred and post-combination remuneration cost.

- To the extent that the replacement awards relate to past services, they are included in the consideration transferred; to the extent that they require future services, they are not part of the consideration transferred and instead are treated as post-combination remuneration cost. If they relate to both past and future services, then the market-based measure of the replacement awards is allocated between consideration transferred and post-combination remuneration cost.

- The market-based measure of both the acquiree awards and the replacement awards is determined at the acquisition date in accordance with IFRS 2 *Share-based Payment*.

- The market-based measure of the acquiree awards is allocated between consideration transferred and post-combination services reflecting the ratio of past services to future services as determined in accordance with IFRS 3.

- Any incremental market-based measure of the replacement awards over the market-based measure of the acquiree awards at the acquisition date is attributed to post-combination services and is not part of the consideration transferred.

- Subsequent changes in the number of replacement awards expected to vest due to service and non-market performance conditions are reflected as an adjustment to remuneration cost in the period in which the changes in estimate occur.

- Subsequent accounting of the replacement awards, including the treatment of vesting and non-vesting conditions, follows the principles of IFRS 2.

- Recent amendments from *Improvements to IFRSs* (the amendments) issued by the International Accounting Standards Board (IASB) result in the requirements for mandatory replacements also applying to certain voluntary replacements.

- The amendments also introduce guidance for acquiree awards that the acquirer chooses not to replace (unreplaced awards). Such equity-settled unreplaced acquiree awards are part of the non-controlling interest in the acquiree at the acquisition date. This applies to:
  - acquiree awards that are vested; and
  - the portion of unvested acquiree awards related to the pre-combination vesting period.

2. Mandatory replacements

This chapter addresses acquiree awards that the acquirer is obliged to replace; it sets out the accounting principles that apply regardless of whether the acquiree awards would have expired as a result of a business combination. In section 2.1, replacement awards for which the service condition is expected to be met are addressed. These scenarios are illustrated in paragraphs IE61 – IE71 of IFRS 3. Section 2.2 addresses replacement awards with estimated forfeitures because a service condition or non-market performance condition is not expected to be met. Section 2.3 illustrates replacement awards with market and non-vesting conditions; replacement awards with various other features are discussed in section 2.4. Finally, accounting for the income tax effect of replacement awards is addressed in section 2.5.

Voluntarily replacements and unreplaced awards are addressed in chapter 3.

2.1 Replacement awards expected to meet service conditions

2.1.1 Accounting principles

IFRS 3.B56 In some circumstances the acquirer is obliged to issue replacement awards to employees of an acquiree in exchange for share-based payment awards issued previously by the acquiree. Such exchanges are accounted for as modifications of share-based payment awards under IFRS 2, and all or a portion of the amount of the acquirer's replacement awards is included in measuring the consideration transferred in the business combination.

IFRS 3.B56 An acquirer is *obliged* to issue replacement awards if the acquiree or its employees are able to enforce replacement. Such obligations may arise from various sources, including:

- the terms of the acquisition agreement;
- the terms of the acquiree's awards; or
- applicable laws or regulations.

Measurement

IFRS 3.30 Share-based payment awards are an exception to the fair value measurement principle of IFRS 3. This exception requires that such awards be measured at the acquisition date in accordance with IFRS 2 and refers to the amounts so determined as the "market-based measure" of the awards. This applies regardless of whether the market-based measurement of replacement awards is included in measuring the consideration transferred in a business combination, or is recognised as remuneration cost in the post-combination financial statements.

Attribution

IFRS 3.B56 In some instances a portion of the value of the replacement awards is allocated to post-combination service and accounted for separately from the business combination. This is the case, for example, when post-combination service is required to be rendered by the employees of the acquiree in connection with the acquirer issuing replacement awards or when the market-based measure of the replacement awards exceeds the market-based measure of the acquiree awards.

The amount of the market-based measure of the replacement awards treated as consideration transferred is determined in the following manner:

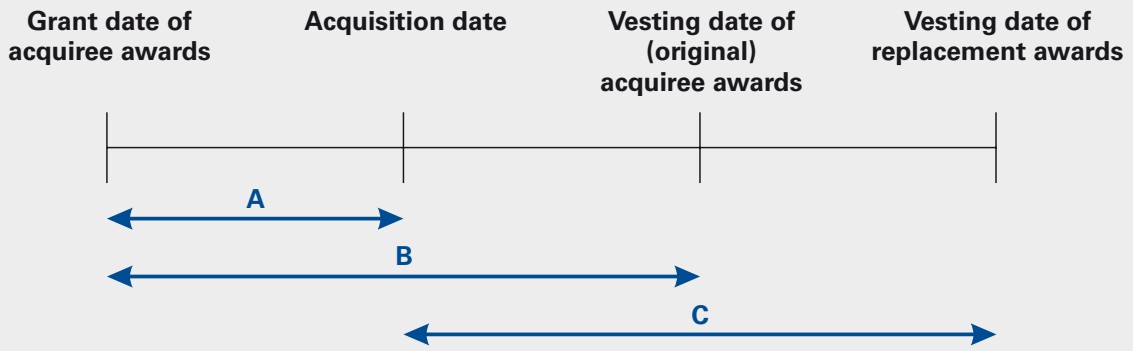
IFRS 3.B57

1. Determine at the acquisition date, in accordance with the market-based measurement method in IFRS 2:

   - the market-based measure of the acquiree's awards (FVa); and
   - the market-based measure of the replacement awards (FVr).

2. Determine:

   - the period for which services have been provided by the employees prior to the acquisition date, i.e. the pre-combination vesting period (see A in the following diagram);
   - the original vesting period of the acquiree's awards (see B in the following diagram);
   - the post-combination vesting period, if any, for the replacement awards (see C in the following diagram); and
   - the greater of the total vesting period (the sum of A plus C) and the original vesting period of the acquiree's awards (B).



The diagram illustrates a situation in which the total period of A plus C is longer than B. In practice, the total vesting period of the original awards may be longer than the sum of the pre-combination vesting period plus the post-combination vesting period of the replacement awards.

IFRS 3.B58

3. Calculate the portion of the replacement awards attributable to pre-combination service as the product of:

   - the market-based measure of the acquiree's awards at the acquisition date; and
   - the ratio of the pre-combination vesting period to the greater of the total vesting period and the original vesting period of the acquiree's awards.

   $$\text{Amount included in consideration transferred} = \text{FVa} \times \frac{A}{\text{Greater of } (A + C) \text{ and } B}$$

IFRS 3.B59

Any remaining amount of the market-based measure of the replacement awards after deducting the amount attributed to consideration transferred is treated as post-combination remuneration cost.

IFRS 3.B61

These requirements for determining the portions of a replacement awards attributable to pre-combination and post-combination service apply equally regardless of whether the replacement awards are classified as cash-settled or as equity-settled in accordance with IFRS 2.

The above process demonstrates several points:

- The acquirer measures both the replacement awards given to employees by the acquirer and the acquiree awards at the acquisition date. The measurement and attribution of replacement awards issued in a business combination are independent of the original grant-date value of the acquiree awards.
- IFRS 3 sets two limits on the amount of the replacement awards' value that is included in the consideration transferred:
  - the amount cannot exceed the market-based measure at the acquisition date of the *acquiree* awards; and
  - the amount includes only the value attributed to *pre-combination* service.
- Any incremental value of the replacement awards over the value of the acquiree awards at the acquisition date is attributed to post-combination service and is not part of the consideration transferred, even if all service has been rendered as of the acquisition date. In this case, the excess value is recognised immediately as remuneration cost in the post-combination financial statements of the combined entity. If additional service is required, then the remuneration cost is recognised in the post-combination financial statements by applying the requirements of IFRS 2.
- Even if acquiree awards are fully vested at the time of a business combination, a portion of the replacement awards is allocated to post-combination service if the acquiree's employees are required to render service in the post-combination period for the replacement awards to vest.

