

# Insights into MFRS 2

## Employee share-based payment agreements with settlement alternatives



The use of share-based payments has grown significantly over time, with many organisations opting to compensate directors, senior executives, employees and other providers of goods and services through equity instruments or cash and other assets linked to the value of equity instruments.

MFRS 2 ‘Share-based Payment’ governs the accounting for share-based payment arrangements including employee agreements, and those with settlement alternatives allowing either equity instruments or cash settlements. The accounting treatment varies depending on whether the employee or the entity has the choice of settlement, with distinct approaches for compound financial instruments and present obligations to settle in cash.

Our ‘**Insights into MFRS 2**’ series is aimed at demystifying MFRS 2 by explaining the fundamentals of accounting for share-based payments using relatively simple language and providing insights to help entities cut through some of the complexities associated with accounting for these types of arrangements.

This article discusses share-based payment arrangements that provide either the entity or the employee with a choice as to whether settlement occurs in equity instruments or in cash or other assets (hereafter ‘cash’). The accounting treatment for agreements with settlement alternatives depends on which party has the choice of settlement.

## Employee has the choice of settlement

When the employee has been granted an award where they have the right to choose whether the transaction is settled in cash or equity instruments, the entity has granted a compound financial instrument that includes a debt component and an equity component. The debt component reflects the employee’s right to demand payment in cash, and the equity component reflects the employee’s right to demand settlement in equity instruments rather than cash.

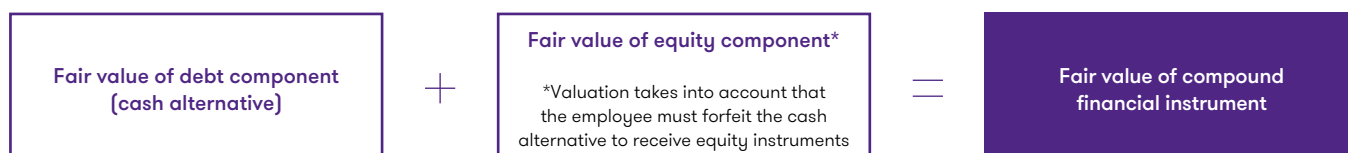
“This article discusses share-based payment arrangements that provide either the entity or the employee with a choice as to whether settlement occurs in equity instruments or in cash or other assets (hereafter ‘cash’).”

### How is the value of a compound financial instrument granted to an employee determined?

At the measurement date, the entity determines the fair value of the compound financial instrument (ie the value of the services received) by taking into account the terms and conditions on which the rights to the equity or cash alternatives were granted.

As discussed in our article '[Insights into MFRS 2 – Basic principles of share-based payment arrangements with employees](#)', the measurement date is the grant date for share-based payment transactions with employees.

The fair value of a compound financial instrument can be illustrated as follows:



The fair value of the debt component is measured first and is equal to the fair value of the cash liability. The fair value of the equity component is then determined and takes into account the fact that the employee must forfeit the cash alternative in order to receive equity instruments. In other words, the fair value of the cash alternative is deducted from the fair value of the equity alternative in order to determine the fair value of the equity component.

In practice, it is common for share-based payment transactions where the employee has the choice of settlement to be structured so that the fair value of the cash and equity alternatives are equal. This structure results in the fair value of the equity component being equal to zero, and therefore the value of the compound instrument is equal to the fair value of the debt component.

To illustrate, assume an entity grants an employee the right to receive either share options or cash-settled share appreciation rights (SARs) upon vesting. Also assume that the exercise price of the share options is equal to the grant date fair value of the entity's shares. The fair value of the cash and equity alternatives will always be equal because the value the employee receives under both alternatives is equal to the difference between the share price at vesting and the grant date fair value (ie the grant date share price). Consequently, the fair value of the equity component will be equal to zero, and the fair value of the compound instruments will be equal to the fair value of the debt component.

Arrangements may also be structured so that the fair value under the settlement alternatives differ. Usually, the fair value of the equity component under these arrangements will be greater than zero and therefore the value of the compound instrument will exceed the fair value of the debt component. An example of such an arrangement and the required accounting treatment can be found in Example 1 below.

### How should the compound financial instrument be accounted for?

Each component of the compound financial instrument is accounted for separately in accordance with the requirements for cash-settled and equity-settled share-based payments, as discussed in our articles '[Insights into MFRS 2 – Cash-settled share-based payment arrangements with employees](#)' and '[Insights into MFRS 2 – Equity-settled share-based payment arrangements with employees](#)'.

