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**International
Accounting Standards
Board**

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: 18 July 2006, London

Project: IFRS 2

Subject: Exposure Draft – Vesting Conditions and Cancellations
(Agenda Paper 6B) – Cancellations

INTRODUCTION

1. The Exposure Draft proposes amendments that would require cancellations by parties other than the entity, whether by employees, shareholders or any other parties, to be accounted for in the same way as cancellations by the entity, in accordance with paragraph 28 of IFRS 2.
2. During its deliberations on the appropriate accounting treatment for a cancellation by a counterparty, the Board considered whether the entity should continue to recognise the expense as if the cancellation had not occurred or accelerate the recognition of the remaining expense (same as a cancellation by the entity). The Board observed that in some cases, legal, taxation or other factors can make it difficult to identify whether the entity or the counterparty cancelled the counterparty's participation in the plan.
3. Further, suitable non-arbitrary and unambiguous criteria to distinguish a cancellation by an entity from a cancellation by a counterparty did not exist and to develop them would be difficult and involve a lengthy process. The Board was not convinced that the potential improvement in financial reporting would be

commensurate with the resources that would be required. Therefore, the Board concluded that a cancellation by the counterparty should be treated in the same way as a cancellation by the entity.

4. Most of the comments submitted by respondents were in respect of this aspect of the proposed amendments. In particular, many responses focused on the economic differences between a cancellation by a counterparty and a cancellation by an entity.
5. The key points raised in respect of the proposed treatment for counterparty cancellations were:
 - (a) Cancellations by counterparties and cancellations by an entity are economically different and should be accounted for differently;
 - (b) There should be an exemption for certain types of plans;
 - (c) The incorporation of the probability of cancellation in the grant date fair value is highly subjective and could be very difficult;
 - (d) Guidance on the definition of a cancellation is required.
6. These points are discussed in greater detail below. The key recommendations which the staff would like to make are as follows:
 - (a) **A limited amount of additional research should be conducted to determine whether guidance could be given on making a distinction between a cancellation by an entity and a cancellation by a counterparty;**
 - (b) **The amendment should apply to all share-based payment transactions that fall within the scope of IFRS 2;**
 - (c) **The proposal to include the probability of counterparty cancellation in the calculation of the fair value of equity instruments issued should be included in the final amendment;**
 - (d) **The Board should give 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 and how a failure to meet these conditions should be accounted for. This could take the form of an organisation chart or table and should not necessitate re-exposure of the proposed amendments.

Comment analysis

Accounting treatment of cancellations by a counterparty

7. The Exposure Draft explores four of the ways in which a cancellation by a counterparty could be treated:
 - (a) reverse the expense charged to date (same as a forfeiture);
 - (b) cease recognising future expense from the date of cancellation;
 - (c) continue recognising the expense as if the cancellation had not occurred; or
 - (d) accelerate the recognition of the remaining expense (same as a cancellation by the entity).
8. The Board regarded the first two options as inappropriate as they would not be compliant with the primary objective of measuring the value of the goods or services received and with the grant date measurement approach. Most respondents, including those who preferred an alternative approach to the Board, agreed with this.
9. Some respondents, however, disagreed with the Board's proposals on the basis that it results in inconsistent treatment of similar transactions. In particular they argue that an employee's cancellation of (withdrawal from) a share purchase plan and the non-exercise of share purchase option are, in substance, similar transactions and should receive the same accounting treatment.
10. [Paragraph omitted from Observer notes].
11. Others argue that there is no difference between an employee choosing to cancel a plan during the vesting period and an employee choosing not to participate at the

end of the vesting period (but having informed the entity of this during the vesting period).