Example 2.1.1: Attribution of market-based measure of replacement award – no forfeitures
On 1 January 2008 Company S granted equity-settled share-based payment awards with a grant-date fair value of 1 million to its employees, subject to a three-year service condition.

Company P purchases 100 percent of S's shares on 1 January 2010 and issues equity-settled replacement awards to S's employees. At the acquisition date the market-based measure of the original awards is 1.2 million; the market-based measure of the replacement awards is 1.4 million. The replacement awards have a one-year vesting condition.

Assuming that all employees are expected to meet the service condition, in order to determine the amount attributed to pre-combination service the following are relevant:

- The period for which services have been provided by S's employees prior to the acquisition date is two years.
- The vesting period of the original (acquiree) awards is three years.
- The vesting period of the replacement awards is one year.
- Both the total vesting period and the original vesting period are three years. The greater of those two periods therefore also is three years.

The market-based measure of the acquiree awards measured at the acquisition date (1.2 million) multiplied by (2 years / 3 years) is attributed to pre-combination service, i.e. an amount of 0.8 million.

In its consolidated financial statements, P records the following entry:

	Debit	*Credit*
Goodwill	0.8 million	
Equity		0.8 million
To recognise the amount of the replacement awards attributed to pre-combination service as part of consideration transferred		

The amount attributed to post-combination service is calculated as the difference between the market-based measure of the replacement award determined at the acquisition date (1.4 million) and the amount allocated to pre-combination service (0.8 million); therefore the amount attributed to post-combination service is 0.6 million. Recognition of the amount of post-combination service is addressed in the worked examples in section 2.1.2.

Example 2.1.2: Attribution of market-based measure of replacement award – forfeitures
Assume the same facts as in example 2.1.1 except that at the acquisition date it is expected that only 90 percent of the replacement awards will vest, i.e. 10 percent of S's employees are expected not to meet the service condition.

The amount attributed to pre-combination service therefore is calculated as 90% x 1.2 million x (2 years / 3 years) = 0.72 million. The amount attributed to post-combination service is ((90% x 1.4 million) - 0.72 million) = 0.54 million.

Allocation of post-combination remuneration cost to reporting periods

IFRS 3.B56 IFRS 3 requires exchanges of share-based payment awards made as part of a business combination to be accounted for as modifications of share-based payment awards in accordance with IFRS 2. As stated above, the market-based measure of the replacement awards after deducting the amount attributed to consideration transferred is accounted for as post-combination remuneration cost. However, IFRS 3 does not specify how the amount attributed to post-combination service is recognised in each period of the post-combination financial statements.

In our view, the following two approaches are acceptable for the recognition of the remuneration cost in the post-combination periods:

- One approach is to treat the replacement award as a new grant (new grant approach), since the shares underlying the replacement award are the acquirer's shares, and not the acquiree's shares. Under the new grant approach, in line with the basic attribution principle in IFRS 2, the amount attributed to post-combination service would be recognised over the vesting period of the replacement award. Although this may appear to be a practical and logical approach, it might be seen as not fully consistent with the reference in paragraph B56 of IFRS 3 to account for such replacements as "modifications of share-based payment awards in accordance with IFRS 2".
- The other approach is to apply the modification accounting principles of IFRS 2 (modification approach). The modification approach entails some complexities because some of the IFRS 2 requirements for modification accounting appear to conflict with the requirements in IFRS 3 regarding replacement awards. Paragraph B43(a) of IFRS 2 requires the incremental fair value, estimated at the date of modification, to be recognised in addition to the grant-date fair value of the original equity instruments. However, this requirement effectively is overridden by paragraph B59 of IFRS 3 that prescribes how the amount of the replacement award allocated to post-combination services is determined. This amount includes any incremental fair value and the unrecognised amount of the acquisition-date market-based measure of the original award.

As a result of the requirement of paragraph B59 of IFRS 3, the cumulative amount recognised will be the same under the two approaches. However, application of IFRS 2's requirements for modifications still may lead to a different pattern of attribution in the post-combination periods in certain circumstances. For example, in order to apply modification accounting the acquirer would have to determine whether the terms of the replacement award, as compared to the terms of the acquiree award, are or are not beneficial to the employee. If the replacement is considered to be non-beneficial (e.g. replacement with no incremental value and an extension of the vesting period),

then the amount allocated to the post-combination services would be recognised over a shorter period under the modification approach than under the new grant approach.

Regardless of the policy elected, an entity applies it consistently. *In this publication we have illustrated the new grant approach only.*

2.1.2 Worked examples

The worked examples (2.1.3 to 2.1.6) in this section illustrate replacement awards for which service conditions are expected to be met. Throughout this publication, with the exception of section 2.5, the income tax effect of share-based payments is ignored.

Example 2.1.3: Acquiree awards for which no future service is required are replaced by awards that require no future service

Company P acquires Company S on 31 December 2010. At the acquisition date S's employees hold share options with a total market-based measure of 3 million. All of the acquiree awards were granted on 1 January 2008, i.e. three years prior to the acquisition date, and had a vesting period of three years; therefore these acquiree awards are fully vested at the acquisition date.

Pursuant to a requirement in the acquisition agreement, P replaces the fully-vested acquiree awards with fully-vested awards with a market-based measure of 4 million at the acquisition date. Both the acquiree awards and the replacement awards are equity settled.

Amount attributed to pre-combination service

3 million[1] x 100% (3 years / 3 years)[2] = 3 million

1 Market-based measure of acquiree awards at the acquisition date.

2 Ratio of service rendered as of 31 December 2010 compared to the greater of the original vesting period and the sum of the pre-combination vesting period plus the post-combination vesting period; both periods are three years in this scenario.

Amount attributed to post-combination service

4 million[3] - 3 million[4] = 1 million

3 Market-based measure of replacement awards.

4 Amount attributed to pre-combination service (see above).

Because no service is required after the date of the business combination, the amount attributed to post-combination service is recognised immediately as remuneration cost.

In its consolidated financial statements, P records the following entries:

	Debit	*Credit*
Goodwill Equity *To recognise the amount of the replacement awards attributed to pre-combination service as part of consideration transferred*	3 million	3 million
Remuneration cost Equity *To recognise the amount of the replacement awards attributed to post-combination service immediately following the acquisition*	1 million	1 million

Example 2.1.4: Acquiree awards for which no future service is required are replaced by awards that require future service

Assume the same facts as in example 2.1.3 except that under the terms of the replacement awards, S's employees are required to provide an additional year of service after the business combination before the replacement awards vest.

Amount attributed to pre-combination service

3 million[1] x 75% (3 years / 4 years)[2] = 2.25 million

1 Market-based measure of acquiree awards at the acquisition date.

2 Ratio of service rendered as of 31 December 2010 compared to the greater of the original vesting period (three years in this scenario) and the sum of the pre-combination vesting period plus the post-combination vesting period (four years in this scenario).

Amount attributed to post-combination service

4 million[3] - 2.25 million[4] = 1.75 million

3 Market-based measure of replacement awards.

4 Amount attributed to pre-combination service (see above).

The remaining value of the replacement awards of 1.75 million is attributed to post-combination service in accordance with IFRS 2.