In summary, the accounting treatment for the debt and equity components is as follows:

Component	Accounting treatment
<b>Debt component</b>	<p>Accounting for cash-settled share-based payments:</p> <ul style="list-style-type: none"><li>• Recognise the services as received over the vesting period in profit and loss (other than amounts that qualify for capitalisation) with a corresponding credit to a liability. Do not recognise amounts relating to awards that are not expected to and ultimately do not vest, because of a failure to satisfy a service or non-market performance vesting condition specified at the grant date.</li><li>• Remeasure the liability to its fair value at the end of each reporting period and upon settlement, taking any differences to profit or loss. Market performance and non-vesting conditions are taken into account when estimating the fair value of the cash-settled share-based payment; if such conditions are not met, any amounts previously recognised in profit or loss are reversed.</li></ul>
<b>Equity component</b>	<p>Accounting for equity-settled share-based payments:</p> <ul style="list-style-type: none"><li>• Recognise the services as received over the vesting period in profit and loss (other than amounts that qualify for capitalisation) with a corresponding credit to equity. Do not recognise amounts relating to awards that are not expected to and ultimately do not vest, because of a failure to satisfy a service or non-market performance vesting condition specified at the grant date.</li></ul>

At the settlement date, the debt component is remeasured to its fair value and the accounting is as follows:

- If the employee chooses to settle in equity instruments, rather than settling in cash, the value of the liability is transferred directly to equity, as consideration for the equity instruments issued.
- If the employee chooses to settle in cash, the payment is used to settle the liability in full. Any equity component previously recognised remains in equity, as the employee has forfeited the right to receive equity instruments. However, the entity may recognise a transfer within equity (ie from one component of equity to another).



### Example 1 – Employee has choice of settlement

Company A grants to an employee the right to choose either 1,000 phantom shares (ie a right to a cash payment equal to the value of 1,000 shares), or 1,200 shares. The grant is conditional upon the completion of three years of service. If the employee chooses the share alternative, the shares must be held for three years after the vesting date.

At the grant date, Company A's share price is CU50 per share. At the end of years one, two and three, the share price is CU52, CU55 and CU60 respectively. Company A does not expect to pay dividends in the next three years. After taking into account the effects of post-vesting transfer restrictions, the entity estimates that the grant date fair value of the share alternative is CU48 per share.

At the end of year three, the employee chooses:

- Scenario one – the cash alternative
- Scenario two – the equity alternative

#### Analysis

Company A first determines the value of the compound financial instrument at the measurement date.

- Fair value of equity alternative = 1,200 shares x CU48 = CU57,600
- Fair value of cash alternative = 1,000 phantom shares x CU50 (grant date share price) = CU50,000

The fair value of the equity component is therefore CU7,600 (CU57,600 less CU50,000).

Company A recognises the following amounts:

Year	Calculation	Expense (CU)	Adjustment to Equity (CU)	Adjustment to Liability (CU)
1	Liability component: (1,000 x CU52 x 1/3 years) Equity component: (CU7,600 x 1/3 years)	17,333 2,533	- 2,533	17,333 -
2	Liability component: (1,000 x CU55 x 2/3 years) – CU17,333 Equity component: (CU7,600 x 2/3 years) – CU2,533	19,333 2,533	- 2,533	19,333 -
3	Liability component: (1,000 x CU60 x 3/3 years) – CU36,666* *(CU17,333 + CU19,333) Equity component: (CU7,600 x 3/3 years) – CU5,066	23,334 2,534	- 2,534	23,334 -
End of Year 3	Scenario 1: Cash alternative – Cash of CU60,000 paid <b>Totals</b>	- <b>67,600</b>	- <b>7,600</b>	(60,000) <b>-</b>
	Scenario 2: Equity alternative – 1,200 shares issued <b>Totals</b>	- <b>67,600</b>	60,000 <b>67,600</b>	(60,000) <b>-</b>

### How should the compound financial instrument be accounted for where each alternative has a different vesting period?

In some situations, arrangements may be structured so that each alternative has a different vesting period. For example, an employee may have the right to choose either 1,000 phantom shares at the end of a three-year vesting period, or 1,200 share options if the employee remains employed for an additional two years following the original vesting period. The IFRS Interpretations Committee (IFRIC) released an Agenda Decision in May 2006 which clarified that MFRS 2 requires that an entity accounts for each component separately, and therefore vesting periods of the debt and equity components should also be determined separately.

### How should an entity account for transactions where the cash alternative is not based on the value of the entity's equity instruments?

An entity may offer an employee the right to receive shares (or another equity alternative), or cash at an amount that is unrelated to the price of the entity's equity instruments. In practice, although the cash alternative in isolation does not fall within the scope of MFRS 2, one acceptable approach is to account for such arrangements as compound financial instruments in accordance with MFRS 2 by analogy. The non-share-based cash alternative would represent the debt component and be accounted for in accordance with the appropriate standard, such as MFRS 119 'Employee Benefits'. As discussed above, any excess of the fair value of the equity alternative over the fair value of the debt component represents the fair value of the equity component.