12. [Paragraph omitted from Observer notes].
13. Most of the respondents who disagreed with the proposed treatment of cancellations preferred option (c) of the proposed amendments which would require an entity to account for employee cancellations by continuing to recognise the expense as if the cancellation had not occurred. They argue that this is most consistent with the general principles underlying IFRS 2.
14. Further, some argue that there is a fundamental difference in substance between a cancellation by an entity and a cancellation by an employee. [Part of paragraph omitted from Observer Notes].
15. The staff has some sympathy with the view that option (c) is the most consistent with the principle of recognising the services as they are received. However, as noted above, the Board concluded that a cancellation by the counterparty should be treated in the same way as a cancellation by the entity because of the difficulty in finding suitable non-arbitrary and non-ambiguous criteria for making a distinction between the two. The Board's conclusion was not based on the assumption that there is no economic difference between a cancellation by a counterparty and a cancellation by an entity. The issue is not whether there is such a distinction, but rather whether and how that distinction could be made in practice.
16. One respondent proposed the following: the distinction between a cancellation by a counterparty such as an employee and an entity could be based on whether the act is motivated by factors, other than the stock price of the employer's shares, that nevertheless have real economic substance to the employee (such as the employee's personal financial situation). In other words a cancellation by an employee must have a real economic impact on the counter-party [Part of paragraph omitted from Observer Notes].
17. In this case, it is argued, it would be possible to identify cases where a cancellation is at the entity's instigation even though it may appear to be a cancellation by an employee. For instance, if employees write a letter indicating their intent to cease participation in a scheme (but at the entity's instigation), this

would still need to be treated as a cancellation by the entity as the writing of the letter has no real economic substance to the employee [Part of paragraph omitted from Observer Notes].

18. One other suggestion has been to base the distinction on the substance of the transaction. For example, it could be based on whether the employee has an economic or otherwise substantive incentive to cancel their participation in the plan such as an inability to continue making the necessary savings. [Part of paragraph omitted from Observer Notes].
19. The staff sees some merit in both these views. However, the staff does not believe that it would be appropriate to develop a set of criteria based on the various factors (some of which may be personal as well as having economic substance) that may motivate counterparties to cancel their participation in a scheme.
20. Other suggestions include leaving the distinction between a cancellation by a counterparty and a cancellation by an entity to professional judgement. Further, one respondent questioned whether the entity could be allowed to account for a cancellation by a counterparty differently from a cancellation by an entity, only in the case where it is demonstrated that the company had no influence over the counterparty's decision to cancel the equity instrument. [Part of paragraph omitted from Observer Notes].
21. One other respondent suggested a slightly stronger form of this *viz.* that there should be a rebuttable presumption that a cancellation is a cancellation by an entity unless it can be demonstrated that it is a cancellation by a counterparty. This approach allows a cancellation to be accounted for using the approach in paragraph 7 (c) above when it is clear that the cancellation is a cancellation by a counterparty.
22. Further, some respondents argue that the concern of the Board about the structuring of transactions to achieve a desired accounting result is not a real concern when there is a company-wide plan with large numbers of employees and tightly controlled tax regulations [Part of paragraph omitted from Observer Notes].

23. The staff notes that if the Board decides to follow either of the two approaches suggested in paragraphs 20 and 21, it would still be necessary to give some guidance on suitable criteria for making a distinction between the two types of cancellations. The staff notes the Board's decision during the deliberation of the ED that suitable non-arbitrary and unambiguous criteria to distinguish a cancellation by an entity from a cancellation by a counterparty did not exist and to develop them would be difficult and involve a lengthy process.
24. The staff is also mindful of the Board's previous decisions that the potential improvement in financial reporting would not be commensurate with the resources that would be required in order to achieve this, if indeed such criteria do exist.
25. The Board noted, further, in the Basis for Conclusions of the Exposure Draft that requiring more than one method of accounting for cancellations would create incentives for structuring transactions to achieve a desired accounting result, particularly because the different methods being considered (ie the acceleration of expense method and the continuation of expense method) produce significantly different accounting results.
26. The staff notes also that around half of the respondents agree that all cancellations should be treated the same for the reasons set out in the Basis for Conclusions and also because it is the option that best meets the objective of the standard to provide consistent and objective financial information. Many respondents also supported this approach on the basis that it would be consistent with SFAS 123 (revised 2004).
27. In particular, most of these respondents agreed that it would be too difficult to make a useful distinction between a cancellation by a counterparty and a cancellation by an entity.
28. However, in light of the responses received in opposition to the proposal, the staff would like to consider further whether there is any possibility of determining a suitable set of criteria to distinguish between cancellations by a counterparty and an entity, before the amendment is finalised.