In its consolidated financial statements, P records the following entries:

	Debit	*Credit*
Goodwill Equity *To recognise the amount of the replacement awards attributed to pre-combination service as part of consideration transferred*	2.25 million	2.25 million
Remuneration cost Equity *To recognise the amount of the replacement awards attributed to post-combination service over the vesting period of the replacement award; in the year ending 31 December 2011*	1.75 million	1.75 million

Example 2.1.5: Acquiree awards for which future service is required are replaced by awards that require future service

Company P acquires Company S on 31 December 2010. At the acquisition date S's employees hold share options with a market-based measure of 3 million. All of the acquiree awards were granted on 1 January 2008, i.e. three years prior to the acquisition date. S's share option plan does not contain a change-in-control clause (see section 2.4.1).

The vesting period of the acquiree awards was four years. Accordingly, prior to the acquisition date, the acquiree awards have a remaining vesting period of one year.

Pursuant to a requirement in the acquisition agreement, P replaces the unvested acquiree awards with unvested awards with a market-based measure of 3 million. These awards require two years of service subsequent to the acquisition date, i.e. they will vest a year later than the acquiree awards would have vested under their original terms.

Amount attributed to pre-combination service

3 million[1] x 60% (3 years / 5 years)[2] = 1.8 million

[1] Market-based measure of acquiree awards at the acquisition date.

[2] Ratio of service rendered as of 31 December 2010 compared to the greater of the original vesting period (four years in this scenario) and the sum of the pre-combination vesting period plus the post-combination vesting period (five years in this scenario).

Amount attributed to post-combination service

3 million[3] - 1.8 million[4] = 1.2 million

[3] Market-based measure of replacement awards.

[4] Amount attributed to pre-combination service (see above).

The remaining value of the replacement awards of 1.2 million is attributed to post-combination service in accordance with IFRS 2.

In its consolidated financial statements, P records the following entries:

	Debit	*Credit*
Goodwill	1.8 million	
Equity		1.8 million
To recognise the amount of the replacement awards attributed to pre-combination service as part of consideration transferred		

The amount of 1.2 million of the replacement awards attributable to post-combination service is recognised in each of the years ending 31 December 2011 and 2012 as follows:

	Debit	*Credit*
Remuneration cost	0.6 million[5]	
Equity		0.6 million
To recognise the amount of the replacement awards attributed to post-combination service in each year of the vesting period of the replacement awards		

[5] Calculated as 1.2 million x (1 year / 2 years).

Example 2.1.6: Acquiree awards for which future service is required are replaced by awards that require no future service

Assume the same facts as in example 2.1.5 except that no post-combination service is required for S's employees to vest in the replacement awards; this means that the replacement awards vest a year earlier than the acquiree awards would have vested under their original terms.

Amount attributed to pre-combination service

3 million[1] x 75% (3 years / 4 years)[2] = 2.25 million

[1] Market-based measure of acquiree awards at the acquisition date.

[2] Ratio of service rendered as of 31 December 2010 compared to the greater of the original vesting period (four years in this scenario) and the sum of the pre-combination vesting period plus the post-combination vesting period (three years in this scenario).

Amount attributed to post-combination service

3 million[3] - 2.25 million[4] = 0.75 million

[3] Market-based measure of replacement awards.

[4] Amount attributed to pre-combination service (see above).

Because no service is required after the date of the business combination, the amount attributed to post-combination service is recognised immediately as remuneration cost.

In its consolidated financial statements, P records the following entries:

	Debit	*Credit*
Goodwill Equity *To recognise the amount of the replacement awards attributed to pre-combination service as part of consideration transferred*	2.25 million	2.25 million
Remuneration cost Equity *To recognise the amount of the replacement awards attributed to post-combination service immediately following the acquisition*	0.75 million	0.75 million

2.2 Replacement awards with expected forfeitures

2.2.1 Replacement awards without change in the estimated forfeitures

IFRS 2.19-21, 30, 3.B60

Recognition of remuneration cost in respect of share-based payment awards is based on the best available estimate at the acquisition date of the total number of replacement awards expected to vest. Accordingly, the determination of the amount of replacement awards to be attributed to pre- and post-combination service takes into account the expected rate of forfeitures of the replacement awards due to expected failure to meet vesting conditions other than market conditions, which are addressed in section 2.3.1.

There are two types of vesting conditions that are not market conditions:

- Service conditions that require the counterparty to complete a specified period of service.
- Non-market performance conditions that require the counterparty, in addition to completing a specified period of service, to meet specified performance targets unrelated to the market price of the entity's equity instruments, e.g. a specified increase in profit or an earnings per share target.

Example 2.2.1: Replacement awards that are not all expected to vest

Company P acquires Company S in a business combination on 1 January 2011. Under the terms of the acquisition agreement, P issues replacement awards in exchange for acquiree awards held by employees of S. The market-based measure of both the acquiree awards and the replacement awards is 2 million at the acquisition date. The acquiree awards were granted on 1 January 2009 and require five years of service to vest. The replacement awards require three years of service to be provided subsequent to the acquisition date for the awards to vest, i.e. the total vesting period is not changed as a result of the acquisition. At the acquisition date, P estimates that 95 percent of the awards will vest.

Expected forfeitures are taken into account in determining the amount of the awards to be attributed between pre-combination and post-combination service. Therefore the 2 million is adjusted by the estimated forfeiture rate of 5 percent and the resulting 1.9 million is attributed to pre- and post-combination service.

Amount attributed to pre-combination service

2 million[1] x 95% x 40% (2 years / 5 years)[2] = 0.76 million

1 Market-based measure of acquiree awards at the acquisition date.

2 Ratio of service rendered as of 1 January 2011 compared to the greater of the original vesting period and the sum of the pre-combination vesting period plus the post-combination vesting period (both periods are five years in this scenario).

Amount attributed to post-combination service

2 million[3] x 95% - 0.76 million[4] = 1.14 million

3 Market-based measure of replacement awards.

4 Amount attributed to pre-combination service (see above).

In its consolidated financial statements, P records the following entries:

	Debit	*Credit*
Goodwill	0.76 million	
Equity		0.76 million
To recognise the amount of the replacement awards attributed to pre-combination service as part of consideration transferred, taking into account expected forfeitures		

Assuming that 95 percent of the awards actually vest, P recognises the amount of 1.14 million of the replacement awards attributable to post-combination service as remuneration cost in each of the years ending 31 December 2011, 2012 and 2013 as follows:

	Debit	*Credit*
Remuneration cost	0.38 million[5]	
Equity		0.38 million
To recognise the amount of the replacement awards attributed to post-combination service in each year of the vesting period of the replacement awards		

5 Calculated as 1.14 million x (1 year / 3 years).

2.2.2 Subsequent changes in estimated forfeitures

IFRS 3.B60

Consistent with the guidance in IFRS 2, changes in estimated forfeitures are reflected as an adjustment to post-combination remuneration cost in the period in which the change in estimate occurs. Therefore, the acquirer does not adjust consideration transferred in periods subsequent to the acquisition date if actual forfeitures differ from the forfeitures estimated at the acquisition date.

Example 2.2.2: Subsequent change in estimated forfeitures

Assume the same facts as in example 2.2.1 except that, subsequent to the acquisition, employee turnover increases unexpectedly among S's employees and at 31 December 2012, the end of the second year after the acquisition date, the estimate of total forfeitures increases to 14 percent, i.e. only 86 percent of the awards are expected to vest. The effect of the change in the estimate of the number of awards expected to vest is reflected in the calculation of remuneration cost from the period in which that change in estimate is made. Therefore, the total post-combination remuneration cost will be adjusted to 0.96 million ((2 million x 86%) - 0.76 million).

The amount of the replacement awards attributable to post-combination service in respect of the year ending 31 December 2011, estimated at 0.38 million (see example 2.2.1), remains unchanged, as does the amount attributed to pre-combination service (0.76 million).