## Entity has the choice of settlement

Where the entity has the choice of settlement, the treatment is binary – that is, the entity accounts for the entire share-based payment transaction as either cash-settled or equity-settled, depending on whether it has a present obligation to settle in cash.

### When does an entity have a present obligation to settle in cash?

An entity has a present obligation to settle in cash if:

- the choice of settlement in equity instruments has no commercial substance (eg because the entity is legally prohibited from issuing shares)
- the entity has a past practice or stated policy of settling in cash (eg an entity settles awards in cash for employees that leave before the vesting date for reasons outside their control (a ‘good leaver’)), or
- the entity generally settles in cash whenever the counterparty asks for a cash settlement.

An entity also has an obligation to settle in cash if the shares issued (including shares issued upon the exercise of share options) are redeemable, either mandatorily (eg upon cessation of employment) or at the counterparty’s option.

If an entity has a present obligation to settle in cash, it accounts for the transaction in accordance with the requirements for cash-settled share-based payment transactions.

### Practical insight – Commercial substance of equity settlements

Some practical examples of circumstances that bring into question the commercial substance of settlement in equity instruments include:

- Group share-based payment schemes where settlement in equity could be restricted due to the practices or laws in the jurisdiction in which the award is granted, that make it illegal or difficult to hold shares in the parent
- Unlisted entities where there are difficulties for the beneficiaries to transfer the shares to third parties, other than existing shareholders, resulting in there being little to no benefit for an employee to receive a share, or
- Entities that are owned by a small number of shareholders eg where the entity is owned by members of a family. In this instance, there may be an assumption that the existing shareholders would not want to dilute their interests and would opt for the cash settlement

### What if an entity does not have a present obligation to settle in cash?

An entity that does not have a present obligation to settle in cash accounts for the entire transaction in accordance with the requirements for equity-settled share-based payment transactions.

Upon settlement:

- (a) If the entity chooses to settle in cash, the cash payment is accounted for as a repurchase of an equity instrument – ie as a deduction from equity, except as noted in (c) below.
- (b) If the entity chooses to settle by issuing equity instruments, no further accounting is required (other than a transfer from one component of equity to another, if necessary), except as noted in (c) below.
- (c) If the entity chooses the settlement alternative with the higher fair value, as at the date of settlement, the entity recognises an additional expense for the excess value (ie the difference between the fair value of the liability (ie cash paid) and the fair value of the equity instruments issued).

### Example 2 – Entity has the choice of settlement

Company C grants an employee a share-based payment arrangement, subject to a service condition of two years. Company C has a choice to settle the transaction in either equity or cash. Company C has accounted for the transaction as equity-settled on the basis that it does not have a present obligation to settle in cash as its stated policy, intention and past practice indicates that the transaction will be settled in equity.

The grant date fair value of the cash alternative is CU1,500 and the grant date fair value of the equity alternative is CU1,800.

#### Analysis – fair value of cash alternative at settlement exceeds fair value of equity alternative

Assume the employee satisfies the service condition. At the end of year two, the fair value of the cash and equity alternatives are CU2,000 and CU1,900 respectively.

If at the end of year two, Company C chooses to settle in equity, the following amounts are recognised:

Year	Calculation	Expense (CU)	Adjustment to Equity (CU)	Adjustment to Liability (CU)
1	Equity component: (CU1,800 × 1/2 years)	900	900	-
2	Equity component: (CU1,800 × 2/2 years) – CU900 No further entries are required as the fair value of the equity alternative at the settlement date is less than the fair value of the cash alternative	900	900	-
<b>Total</b>		<b>1,800</b>	<b>1,800</b>	<b>-</b>

If at the end of year two, Company C chooses to settle in cash, the following amounts are recognised:

Year	Calculation	Expense (CU)	Adjustment to Equity (CU)	Adjustment to Liability (CU)
1	Equity component: (CU1,800 × 1/2 years)	900	900	-
2	Equity component: (CU1,800 × 2/2 years) – CU900 Repurchase of equity: CU1,900 (fair value of equity alternative at settlement date) Additional expense for excess value: CU2,000 (fair value of cash alternative at settlement) less CU1,900 (fair value of equity alternative at the settlement date)	900 100	900 (1,900)	- (2,000)
<b>Total</b>		<b>1,900</b>	<b>(100)</b>	<b>(2,000)</b>

## Example 2 – Entity has the choice of settlement (continued)

### Analysis – fair value of equity alternative at settlement exceeds fair value of cash alternative

Assume the employee satisfies the service condition. At the end of year two, the fair value of the cash and equity alternatives are CU1,900 and CU2,000 respectively.

