

# AUDIT OF SHARE-BASED PAYMENTS

## Highlights of Technical Clinic



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Share-based payments continue to feature as part of employee remuneration arrangements and other transactions entered into by Singapore companies, including, increasingly, SMEs. The relatively complex accounting requirements for these arrangements present specific challenges not only for preparers of financial statements, but also for auditors.

Ng Kian Hui, Audit and Assurance Partner, BDO LLP, facilitated this topic among a group of practitioners at ISCA's monthly technical clinic. Here are the highlights of the discussion.

### 1 DOES A SHARE-BASED PAYMENT ARRANGEMENT ALWAYS INVOLVE AN EMPLOYER AND AN EMPLOYEE?

The scope of FRS 102 *Share-based Payment* (FRS 102) can be surprisingly broad. FRS 102 applies to all transactions in which an entity receives goods or services in exchange for transfer of its own (or another

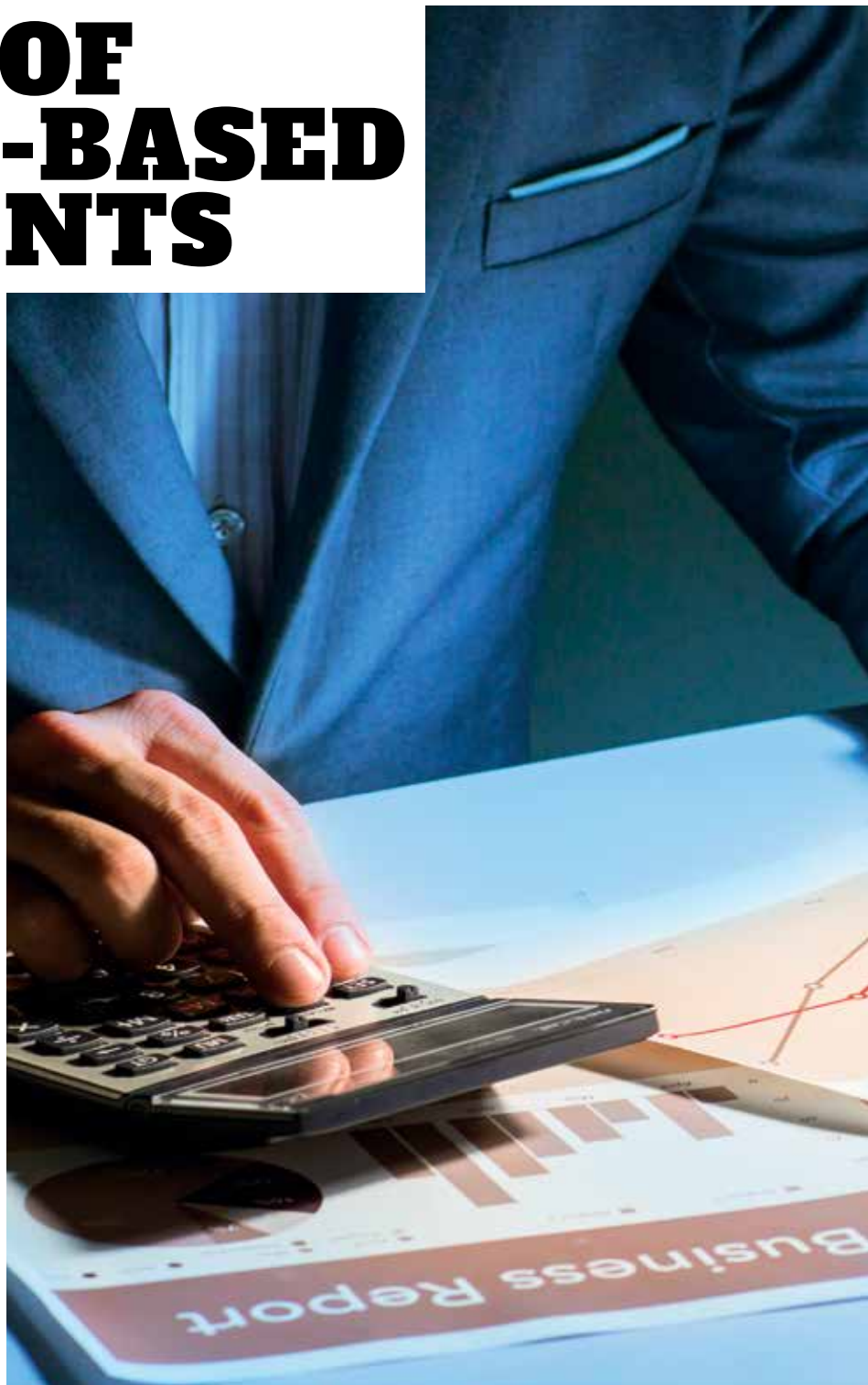




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group entity's) equity instruments to the counterparty, or payment of an amount of cash that is based on its own (or another group entity's) share price. The granting of shares or share options by an entity to its employees is a common example of a share-based payment arrangement; however, many other transactions fall within the scope of FRS 102.

Assessing the completeness of share-based payments accounted for by an entity can therefore be an area with high/significant risk of material misstatement which requires greater audit focus. Situations to look out for, where entities may fail to identify and account for share-based payments, may include:

- + Shares or share options issued to an entity's employees by a parent company;
- + Shares transferred by a shareholder directly, rather than issued by the company itself, to employees, management or directors of the company;
- + Payment in shares for external consultancy services, common among startup companies and in pre-IPO situations, and
- + Payment in shares to a supplier for goods/other assets, including asset acquisitions that do not meet the criteria for business combination accounting.

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**Equity-settled transactions are recognised in equity at fair value, as measured at the grant date with no subsequent re-measurement. By contrast, cash-settled transactions involve the recognition of a liability, which must be recorded at fair value through profit or loss at each reporting date until it is settled.**

## 2 WHAT ARE THE DIFFERENT TYPES OF SHARE-BASED PAYMENT ARRANGEMENTS FOR EMPLOYEE SERVICES?

Auditors need to be aware of the different types of share-based payments in order to assess the appropriateness of the accounting treatment. There are many variations to the detailed accounting requirements depending on the specific features of the arrangement. Additionally, the auditor needs to ensure that the key features of the arrangement are properly reflected in fair value measurement. Some of the distinctions auditors should focus on include:

- + Share-based payments can be either *equity settled* (for example, grant of shares or share options to employees), or *cash settled* (for example, share appreciation rights and phantom shares). Equity-settled transactions are recognised in equity at fair value, as measured at the grant date with no subsequent re-measurement. By contrast, cash-settled transactions involve the recognition of a liability, which must be recorded at fair value through profit or loss at each reporting date until it is settled.
- + Many share-based payments are conditional on the employee satisfying certain vesting conditions. Vesting conditions may affect both the timing of recognition and fair value measurement of the share-based payment expense and therefore must be carefully identified and classified. There may be *service conditions* (for example, continuing employment with the entity) and either *market* or *non-market performance conditions*. Market conditions (for example, achieving a target share price) are taken into account in the estimate of fair value of the equity instrument at grant date, whereas all other

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## AUDIT OF SHARE-BASED PAYMENTS

non-market vesting conditions are reflected in the number of equity instruments included in the fair value measurement.

To illustrate with reference to a group scenario, shares granted by the parent to employees of a subsidiary would be an *equity-settled share-based payment transaction* (recorded as Debit Expense, Credit Equity) in the consolidated financial statements, and also in the financial statements of the subsidiary if the subsidiary has no obligation to settle the award. The subsidiary and the group have received a service, and the parent and the group have issued shares as consideration. The share-based payment transaction would be recognised at the grant date of the award, unless vesting conditions are specified. For example, if the shares vest after three years of continuous employment, the share-based payment transaction might be recorded over those three years.

### 3 WHAT ARE THE CONSIDERATIONS RELATING TO THE CHOICE OF AN OPTION-PRICING MODEL FOR CALCULATING THE FAIR VALUE OF SHARE OPTIONS?

Since employee share options are not traded, observable market prices are generally not available and therefore, fair value is typically determined using an option-pricing model. The most commonly used are the Black-Scholes-Merton formula (Black-Scholes) and Binomial models, but other models such as Lattice models and the Monte Carlo simulation may also be appropriate for certain arrangements. When evaluating its appropriateness, the auditor should consider whether the model selected by the entity is applied in a manner consistent with FRS guidance and economic theory, and reflects the substantive characteristics of the share option scheme in question.