In the second year after the business combination, i.e. the year ending 31 December 2012, post-combination remuneration cost is recognised as follows:

	Debit	*Credit*
Remuneration cost	0.26 million[1]	
Equity		0.26 million
To recognise the amount of the replacement awards attributed to post-combination service in the second year after the business combination, taking into account the revised estimated forfeiture rate of 86%		

[1] Calculated as 0.96 million (adjusted post-combination remuneration cost) x (2 years / 3 years) - 0.38 million.

In the third year after the business combination, i.e. the year ending 31 December 2013, post-combination remuneration cost is recognised as follows:

	Debit	*Credit*
Remuneration cost	0.32 million[2]	
Equity		0.32 million
To recognise the amount of the replacement awards attributed to post-combination service in the third year after the business combination		

[2] Calculated as 0.96 million (adjusted post-combination remuneration cost) - 0.38 million - 0.26 million.

Likewise, an acquirer does not adjust the amount of consideration transferred for other changes resulting from changes in estimates, such as those related to non-market performance conditions or modifications occurring after the acquisition date. Accordingly, all relevant information is taken into account when determining the probability of meeting a non-market performance condition at the acquisition date. If at the acquisition date it is not probable that the non-market performance condition for the replacement awards will be met, then no amount is attributed to pre-combination service and recognised as part of consideration transferred. If the non-market condition of the replacement award ultimately is met, then the whole amount of the acquisition-date market-based measure of that award is recognised as post-combination remuneration cost.

2.3 Replacement awards with market or non-vesting conditions

2.3.1 Replacement awards with market conditions

IFRS 2.A A share-based payment may contain a market condition (a performance condition that determines whether a share-based payment vests that is related to the market price of the entity's equity instruments). Examples of market conditions include a specific share price target or total shareholder return, measured based on the share price of an entity's shares adjusted for the reinvestment of dividends, or based on the share price of an entity's shares relative to a stock-exchange index.

Market conditions are reflected as an adjustment (discount) to the market-based measure of both the replacement and the acquiree's awards at the acquisition date. This applies regardless of the classification of the share-based payment as equity-settled or cash-settled.

IFRS 3.B61 The attribution of the acquisition-date market-based measure of the replacement awards to pre-combination service and post-combination service follows the general requirements set out in paragraphs B56 – B62 of IFRS 3. This applies regardless of the classification of the share-based payment as equity-settled or cash-settled.

However, the accounting for the replacement awards during the post-combination periods differs depending on the classification of the share-based payment with a market condition:

IFRS 2.21, IG24
- For equity-settled share-based payments, there is no "true up" for differences between the expected and actual outcome of market conditions. Therefore, if the market condition is not met, then the acquirer continues to recognise the post-combination cost as long as the service condition, and any non-market performance condition, is/are met in accordance with IFRS 2.

IFRS 2.33, 3.B61
- For cash-settled share-based payments, the liability is remeasured at the end of each reporting period. Changes in the liability occurring after the acquisition date are recognised in the post-combination financial statements of the acquirer in accordance with IFRS 2.

Example 2.3.1 Equity-settled replacement awards with a market condition that ultimately is not met

On 1 January 2010 Company S granted its CEO share options. The options vest if, at the vesting date, the CEO still is in service with S and if S's share price has increased by at least 20 percent. The vesting date of the acquiree's awards is 31 December 2012.

Company P acquires S on 1 January 2011. At that date, the market-based measure of the acquiree's awards is 1.2 million. The acquisition agreement states that P is obliged to issue the CEO replacement awards. As a result, at the acquisition date P issues replacement awards in exchange for S's awards. The replacement share options (on shares of P) have a remaining vesting period of two years and vest if, at the vesting date, the CEO still is in service with P's group and if P's share price has increased by at least 15 percent. It is expected that the CEO will remain employed by P's group until the vesting date. The market-based measure of the replacement awards at the acquisition date is 1.3 million.

Amount attributed to pre-combination service

1.2 million[1] x 100%[2] x 33% (1 year / 3 years)[3] x = 0.4 million

1 Market-based measure of acquiree awards at the acquisition date.

2 The CEO is expected to remain employed by the group, so the estimated forfeiture is zero.

3 Ratio of service rendered as of 1 January 2011 compared to the greater of the original vesting period and the sum of the pre-combination vesting period plus the post-combination vesting period (both periods are three years in this scenario).

Amount attributed to post-combination service

1.3 million[4] x 100% - 0.4 million[5] = 0.9 million

[4] Market-based measure of replacement awards.

[5] Amount attributed to pre-combination service (see above).

In its consolidated financial statements, P records the following entries:

	Debit	*Credit*
Goodwill	0.4 million	
Equity		0.4 million
To recognise the amount of the replacement awards attributed to pre-combination service as part of consideration transferred		

Late in 2011, it still is expected that the CEO will remain in service until the end of the vesting period. The market-based measure attributed to post-combination service is recognised as follows in the year ending 31 December 2011:

	Debit	*Credit*
Remuneration cost	0.45 million[6]	
Equity		0.45 million
To recognise the amount of the replacement awards attributed to post-combination service in 2011		

[6] Calculated as 0.9 million x (1 year / 2 years).

Due to a downturn in the financial market during the second half of 2012, P's share price decreases significantly and the market condition is not met at 31 December 2012. The CEO is still in service on that date. Despite the market condition ultimately not being met, P continues to recognise the post-combination remuneration cost estimated initially. The market-based measure attributed to post-combination service in the year ending 31 December 2012 is recognised as follows:

	Debit	*Credit*
Remuneration cost	0.45 million[7]	
Equity		0.45 million
To recognise the amount of the replacement awards attributed to post-combination service in 2012		

[7] Calculated as 0.9 million x (2 years / 2 years) - 0.45 million.

Example 2.3.2: Cash-settled replacement awards with market condition that ultimately is not met

Assume the same facts as in example 2.3.1 except that the replacement and acquiree awards granted to the CEO are cash-settled share appreciation rights (SARs), and the services received do not qualify for capitalisation. The market-based measures of the replacement awards are 1.5 million at 31 December 2011 (assuming that at that time it is expected that the market-condition will be met) and zero at the end of the vesting period at 31 December 2012 since the market condition ultimately is not met.

As illustrated previously, the market-based measure of the replacement awards attributed to pre- and post-combination services remains the same since the requirement for attribution of the market-based measure of the replacement awards applies regardless of the classification of the share-based payment. Therefore, the market-based measure attributed to pre-combination service is recognised as follows:

	Debit	*Credit*
Goodwill	0.4 million	
Liability		0.4 million
To recognise the amount of the replacement awards attributed to pre-combination service as part of consideration transferred		

Since the cash-settled replacement awards are remeasured at the end of each reporting period until settlement, the amounts recognised in the financial statements of P for the year ending 31 December 2011 are presented as follows:

	Debit	*Credit*
Remuneration cost[1]	0.45 million	
Liability		0.45 million
To recognise the amount of the replacement awards attributed to post-combination service in 2011, based on the market-based measure at the acquisition date		

[1] Calculated as (1.3 million - 0.4 million) x (1 year / 2 years).

	Debit	*Credit*
Remuneration cost/finance income or expense[2]	0.1 million[3]	
Liability		0.1 million
To recognise the remeasurement of the liability to 1.5 million at the end of 2011		

[2] There is no guidance on whether the remeasurement of the liability should be presented in profit or loss as an employee cost or as a finance income or expense. In our view, both presentations are permitted and entities should make an accounting policy choice and apply that policy consistently. This issue is discussed in our publication *Insights into IFRS* (4.5.630.30).