If at the end of year two, Company C chooses to settle in cash, the following amounts are recognised:

Year	Calculation	Expense (CU)	Adjustment to Equity (CU)	Adjustment to Liability (CU)
1	Equity component: (CU1,800 × 1/2 years)	900	900	-
2	Equity component: (CU1,800 × 2/2 years) – CU900 Repurchase from equity: CU1,900 No further entries are required as the fair value of the cash alternative at settlement is less than the fair value of the equity alternative	900 -	900 (1,900)	- (1,900)
<b>Total</b>		<b>1,800</b>	<b>(100)</b>	<b>(1,900)</b>

If at the end of year two, Company C chooses to settle in equity, the following amounts are recognised:

Year	Calculation	Expense (CU)	Adjustment to Equity (CU)	Adjustment to Liability (CU)
1	Equity component: (CU1,800 × 1/2 years)	900	900	-
2	Equity component: (CU1,800 × 2/2 years) – CU900 Additional expense for excess value: CU2,000 (fair value of equity alternative at settlement) less CU1,900 (fair value of cash alternative at settlement)	900 100	900 100	- -
<b>Total</b>		<b>1,900</b>	<b>1,900</b>	<b>-</b>

### What happens if an entity changes its stated policy or intent in relation to the manner of settlement?

Subsequent to the grant date, there may be circumstances that give rise to a change in the manner of settlement and therefore, the classification of the share-based payment transaction as either equity-settled or cash-settled should be reassessed. For example, an entity may have a stated policy or history of settling in equity but now has the intent to settle in cash. MFRS 2 does not address this issue; however, in practice, changes in intent, settlement policy or settlement practice that give rise to a change in classification are accounted for as a modification, since these changes effectively represent a change to the terms and conditions of the existing arrangement. Some entities also treat changes in circumstances that are within an entity's control as modifications. Accounting for modifications is explained in our article '[Insights into MFRS 2 – Modifications and Cancellations of Share-Based Payment Arrangements with Employees Part 1 and Part 2](#)'.

### Practical insight – What happens when the method of settlement is contingent upon a future event?

An entity may also structure arrangements in a way that the method of settlement is contingent upon a future event, such as an initial public offering (IPO) or a change in control of the entity. MFRS 2 does not provide guidance for this situation, however, as discussed above, where the event is within the control of the entity, we believe that the change in manner of settlement should be accounted for as a modification. In contrast, where the event is outside of the entity and the counterparty's control (eg some change of control events), our view is that the entity should account for the transaction as either cash or equity-settled using one of two approaches, based on the facts and circumstances of the transaction:

- Under the first approach, the entity determines whether the award is cash-settled or equity-settled using the principles in MFRS 137 'Provisions, Contingent Liabilities and Contingent Assets'. In essence, where it is possible but not probable (ie not more likely than not) for cash settlement to occur, the entity should account for the transaction as equity-settled. Whereas if cash settlement is probable, then the award should be accounted for as cash-settled. Furthermore, if the probability of one settlement alternative changes from not probable to probable, the entity assesses whether to reclassify the transaction (ie from equity-settled to cash-settled, or from cash-settled to equity-settled (using the grant date fair value)) and accounts for any differences in profit or loss.
- Under the second approach, the entity accounts for the transaction as cash-settled if it is possible for cash-settlement to occur, regardless of the probability of occurrence, since the entity cannot unilaterally avoid cash-settlement. The entity would reclassify the transaction upon settlement if necessary. This approach is similar to the guidance for contingent settlement provisions in MFRS 132 'Financial Instruments: Presentation'.

Overall, the cumulative amount recognised to profit or loss between the grant date and settlement date will be equal to either the grant date fair value of the equity instrument (for the equity-settled alternative) or the fair value of the liability at settlement (for the cash-settled alternative), depending on which alternative ultimately occurs. However, by reclassifying the transaction from equity-settled to cash-settled or vice versa where necessary, volatility is introduced to profit or loss between the grant date and settlement date due to the requirement to remeasure the cash-settled alternative to its fair value at the end of each reporting period and upon settlement.

## How we can help

We hope you find the information in this article helpful in giving you insight into aspects of MFRS 2. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact.



© 2026 Grant Thornton Malaysia PLT. All rights reserved.

'Grant Thornton' refers to the brand under which the Grant Thornton member firms provide assurance, tax and advisory services to their clients and/or refers to one or more member firms, as the context requires. Grant Thornton International Ltd (GTIL) and the member firms are not a worldwide partnership. GTIL and each member firm is a separate legal entity. Services are delivered by the member firms. GTIL does not provide services to clients. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions.