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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**18 July 2006, London**
Project:	**IFRS 2**
Subject:	**Exposure Draft – Vesting Conditions and Cancellations (Agenda Paper 6A) – Vesting Conditions**

INTRODUCTION

1. The Exposure Draft of the proposed amendments to IFRS 2 requires vesting conditions to be restricted to performance conditions or service conditions only.

2. This proposal is based on the statement in paragraph BC171 of the Basis for Conclusions to IFRS 2, which describes vesting conditions as those conditions that ensure that the counterparty provides the services required to 'pay' for the equity instruments issued. So, for example, service conditions are imposed to ensure that employees provide a minimum period of service in return for the equity instruments and are vesting conditions. Performance conditions are usually imposed to ensure that a minimum level or quality of service is provided by using performance targets as an incentive and are also vesting conditions.

3. Most respondents agreed with the restriction of vesting conditions to performance conditions and service conditions only. However, many respondents requested additional guidance on or further clarification of what constitutes a performance condition.

4. The significant comments received relate primarily to the following two issues:

   (a) whether vesting conditions should be restricted to performance conditions and service conditions only; and

   (b) the definition of a performance-related vesting condition.

COMMENT ANALYSIS

Vesting conditions are performance conditions or service conditions only

5. Most respondents agreed that vesting conditions should be restricted to performance conditions and service conditions for the reasons set out in the Basis for Conclusions of the Exposure Draft.

   [Part of paragraph omitted from Observer Notes].

6. A small minority of respondents disagreed with the proposed change in respect of vesting conditions. In particular, some respondents disagreed with the proposal that a contribution requirement in a Save As You Earn plan is an additional feature of the plan but is not a vesting condition. [Part of paragraph omitted from Observer Notes].

7. Typically in an SAYE, employees are required to make regular contributions to a plan. These contributions accrue interest and the accumulated amount is used after a specified period (usually 3, 5 or 7 years) to purchase shares. The Exposure Draft acknowledges that the contribution requirement constitutes a term that must be satisfied in order for the equity instrument to be issued to the employee. However, the contribution requirement is not a condition that ensures the counterparty provides the services required to 'pay' for the equity instruments issued. Therefore it is not a vesting condition.

8. The main reason cited for the disagreement with the proposal was that a condition which must be satisfied in order for the counterparty to obtain the equity instrument should be a vesting condition.

9. The staff does not agree with this. There are many types of conditions that affect whether a counterparty may obtain the equity instruments granted. The staff

acknowledges, as suggested by one respondent, that the timing of vesting is often dictated by specific circumstances outlined in the plan documentation in addition to conditions of performance and service. However, as explained in the Basis for Conclusions of the Exposure Draft, these circumstances are not necessarily vesting conditions. The vesting conditions are only those conditions that ensure the counterparty provides the services required to 'pay' for the equity instruments. A majority (84%) of the respondents agreed with this approach.

Recommendation

The staff recommends that the current proposal in respect of restricting the definition of vesting conditions to service conditions and performance conditions is included in a final amendment to IFRS 2.

Definition of a performance condition

10. A number of respondents asked for clarification of the definition of a performance condition. The main concern appeared to be that some of the conditions cited by the Exposure Draft as not being a performance condition (eg a contribution requirement) have been treated as performance conditions in the past. Therefore a failure to meet these conditions has been treated as a forfeiture in the past, whereas the Exposure Draft proposes that it should be treated as a cancellation. The difference in accounting treatment in some cases would be significant.

11. One respondent commented that the implications of the Exposure Draft extend beyond SAYE plans and so the impact on a wide range of other conditions that are not service conditions or performance conditions should be considered.

12. The staff notes that there appears to be a considerable lack of clarity in respect of the definition and treatment of performance conditions as well as of other conditions that are not service or performance conditions.

13. Some respondents asked for clarification that performance conditions are both market-related and non-market related conditions. Others asked for clarification of the difference between a performance condition and an additional feature that affects the timing of vesting. [Part of paragraph omitted from Observer Notes].

14. In particular, respondents questioned whether performance means performance by the entity or performance by the employee only. Other questions raised included: could a performance condition include factors that are unrelated to the performance of either the entity or the employee, for example: the failure or success of an IPO; the price of gold or crude oil? One respondent questioned whether non-compete provisions should be considered to be vesting conditions under IFRS 2. [Part of paragraph omitted from Observer Notes].

15. Another respondent also noted that it would be helpful if the Board acknowledges that the timing of vesting is often dictated by specific circumstances outlined in the plan documentation in addition to conditions of performance and service.

16. The staff believes that BC171 of the Basis for Conclusions to IFRS 2, which states that vesting conditions are those conditions that ensure that the counterparty provides the services required to 'pay' for the equity instruments issued, gives adequate guidance on what constitutes a performance condition that is a vesting condition. The staff would recommend that a reference to this paragraph is included in the basis for conclusions in the final amendment.

17. Further, the lack of clarity appears to be centred on differentiating the various conditions that may affect the grant date fair value of an equity instrument. Therefore the staff believes that it would be more useful to have guidance on all the conditions (including performance conditions) that may affect the accounting for share-based payments rather than to attempt a definition of a performance condition.

18. The staff believes that such guidance must be necessarily high level and could be based on the generic groupings set out in the paragraph below.

19. There are many conditions that affect whether an entity obtains the equity instruments granted. They could be grouped as follows:

    (a) *Market conditions.* These may or may not be vesting conditions and are defined in IFRS 2 as conditions upon which the exercise price, vesting or exercisability of an equity instrument depends that are related to the market price of the entity's equity instruments. For example, attaining a specified share price.

(b) *Other vesting conditions*. These are conditions that must be satisfied for the counterparty to become entitled to the equity instrument. Under BC 171, they are also conditions that ensure the counterparty provides the goods or services required to 'pay' for the equity instrument. They may be either:

(i) Service conditions (eg a minimum 3 year service period); or

(ii) Non-market related performance conditions (eg a volume of sales target).

(c) *Other conditions (that are not vesting conditions)*: These are conditions that must be satisfied in order for the equity instruments to be issued to a counterparty. However they do not ensure that the counterparty provides the services required to pay for the equity instrument and are not vesting conditions. They may be either:

(i) Entity specific (eg a successful IPO)

(ii) Employee specific (eg a contribution requirement); or

(iii) Other condition (eg linked to a commodity index that is unrelated to the entity's shares).

20. The staff suggests that the addition of a table or organisation chart, to the Implementation Guidance of IFRS 2, which groups the three types of conditions above with examples, would be very useful [Part of paragraph omitted].

21. This approach has the advantage of being high level enough to be consistent with a principles- based approach, avoids giving definitions that are unlikely to fully encapsulate the wide range of factors that may influence the category into which a particular condition may fall and responds to constituents' requests for more guidance.

Recommendation

The staff recommends that the Board gives some further guidance, as an addition to the Implementation Guidance for IFRS 2, on the various conditions that may determine whether a counterparty obtains the equity instruments granted.

This could take the form of a simple organisation chart or table and should not necessitate re-exposure of the proposed amendments.

The staff recommends that this guidance is combined with the guidance requested in respect of the accounting treatment of these conditions (as detailed in paper 6B)