[3] Calculated as (1.5 million - 1.3 million) x (1 year / 2 years).

The post-combination service and remeasurement of the liability recognised in the year ending 31 December 2012 are as follows:

	Debit	*Credit*
Remuneration cost	0.45 million[4]	
Liability		0.45 million
To recognise the amount of the replacement awards attributed to post-combination service received in 2012, based on the market-based measure at the acquisition date		

[4] Calculated as ((1.3 million - 0.4 million) x (2 years / 2 years)) - 0.45 million.

	Debit	*Credit*
Liability	1.4 million[5]	
Remuneration cost/finance income or expense[6]		1.4 million
To recognise the remeasurement of the liability to zero at the end of 2012		

[5] Calculated as 0.4 million + 0.45 million + 0.1 million + 0.45 million.
[6] See note 2 above.

The cumulative amounts recognised by P in respect of this replacement are therefore as follows:

	Debit	*Credit*
Goodwill	0.4 million	
Profit or loss		0.4 million[7]

[7] Calculated as 1.4 million - (0.45 million + 0.45 million + 0.1 million).

As illustrated in examples 2.3.1 and 2.3.2, the overall impact of not meeting a market condition can differ significantly depending on the classification of the share-based payment. In an equity-settled share-based payment (example 2.3.1) the accounting for post-combination remuneration cost is not affected when a market condition is not met. In contrast, when such a condition is not met in a cash-settled share-based payment (example 2.3.2), the liability is reversed through profit or loss, even though the amount of the liability recorded for services attributed to pre-combination service remains in goodwill.

Cumulative journal entry example 2.3.1 (equity-settled)			Cumulative journal entry example 2.3.2 (cash-settled)		
	Debit	*Credit*		*Debit*	*Credit*
Goodwill	0.4 million		Goodwill	0.4 million	
Remuneration cost	0.9 million		Profit or loss		0.4 million[9]
Equity		1.3 million[8]			
[8] Calculated as 0.4 million + 0.45 million + 0.45 million (i.e. market based measure of the replacement awards).			[9] Calculated as 0.45 million + 0.45 million + 0.1 million - 1.4 million.		

2.3.2 Replacement awards with non-vesting conditions

For equity-settled share-based payments, non-vesting conditions, similar to market conditions, are reflected in the market-based measure of the share-based payment at the acquisition date.

For cash-settled share-based payments, in our view non-vesting conditions also should be taken into account when measuring the market-based measure of a cash-settled liability at the acquisition date, similar to market conditions. This issue is discussed in our publication *Insights into IFRS* (4.5.640.50).

As with awards with market conditions, the accounting for the replacement awards during the post-combination periods differs depending on the classification of the share-based payment with the non-vesting condition:

- For equity-settled share-based payments, there is no "true up" for differences between the expected and actual outcome of non-vesting conditions. Therefore, if all service and non-market performance conditions are met, then the acquirer recognises the amount attributed to post-combination service as a remuneration cost even if the counterparty does not receive the share-based payment due to a failure to meet a non-vesting condition. In addition:
  - When either the entity or the counterparty can choose whether to meet a non-vesting condition and one chooses not to do so during the vesting period, the failure to meet the condition is treated as a cancellation. Under cancellation accounting, the unrecognised amount of the remuneration cost is recognised immediately (accelerated vesting) in profit or loss.
  - When neither the entity nor the counterparty can choose whether to meet a non-vesting condition (for example, if an option can be exercised only when the price of gold does not exceed a specified price), then there is no change to the accounting if the non-vesting condition is not satisfied, and the entity recognises the remuneration cost so long as service and non-market performance conditions are met.
- For cash-settled share-based payments, in our view the requirement to remeasure cash-settled share-based payments until and to their ultimate settlement amount overrides the prohibition on "true up" for failure to satisfy a non-vesting condition. This is the same as our approach to cash-settled share-based payments with market performance conditions (see section 2.3.1). This issue is discussed in our publication *Insights into IFRS* (4.5.640.50).

Example 2.3.3: Equity-settled replacement award with a non-vesting condition that the counterparty can choose to meet

On 1 January 2010 Company S granted share options to an employee. The options vest after three years if the employee still is in service with S. In addition, there is a non-vesting condition requiring the employee to pay a monthly deposit, which will be used to pay the exercise price of the options after three years, with accumulated interest paid to the employee. The options lapse if the employee stops contributing a deposit, in which case S will refund to the employee the contributed amount plus accumulated interest.

Company P acquires S on 1 January 2011. At that date, the market-based measure of the employee's award is 0.72 million and the employee has paid all deposits due so far. The acquisition agreement states that P is obliged to issue the employee a replacement award. As a result, at the acquisition date P issues a replacement award in exchange for S's award for which the vesting date is 1 January 2013. The service condition and non-vesting condition attached to the replacement award are the same as those attached to the original award. The market-based measure of the replacement award at the acquisition date is 1.08 million, and the employee is expected to remain in service until the vesting date.

Amount attributed to pre-combination service

0.72 million[1] x 100%[2] x 33% (1 year / 3 years)[3] = 0.24 million

1 Market-based measure of acquiree award at the acquisition date.

2 The employee is expected to remain employed by the group, so the estimated forfeiture is zero.

3 Ratio of service rendered as of 1 January 2011 compared to the greater of the original vesting period and the sum of the pre-combination vesting period plus the post-combination vesting period (both periods are three years in this scenario).

Amount attributed to post-combination service

1.08 million[4] x 100% - 0.24 million[5] = 0.84 million

4 Market-based measure of replacement award.

5 Amount attributed to pre-combination service (see above).

In its consolidated financial statements, P records the following entries:

	Debit	*Credit*
Goodwill	0.24 million	
Equity		0.24 million
To recognise the amount of the replacement award attributed to pre-combination service as part of consideration transferred		

In December 2011 P's share price has dropped and the employee does not expect the share price to increase to an amount greater than the exercise price of the options. Therefore, the employee does not pay the required deposit.

Since the employee has chosen not to meet the non-vesting condition, the failure to meet that condition (payment of the deposit) is treated as a cancellation. In this example, under cancellation accounting, the full amount of the post-combination remuneration cost is recognised immediately (accelerated vesting) in profit or loss.

The amount for post-combination service as at 31 December 2011 is recognised as follows:

	Debit	*Credit*
Remuneration cost	0.84 million	
Equity		0.84 million
To recognise the amount of the replacement award attributed to post-combination service taking into account the accelerated vesting		

2.4 Replacement awards with various other features

2.4.1 Acquiree award provides for accelerated vesting on change in control

Share options or other share-based payment plans often include a clause that provides for the acceleration of vesting in the event of a change in control of the issuer (a "change-in-control" clause). In other instances, existing awards sometimes are modified to add such a change-in-control clause in contemplation of a change in control of an acquiree. The effect of the change-in-control clause that accelerates vesting on the attribution of an acquirer's replacement awards between pre-combination and post-combination service depends on how the change-in-control clause arose. For share-based payments that expire upon a change in control and that are replaced nevertheless, see section 3.1.

In some circumstances a change-in-control clause is included in the original terms of an acquiree award and the clause is triggered by an acquisition of the acquiree such that unvested awards immediately vest at the acquisition date. In such cases, the shortened vesting period resulting from the change in control was provided for by the terms of the acquiree award and is in our view regarded as the original vesting period for the purposes of determining the amount of a replacement award to be attributed to pre-combination service and to post-combination service.