Recommendation

The staff recommends that a limited amount of additional research is conducted to determine whether guidance could be given on making a distinction between a cancellation by an entity and a cancellation by a counterparty.

Exemptions for certain types of plans

29. Some respondents mentioned that counterparty cancellation in an SAYE plan has several unique characteristics and should be excluded from the scope of this amendment. [Part of paragraph omitted from Observer Notes].
30. The staff does not believe that any of the characteristics of SAYE plans mentioned necessitate a scope exclusion. More generally, there appears to be no reason to treat SAYE (or similar) plans differently from other employee share-based payment plans.
31. The staff acknowledges that due to the high level of cancellations in these plans, the recommended treatment could result in some volatility in the income statement. Further this volatility is significantly higher than the volatility in the amount or level of services received (or to be received) in return for the share-based payment.
32. However, if it is not possible to distinguish between a cancellation by a counterparty and a cancellation by an entity, it is not clear that this volatility would be inappropriate (most respondents accept the justification for the volatility when there is a cancellation by the entity). Further, the fact that too many transactions will be affected by the amendment is an inadequate principle for excluding a plan from the scope of an amendment.
33. [Paragraph omitted from Observer Notes].

Recommendation

The staff recommends that the amendment should apply to all share-based payment transactions that fall within the scope of IFRS 2.

Incorporation of the probability of cancellation (and other additional features) into the grant date fair value

34. Paragraph BC 10 of the Basis for Conclusions of the Exposure Draft states that the fair value of the equity instrument takes into account all the factors that a knowledgeable, willing market participant would take into account at the grant date, including the probability that counterparties will cancel their participation in a plan.
35. Some respondents disagreed with this approach for conceptual reasons. One argument put forward is that while the probability of counterparty cancellation is included in the fair value, IFRS 2 does not require the probability of cancellation by the entity to be included in the fair value. Therefore the two types of cancellations should be treated differently.
36. The staff disagrees with this. The underlying probability assumption for a cancellation by the entity is nil. Alternatively, it could be assumed that if the entity cancels, it would provide a replacement benefit of equivalent value. Either way, there is no discrepancy in the proposed approaches for entity and counterparty cancellations. Moreover, if it is not possible to make a distinction between a cancellation by an entity and a cancellation by a counterparty, this also becomes a moot point.
37. Another respondent suggested that it is inconsistent to include the risk of cancellation into the fair value and accelerate the recognition of the remaining cost on cancellation.
38. The staff does not agree with this suggestion. The staff agrees that it would be inconsistent to include the risk of cancellation in the grant date fair value and subsequently recognise the full cost of the equity instrument (ignoring the probability of cancellation) when a cancellation occurs.
39. However, the proposed approach does not require this. The acceleration is only of the cost which would have been recognised (assuming the same probability of cancellation as assumed at the grant date) had the cancellation not occurred. The amount of the cost to be recognised is the same (ie the grant date fair value, all other things being equal). However, the timing of recognition changes, which is

appropriate if a plan is cancelled. Therefore the staff does not believe that the proposed approach is inconsistent.

40. Some respondents noted that including the probability of cancellation in the grant date fair value would result in calculations that are highly subjective as many schemes involve conditions that are not service or performance conditions which will be difficult to measure. Others noted that for SAYEs in particular, the number of cancellations is so high and difficult to predict that there would be considerable difficulties in establishing a reliable fair value [Part of paragraph omitted from Observer Notes].
41. Other respondents pointed out that BC 197 of IFRS 2 acknowledges the difficulty of incorporating non-market vesting conditions into the grant date fair value and that this was the key reason for excluding service and non-market performance conditions from the calculation of the grant date fair value. Therefore, they maintain that the requirement to include the additional features of a plan into the fair value would be inconsistent with this.
42. The staff notes that the inclusion of many factors in the grant date fair value is difficult and subjective and the staff acknowledges that in the case of counterparty cancellation, the calculation of the grant date fair value could be more subjective than in other cases. However, given that many plans are outsourced to large administrators it would be possible in some cases to get a reliable indication of the approximate number of cancellations. More importantly, the staff believes that it would be better to have a subjective estimate based on professional judgement than no estimate.
43. The staff believes that the requirement to include all features other than service and non-market performance conditions is consistent with the principles underlying IFRS 2. Further, the staff notes that if an entity implements a share-based payment plan, the entity could be reasonably expected to have made a reliable estimate of the proportion of cancellations or the impact of any additional features in order to determine the benefit structure to be provided.
44. A small minority of respondents disagreed with the proposed approach for cancellations due to the practicalities of implementation. In particular, they argue that the information obtained from the administrator for shares granted is often not

detailed enough to determine whether a cancellation has occurred because the employee has left the company or for other reasons.

45. The staff understands that the Exposure Draft potentially imposes an additional administrative requirement on the entity. However, the alternative to this would be either to treat all counterparty cancellations as cancellations by the entity or all counterparty cancellations as forfeitures. Neither of these alternatives would be appropriate in most cases. Also, the staff notes that, under IFRSs, entities are permitted to evaluate the balance between benefits and costs in determining the appropriate level of relevant and reliable information that should be provided.

Recommendation

Therefore, the staff recommends that the proposal to include the probability of counterparty cancellation in the calculation of the fair value of equity instruments issued is included in the final amendment.

Definition of a cancellation

46. Some respondents asked for clarification of the definition of a cancellation. [Part of paragraph omitted from Observer Notes].
47. The staff notes that IFRS 2 does not define a cancellation explicitly. Given the large number of ways in which an entity or counterparty could cancel their participation in a plan, the staff does not believe that it is appropriate to attempt to capture all the possible factors in a single definition of the term. The staff also notes that although many other types of contracts, apart from share-based payments, may be cancelled, cancellations are not explicitly defined in other IFRSs. The staff believes that this is largely because the term cancellation is widely and commonly understood to be a discharge of one's obligations to comply with a set of terms and conditions and no further clarification is usually required.
48. The staff does not recommend that a definition of a cancellation is included in the amendment to the standard. However, the staff notes that many respondents have requested guidance on the definition and treatment of the many conditions that determine whether a counterparty may receive an equity instrument granted.

49. Paragraph 19 of Paper 6A sets out a possible grouping for these conditions. The analysis below describes the appropriate accounting treatment for these groupings:

- (a) All market conditions are included in the fair value of the equity instrument and if a market condition is not met there is no adjustment to the accounting.
- (b) Other vesting conditions are not included in the fair value of the equity instrument. If a vesting condition that is a service condition or non-market performance condition is not met, the event is accounted for as a forfeiture and the transaction costs are adjusted so that ultimately the amount recognised is based on the number of equity instruments that actually vest.
- (c) IFRS 2 does not explicitly address the treatment of other conditions that are not market conditions or vesting conditions. The staff suggests that it would be consistent with the principles underlying IFRS 2 for these conditions to be treated as follows:
 - (i) Other conditions that are not market conditions or vesting conditions should be taken into account in the grant date fair value of the equity instrument.
 - (ii) If one of these conditions is not met it should be treated as follows:
 - 1. If either the entity or the counterparty has control over whether or not the condition is met (eg the employee chooses to cease contributions), this should be treated as a cancellation.
 - 2. If the condition is outside of the control of both the entity and the counterparty, (eg a cessation of contributions because tax legislation prohibits further contributions to the plan) then no adjustment shall be made and the entity shall continue recognising the expense as if the event had not occurred.

50. If the Board agrees with the above analysis, in light of the comments received about the need for clarification, the staff would like to ask the Board whether it wishes to give some guidance on this. [Part of paragraph omitted from Observer Notes].

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 affect