This may be particularly important where an entity has performed the valuation of their share options themselves, rather than engaging an external valuation specialist. The auditor should bear in mind that the Black-Scholes method is likely to be the first choice for entities performing inhouse valuations, but it may not be appropriate for all types of share option schemes. For example, the Black-Scholes model requires adjustment if the options can be exercised prior to the maturity date; share options that include market performance conditions are generally better valued with a Binomial valuation or Monte Carlo simulation.

### 4 WHAT AUDIT PROCEDURES SHOULD THE AUDITOR PERFORM ON THE ACCOUNTING FOR SHARE-BASED PAYMENTS?

In evaluating the appropriateness of the accounting treatment, the auditor must ensure that the share-based payments are both recognised and measured in accordance with FRS 102. In addition to the above-mentioned considerations, the auditor should assess both the accuracy of the option-pricing model calculations, and the appropriateness of the underlying data used as inputs to the model, including the assumptions made by management. In practice, the nature and extent of work by the auditor may depend on whether the fair value has been determined by management or an external valuation specialist.

#### (a) What are the audit procedures that should be performed?

Some of the key audit procedures typically performed include:

- ⊕ Obtaining copies of spreadsheets with the valuation *calculations*, checking and re-performing these for mathematical and theoretical accuracy;
- ⊕ Holding discussions with management and external valuation specialists engaged,

if applicable, as to specific *assumptions* made for inputs to the valuation, and corroborating such assumptions (for example, expected term of options, share price and expected volatility, expected dividends), and

- ⊕ Assessing the *systems, and related controls*, that generate the data used in the fair value computations, including share option/share award systems (for example, records of grants, forfeitures, lapses, exercise) and payroll/HR systems (for example, employee numbers, employment contracts, periods of employment, attrition rates).

#### (b) Can a subsidiary auditor rely on audit work performed by the auditor of the parent?

Arrangements where a parent company grants shares or share options to employees of a subsidiary can present additional practical challenges for the auditor of the subsidiary. The extent to which the subsidiary auditor can rely on audit work by the parent company auditor requires judgement. Generally, the subsidiary auditor would not rely



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solely on the parent company auditor, but would also request and review copies of the relevant workings, reconcile amounts within them to both the subsidiary and parent company financial statements, review statements issued to employees, and obtain relevant confirmations from the employees and the parent company as to completeness. It may also be possible to access and review the parent company's share-based payment systems, or the working papers of the parent company auditor, but such arrangements require early communication. The subsidiary auditor should bear in mind that the parent company auditor is likely to work to a higher materiality threshold.

**(c) When is an auditor's expert required?**

The auditor may need to engage an expert to assist in the review of the valuation of share-based payments. According to SSA 620 *Using the Work of an Auditor's Expert*, whenever expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor must consider whether to engage an auditor's

expert. In order to decide when to engage an expert, the engagement partner takes into consideration, among others, the complexity of the valuation performed, the significance of the amounts involved, whether the management has engaged a management's expert, and their competence and capabilities .

**5 WHAT SHOULD THE AUDITOR DO TO SATISFY THE REQUIREMENT TO EVALUATE THE QUALIFICATIONS OF A SPECIALIST?**

SSA 500 *Audit Evidence* requires the auditor to evaluate the competence, capabilities and objectivity of any expert used by management, including a valuation specialist, as part of assessing the reliability of the expert's work as audit evidence. This involves considering whether the specialist has the necessary qualifications and experience to perform the valuation in question.

In practice, to evaluate the expert's qualifications, the auditor can look into their membership of, and licenses given by, relevant professional bodies, including seeking

evidence in the form of certificates, letters of good standing and/or records of disciplinary procedures. Even with appropriate qualifications in place, the auditor should also consider whether the specialist has experience in valuing the specific type of share-based payment arrangement.

Evaluation of the expert's experience can in practice often be done through a review of the expert's resume and discussions with the expert. The auditor should consider the experience of both the valuation firm and the individual performing the service, and remain alert to, and be sceptical of, situations where the individual might be inexperienced even if the firm overall has relevant experience.

**CONCLUSION**

Auditors should consider the potential impact of FRS 102 on their clients at an early stage of the audit since the audit of share-based payment is likely to involve other professional parties, including valuation specialists and/or auditors of the parent. This will allow the auditors sufficient time and effort to perform an effective and efficient share-based payments audit. ISCA

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