Consider a case in which an acquiree award that includes a change-in-control clause that provides for the acceleration of vesting in its terms is exchanged for a replacement award that does not require post-combination service to vest. In this case we believe that the original vesting period and the sum of the pre-combination vesting period plus the post-combination vesting period would be the same for purposes of attributing the replacement award to pre-combination and post-combination services. Accordingly, if in such situations the market-based measure of the

replacement award is not in excess of that of the acquiree award, then we believe that the total market-based measure of the replacement award would be attributed to the consideration transferred in the business combination; no amount would be attributed to post-combination remuneration cost. Any market-based measure of the replacement award in excess of that of the acquiree award would be recognised immediately as post-combination cost.

Example 2.4.1: Immediate vesting upon a change in control

On 1 January 2009 Company S granted its employees a share-based payment award. Under the terms of the award, the entire award vests at the end of four years of service; however, the award vests immediately in the event of a change in control of S. Assume that forfeitures are estimated at zero.

Company P acquires S on 1 January 2011. Because of the change-in-control clause, S's share award vests immediately at the acquisition date. At that date, the market-based measure of the fully vested S award is 2 million and P issues a fully vested replacement award to S's employees with a market-based measure of 2 million.

Before the acquisition date, two years of the original four-year vesting period for S's award were complete. However, because the terms of S's award provide for accelerated vesting in the event of a change in control, we believe that the change in control results in a change in the original vesting period from four years to two years and, as a result, the original service period and the sum of the pre-combination service period plus the post-combination service period are the same (two years) for the purpose of attributing the replacement award to pre-combination and post-combination service.

Since no post-combination service by S's employees is required, and since the market-based measure of the replacement award issued by P (the acquirer) is equal to the market-based measure of the acquiree award, we believe that the entire market-based measure of the replacement award (2 million) is attributed to pre-combination service and included in the consideration transferred in the business combination (see also example 2.1.3).

2.4.2 Acquirer requests modification of acquiree award in contemplation of change in control

If a change-in-control clause is added to an acquiree's share-based payment award at the request of an acquirer, then in our view the accounting would be the same as if the acquirer issued a fully vested replacement award in exchange for an unvested acquiree award.

Example 2.4.2: Vesting upon a change in control linked to acquisition

On 1 January 2010 Company S granted its CEO a share-based payment award. The terms of the award provide for the vesting of the entire award at the end of four years.

Company P acquires S on 1 January 2011. Shortly before the acquisition date, in contemplation of the acquisition, S modified the award to add a change-in-control clause that accelerates vesting at the request of P. At the acquisition date, the market-based measure of the acquiree award is 2 million. As a result, at the acquisition date P issues a fully vested replacement award in exchange for S's award.

In this example, the modification of the CEO's award is effected at the request of P. Accordingly, we believe that the attribution of the market-based measure of the replacement award issued by P between pre-combination and post-combination service is the same as it would have been had S's award remained outstanding under its original terms at the acquisition date and been

exchanged for a fully-vested replacement award with the same market-based measure at the acquisition date issued by P (see also example 2.1.6).

2.4.3 Awards with graded vesting

IFRS 2.IG11

In some cases share-based payment awards vest in instalments over the vesting period (graded-vesting awards). IFRS 2 requires each such instalment to be treated as a separate grant of share-based payment awards. Accordingly, an entity determines the portion of replacement awards to be attributed to pre- and post-combination service separately for each tranche of a graded-vesting award.

Example 2.4.3: Graded-vesting replacement awards

Company P acquires Company S on 1 January 2011. P issues replacement awards of 100 share options with a market-based measure of 1 million to replace share options held by S's employees with the same market-based measure and vesting conditions on the acquisition date.

The vesting for the acquiree awards is graded, with 25 percent vesting each year for four years, rather than all the awards vesting at the end of a four-year period (a "cliff-vesting" award). At the acquisition date, S's employees have provided two years of service. S's share option plan does not contain a change-in-control clause under which either vesting is accelerated or the awards expire (see 2.4.1). Assume that estimated forfeitures are zero. Also assume for the purposes of illustration that the market-based measure of each tranche is identical, which may not be the case in practice as the expected life of an option affects its market-based measure.

Assuming that none of the options are exercised by the acquisition date, the amount of the awards attributed to pre-combination and post-combination service is determined as follows:

Amount attributed to pre-combination service

Tranche 1: 250,000[1] x (1 year / 1 year)[2] =	250,000
Tranche 2: 250,000[1] x (2 years / 2 years)[2] =	250,000
Tranche 3: 250,000[1] x (2 years / 3 years)[2] =	166,667
Tranche 4: 250,000[1] x (2 years / 4 years)[2] =	125,000
Total =	791,667

1 Market-based measure of acquiree awards at the acquisition date.

2 Ratio of service rendered as of 1 January 2011 compared to the greater of the original vesting period and the sum of the pre-combination vesting period plus the post-combination vesting period (determined separately for each tranche.

Amount attributed to post-combination service

Tranche 1: 250,000[3] - 250,000[4] =	0
Tranche 2: 250,000[3] - 250,000[4] =	0
Tranche 3: 250,000[3] - 166,667[4] =	83,333
Tranche 4: 250,000[3] - 125,000[4] =	125,000
Total =	208,333

3 Market-based measure of replacement awards.

4 Amount attributed to pre-combination service (see above).

In its consolidated financial statements, P records the following entries:

	Debit	*Credit*
Goodwill Equity *To recognise the amount of the replacement awards attributed to pre-combination service as part of consideration transferred*	791,667	791,667
Remuneration cost Equity *To recognise the amount of the replacement awards attributed to post-combination service in the first year after the business combination, i.e. the year ending 31 December 2011*	145,833[5]	145,833

[5] Calculated as (83,333 x 1 year / 1 year) + (125,000 x 1 year / 2 years).

	Debit	*Credit*
Remuneration cost Equity *To recognise the amount of the replacement awards attributed to post-combination service in the second year after the business combination, i.e. the year ending 31 December 2012*	62,500[6]	62,500

[6] Calculated as (125,000 x (2 years / 2 years)) - 62,500.

2.5 Accounting for the income tax effects of replacement awards

2.5.1 Accounting principles

IAS 12.68B

IAS 12 *Income Taxes* states that the difference between the tax base of employee services rendered to date and their carrying amount (zero)[1] is a temporary difference on which deferred tax is recognised. If the amount of any future deduction is not known, then an entity estimates that amount based on information available. For example, in many jurisdictions a tax deduction is given for the intrinsic value of an award at its exercise date, in which case an entity recognises a deferred tax asset, which is measured based on the entity's current share price.

IFRS 3.B62, IAS 12.IE-Ex6

If an acquirer issues an equity-settled replacement award that will result in a tax deduction at a later date, then, if recovery is probable, a deferred tax asset is recognised in the acquisition accounting for the deductible temporary difference that relates to the portion of the award attributed to pre-combination employee service. For portions of the award attributable to post-combination employee service, a deferred tax asset is recognised in the period that the remuneration cost is recognised for financial reporting purposes.

The deferred tax asset recognised in the acquisition accounting subsequently may be remeasured for changes in the amount expected to be received as a tax deduction, for example due to fluctuations in the market price of the related shares. IAS 12 does not stipulate how such changes in the deferred tax asset arising from the expected tax deduction are recognised. In our view, an entity makes an accounting policy choice to either:

- recognise all such changes in profit or loss;

1 This applies to equity-settled share-based payments only.

- recognise all such changes directly in equity; or
- recognise the effect of estimated future tax deductions in excess of a certain amount directly in equity and other such changes in profit or loss.

An entity that adopts the latter "asymmetric" accounting policy recognises changes in the expected tax deduction differently depending on whether the total estimated tax deduction attributed to the pre-combination service element of an award exceeds the amount of the acquisition-date market-based measure of that element of the award. To the extent that the expected tax deduction exceeds the market-based measure, the related tax effects are recognised in equity; all other such changes are recognised in profit or loss.

2.5.2 Tax deductible share-based payment replacement awards

The following two examples illustrate the accounting for income taxes related to share-based payment replacement awards.

Example 2.5.1: Fully vested awards

Company P acquires Company S on 1 January 2010. P issues replacement awards of 10 million share options over P's shares with a total market-based measure of 10 million and an exercise price of 2.00 each to replace share options with a market-based measure on the acquisition date of 10 million held by S's employees. The share option replacement awards are tax deductible with the amount of the tax deduction based on the intrinsic value of the awards at exercise date. At the acquisition date, the awards are fully vested and the replacement awards require no further service to vest. Accordingly, the entire market-based measure of the replacement awards is attributed to pre-combination service. The options must be exercised by 31 December 2010. P's share price on the acquisition date is 2.75. The applicable tax rate is 40 percent. Assume that P expects sufficient future taxable income to enable it to recognise all of its deferred tax assets.

All of the holders of the replacement awards exercise their options on 31 December 2010, when the share price is 3.25. In its consolidated financial statements, P records the following entries:

	Debit	*Credit*
Deferred tax asset	3 million[1]	
Goodwill		3 million
To recognise a deferred tax asset in the acquisition accounting based on the then-expected future tax deduction		

[1] Calculated as 10 million x 0.75 (2.75 - 2.00) x 40%.

	Debit	*Credit*
Deferred tax asset	2 million[2]	
Deferred tax income in profit or loss		2 million[3]
To recognise at 31 December 2010 the increase in the deferred tax asset initially recognised based on the increase in the then-expected future tax deduction		

[2] Calculated as 10 million x 0.50 (3.25 - 2.75) x 40%.

[3] Alternatively, depending on P's accounting policy choice, this amount might be recognised directly in equity, or some in profit or loss and some directly in equity. The estimated tax deduction at 31 December 2010 is 12.5 million ((3.25 - 2.00) x 10 million). This amount exceeds the acquisition-date market-based measure of the replacement

awards (10 million). If the tax effect is recognised partly in equity and partly in profit or loss, then the tax effect on the excess, which amounts to 1 million ((12.5 million - 10 million) x 40%) is recognised in equity, and an amount of 1 million ((10 million x 40%) - 3 million) is recognised in profit or loss.

Based on P's accounting policy choice to recognise all deferred taxes in profit or loss, the subsequent journal entries are as follows:

	Debit	*Credit*
Current taxes receivable Current tax income in profit or loss *To recognise the current tax effects of the exercise of all share options at 31 December 2010*	5 million	5 million[4]
Deferred tax expense Deferred tax asset *To recognise the deferred tax effects of the exercise of all share options at 31 December 2010*	5 million	5 million[4]

[4] Calculated as 10 million x 1.25 (3.25 - 2.00) x 40%. This equals the total deferred tax asset recognised at 31 December 2010, being the sum of the deferred tax asset recognised initially in the acquisition accounting and the subsequent adjustments made in the year ended 31 December 2010 to reflect changes in the expected amount of future tax deductions (3 million + 2 million).

Example 2.5.2: Awards that require further service subsequent to the business combination

Assume the same facts as in example 2.5.1 except that the acquisition-date market-based measure of the options of 10 million is attributed 5 million to pre-combination service (recognised in the acquisition accounting) and 5 million to post-combination services (accounted for separately from the business combination).

	Debit	*Credit*
Deferred tax asset Goodwill *To recognise a deferred tax asset in the acquisition accounting based on the then-expected future tax deduction*	1.5 million[1]	1.5 million

[1] Calculated as 10 million x 0.75 (2.75 - 2.00) x 40% x 50%.

	Debit	*Credit*
Deferred tax asset Deferred tax income in profit or loss *To recognise at 31 December 2010 the increase in the deferred tax asset recognised initially in respect of the replacement awards attributed to pre-combination service based on the increase in the then-expected future tax deduction*	1 million[2]	1 million[3]

[2] Calculated as 10 million x 0.50 (3.25 - 2.75) x 40% x 50%.

[3] Alternatively, depending on P's accounting policy choice, this might be recognised directly in equity, or some in profit or loss and some directly in equity. The estimated tax deduction at 31 December 2010 in respect of the

market-based measure recognised in the acquisition accounting is 6.25 million ((3.25 - 2.00) x 5 million). This amount exceeds the market-based measure of the replacement awards recognised in the acquisition accounting (5 million). If the tax effect is recognised partly in equity and partly in profit or loss, then the tax effect on the excess, which amounts to 0.5 million ((6.25 million - 5 million) x 40%) is recognised in equity, and an amount of 0.5 million ((5 million x 40%) - 1.5 million) is recognised in profit or loss.

	Debit	*Credit*
Deferred tax asset	2.5 million[4]	
Deferred tax income in profit or loss		2 million[5]
Deferred tax income in equity		0.5 million[5]
To recognise the tax effects of the replacement awards attributed to post-combination service		

[4] Calculated as 10 million x 1.25 (3.25 - 2.00) x 40% x 50%.

IAS 12.68C, IE-Ex5

[5] As the amount of the tax deduction of 6.25 million (see note 4) exceeds the amount recognised as cumulative remuneration expense by the combined entity in profit or loss of 5 million (10 million x 50%), only the tax effect of the cumulative remuneration expense, being 2 million (5 million x 40%), is recognised in profit or loss. The excess of 0.5 million ((6.25 million x 40%) - 2 million) is recognised directly in equity.

	Debit	*Credit*
Current taxes receivable	5 million[6]	
Current tax income in profit or loss		4.5 million
Current tax income in equity		0.5 million[7]
To recognise the current tax effects of the exercise of all share options at 31 December 2010		
Deferred tax expense in profit or loss	4.5 million	
Deferred tax expense in equity	0.5 million[7]	
Deferred tax asset		5 million[6]
To recognise the deferred tax effects of the exercise of all share options at 31 December 2010		

[6] Calculated as 10 million x 1.25 (3.25 - 2.00) x 40%. This equals the total deferred tax asset recognised at 31 December 2010, being the sum of the deferred tax asset recognised initially in the acquisition accounting and the subsequent adjustments made in the year ended 31 December 2010 to reflect changes in the expected amount of future tax deductions (1 million + 2.5 million).

[7] See note 5 above.

3. Voluntary replacements and unreplaced awards

IFRS 3 provides guidance about the accounting for replacements of acquiree awards in a business combination when the acquirer:

- is *obliged* to issue replacement awards (see chapter 2); or
- *chooses* to replace awards that expire as a result of the business combination (see section 3.1.1).

However, IFRS 3 does not provide guidance on voluntary replacement of unexpired awards and unreplaced awards.

On 6 May 2010 the IASB published amendments to IFRS 3 as part of its annual improvements process so that the guidance for mandatory replacements also applies to voluntary replacements of unexpired awards. In addition, the amendments introduce requirements in respect of the accounting for acquiree awards that the acquirer does not replace (see section 3.2).

The amendments are applied prospectively from the date the entity first applied IFRS 3 (revised 2008) and are effective for annual reporting periods beginning on or after 1 July 2010. Earlier application is permitted. If an entity applies the amendments for an earlier period, then it discloses that fact.

3.1 Voluntary replacements

IFRS 3.BC311B An entity may replace awards other than when obliged to do so, which is referred to here as voluntary replacements. Following the amendments to IFRS 3, the standard now provides guidance about the accounting for voluntary replacement of expired as well as unexpired awards. However, as a consequence of the amendments, there is a contrast between the accounting for voluntary replacement of expired awards (see section 3.1.1) and accounting for voluntary replacement of unexpired awards (see section 3.1.2). This is because when an acquirer replaces an unexpired award, part of the market-based measure of the replacement award reflects the acquiree's obligation that remains outstanding at the acquisition date, and that part is accounted for as part of the consideration transferred in the business combination. When an acquirer voluntarily replaces an expired award there is no such obligation and the new award can be for future services only.

3.1.1 Voluntary replacement of an expired award

IFRS 3.B56 If an award that expires as a result of a business combination is replaced voluntarily, then all of the market-based measure of the replacement award is recognised as post-combination remuneration cost. In other words, none of the market-based measure of the replacement awards is attributed to pre-combination service in the business combination.

Example 3.1.1 – Voluntary replacement of an expired award

Company S granted a share-based payment award to its employees on 1 January 2008, subject to a five-year service condition. The awards contain a clause stating that the share-based payment would expire upon a change in control over S.

Company P acquires S on 1 January 2011; consequently all of S's acquiree awards expire. In order to motivate S's employees, P grants an equity-settled replacement award on 1 January 2011 with a market-based measure of 2 million. The replacement awards contain a one-year service condition.

Assuming that all employees have met the service condition at 31 December 2011, in its consolidated financial statements P records the following entry:

	Debit	*Credit*
Remuneration cost	2 million	
Equity		2 million
To recognise the amount of the replacement awards that entirely is attributed to post-combination service		

No amount of the market-based measure of the replacement award is attributed to pre-combination service. In effect, the replacement award is recognised as if P had issued a new share-based payment award on 1 January 2011.

3.1.2 Voluntary replacement of an unexpired award

As a result of the amendments, the requirements to attribute the market-based measure of the replacement award contained in paragraph B56 of IFRS 3 that previously applied only to mandatorily replaced acquiree awards now also applies to unexpired acquiree awards that are replaced voluntarily (see chapter 2).

3.2 Unreplaced awards

The amendments introduce requirements in respect of the accounting for acquiree awards that the acquirer does not replace. If an acquiree award is not replaced in a business combination, then the amendments distinguish between two scenarios:

- the acquiree awards were vested at the acquisition date (see section 3.2.1); and
- the acquiree awards were not vested at the acquisition date (see section 3.2.2).

3.2.1 Vested acquiree awards are not replaced

IFRS 3.19, B62A

If an equity-settled unreplaced acquiree award is vested at the acquisition date, then those acquiree awards are part of the non-controlling interest in the acquiree and are measured at their market-based measure at the acquisition date in accordance with IFRS 2. This is because the awards do not represent present access to ownership interest and do not entitle their holders to a proportionate share of the acquiree's net assets in the event of liquidation. The amendments do not provide any illustrative examples as to how such a transaction would be accounted for. Example 3.2.1 illustrates how an equity-settled unreplaced vested award potentially is accounted for by the acquirer in a business combination.

Example 3.2.1: Vested equity-settled acquiree awards that are not replaced

Company P acquires Company S on 1 January 2011. At the acquisition date, S's employees hold share options. All of the acquiree awards were granted on 1 January 2009, i.e. two years prior to the acquisition date, have a vesting period of two years and can be exercised any time thereafter within three years. Therefore, these acquiree awards are fully vested at the acquisition date.

There is no requirement, in either the original terms of the acquiree award, or in the acquisition agreement, to replace the acquiree awards. P decides not to replace the acquiree awards. At the acquisition date, the market-based measure of the acquiree awards is 0.48 million.

Amount attributed to pre-combination service
Since the acquiree options are vested, they are part of the non-controlling interest in the acquiree and are measured at their market-based measure at the acquisition date.

Amount attributed to post-combination service
Because the acquiree options are vested at the date of the business combination and are not replaced, no amount is attributed to post-combination service.

In its consolidated financial statements, P records the following entry:

	Debit	*Credit*
Goodwill	0.48 million	
Non-controlling interest		0.48 million
To recognise the non-controlling interest relating to the unreplaced acquiree awards		

3.2.2 Unvested acquiree awards are not replaced

IFRS 3.B62A If an equity-settled unreplaced acquiree award is not vested at the acquisition date, then it is measured at its market-based measure as if the acquisition date were the grant date under IFRS 2. In determining the portion of the market-based measure that is allocated to pre-combination services, all relevant data regarding the probability of meeting vesting conditions other than market conditions is taken into account. If the acquiree's awards have non-market performance conditions that are not probable of being met as of the acquisition date, then no amount is allocated to pre-combination services and therefore no amount is allocated to non-controlling interest.

IFRS 3.B62B When the non-market performance condition is probable of being met such that a portion of the market-based measure is allocated to pre-combination services, the market-based measure of the unvested share-based payment awards is allocated to pre-combination services, and therefore to the non-controlling interest, based on the ratio of the portion of the vesting period completed to the greater of the total vesting period or the original vesting period of the unreplaced awards. The balance is allocated to post-combination service. The attribution formula for unreplaced awards is the same as the formula for replaced awards, meaning that it also applies to unreplaced awards in which the vesting period is modified. The amendments do not provide any illustrative examples as to how unreplaced unvested awards would be accounted for. Example 3.2.2 illustrates how an equity-settled unreplaced unvested award potentially is accounted for by the acquirer in a business combination.

Example 3.2.2: Unvested equity-settled acquiree awards that are not replaced
Company P acquires Company S on 1 January 2011. At the acquisition date, S's employees hold share options. All of the acquiree awards were granted on 1 January 2009, i.e. two years prior to the acquisition date, and have a vesting period of five years; therefore these acquiree awards are not yet vested at the acquisition date. All vesting conditions are expected to be met.

There is no requirement, in either the original terms of the acquiree award or in the acquisition agreement to replace the acquiree awards. The acquirer decides not to replace or modify the acquiree awards. At the acquisition date, the market-based measure of the acquiree awards is 0.6 million.

Amount attributed to pre-combination service

Since the acquiree options are not vested the market-based measure of those unvested share-based payment awards is attributed to pre- and post-combination service based on the ratio of the portion of the vesting period completed to the greater of the total vesting period or the original vesting period of the share-based payment awards. The portion of the awards that is attributed to pre-combination service is part of the non-controlling interest in the acquiree.

The market-based measure of the options at the acquisition date allocated to non-controlling interest is calculated as follows:

0.6 million[1] x 40% (2 years / 5 years)[2] = 0.24 million

1 Market-based measure of acquiree awards at the acquisition date.

2 Ratio of service rendered as of 1 January 2011 compared to the greater of the total vesting period or the original vesting period of the unreplaced award (both periods are five years in this scenario).

Amount attributed to post-combination service

The balance of the total market-based measure of the unvested awards is attributed to post-combination service as follows:

0.6 million[3] - 0.24 million[4] = 0.36 million

3 Market-based measure of acquiree awards at the acquisition date.

4 Amount allocated to non-controlling interest (see above).

In its consolidated financial statements, P records the following entries:

	Debit	*Credit*
Goodwill Non-controlling interest *To recognise the non-controlling interest relating to the unreplaced acquiree awards*	0.24 million	0.24 million
Remuneration cost Non-controlling interest[6] *To recognise the amount of the unreplaced awards attributable to post-combination service in 2011, 2012 and 2013*	0.12 million[5]	0.12 million

5 Calculated as 0.36 million x (1 year / 3 years).

6 The amendments do not state explicitly that the amount recognised as post-combination remuneration cost is allocated to non-controlling interest.

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