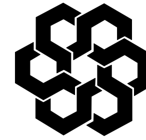

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
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 October 2006, London**

Project: **Proposed amendments to IFRS 2 *Share-based Payment***

Subject: **Vesting Conditions and Cancellations (Agenda Paper 19)**

INTRODUCTION

1. At the July meeting, the IASB commenced its deliberations in respect of the proposed amendments to IFRS 2, to restrict vesting conditions to service and performance conditions only.

2. At that meeting, the Board reaffirmed its proposal to restrict vesting conditions to service conditions and performance conditions. However, the Board acknowledged that the requests for a definition of vesting conditions and performance conditions were valid. In particular, noting that the rationale for the proposed amendment was given in the Basis for Conclusions, the Board asked the staff to consider revising the definition of a vesting condition in the standard to incorporate the information currently given in the Basis.

3. The Board also accepted the staff's proposal to expand the Implementation Guidance to clarify the categorisation of the wide range of conditions that determine whether a counterparty obtains a share-based payment, including non-compete provisions.

4. Finally, the Board asked the staff to explore whether there might be some types of events, (for example, when an employee exercises a choice to stop making contributions to an SAYE) that are not one of the stated possible events under IFRS 2, and that might require an accounting treatment different from that of a lapse, forfeiture or cancellation.

5. This paper addresses these issues as well as three other issues which were noted in the comment analysis: the request for a definition of a cancellation, consistency with FAS 123 (revised 2004) and transition requirements.

Summary of Staff Recommendations

6. The staff recommends:

   (a) The following revision to the current definition of a vesting condition[1]:

   The conditions that ~~must be satisfied,~~ determine whether the entity receives the quantity or quality of service that entitles ~~for~~ the counterparty ~~to become entitled~~ to receive cash, other assets or **equity instruments** of the entity under a **share-based payment arrangement** without providing future service. Vesting conditions are either ~~include~~ service conditions, which require the other party to complete a specified period of service, or ~~and~~ **performance conditions.** ~~, which require …(. specified time)~~.

   (b) The addition of the following definition of a performance condition:

   Performance conditions are **vesting conditions,** other than service conditions. They may be **market conditions** or non-**market conditions.**

   (c) That the Board issues a revised Exposure Draft which adds a rebuttable presumption to the standard that a failure to meet a non-vesting condition, when the counterparty can choose whether that condition is met, is a cancellation by the entity unless it can be demonstrated that the entity had no influence over the counterparty's decision.

[1] This revised definition is consistent with the definition of vesting under IAS 19 *Employee Benefits* which describes vested benefits as benefits that are not conditional on future employment. In the case of share-based payments, the vested benefits would also be those that are not conditional on future 'performance'.

(d) No definition of a cancellation is included in the final amendment. However, the organisation table set out in Appendix A should be added to the Implementation Guidance for IFRS 2 to help clarify the accounting treatment of all conditions that determine whether a share-based payment granted is received. This table would confirm that all non-vesting conditions should be included in the grant date fair value of the share-based payment. Further, failure to meet a non-vesting condition should be treated the same as a failure to meet a market condition ie continue to recognise the expense as if the event had not occurred, unless it is a non-vesting condition which the counterparty could choose not to meet (eg cessation of contributions to an SAYE) and it cannot be demonstrated that the entity had no influence over the counterparty's decision. In this case it is treated as a cancellation by the entity.

(e) The addition of an illustrative example to confirm that the salary sacrifice component of SAYE plans should be recognised as a liability until the liability is settled either because the counterparty elects to receive a return of the contributions paid by salary sacrifice or the SAYE option is exercised. This example would also clarify the accounting treatment of an event when the counterparty chooses not to meet a non-vesting condition.

(f) No changes are made in spite of the areas of divergence with FAS 123 (revised 2004) as these divergences do not occur as a result of the proposed changes.

(g) The effective date is 1 January 2008 and retrospective application is required.

Definition of vesting conditions and performance conditions

Vesting conditions

7. Appendix A of IFRS 2 defines vesting conditions as *the conditions that must be satisfied for the counterparty to become entitled to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement.*

8. The Board agreed, in the Exposure Draft, to restrict vesting conditions to service conditions and performance conditions only. This was based on the rationale set out in paragraph BC 171 of the Basis for Conclusions to IFRS 2, which indicates

that vesting conditions are the conditions which “ensure that employees provide the services required to ‘pay’ for their share options”.

9. The staff notes that using the term ‘pay’ in a revised definition of vesting conditions is potentially misleading as, for instance, an employee paying contributions towards an exercise price may then be confused with a vesting condition. Also, a counterparty may be required to perform a number of acts which are unrelated to the amount or quantity of services they provide to the entity. For instance, in some plans, a counterparty may be required to enter a special contractual savings arrangement in order to accumulate the purchase price of an option. The staff does not believe that this is a vesting condition, but notes that in the responses to D11 and the Exposure Draft, many constituents were unconvinced that the requirement to pay contributions to a special savings arrangement was not a vesting condition.

10. In order to avoid the confusion that a focus on the actions of the counterparty could present, the staff proposes to focus the definition on the services which the entity receives rather than on the services the counterparty provides. This clearly eliminates conditions that may be counterparty specific (eg the requirement to pay contributions) but which are not part of the employee services being rendered in return for the share-based payment.

11. As a starting point only, the staff proposes the following definition of vesting conditions:

The conditions that ~~must be satisfied,~~ determine whether the entity receives the quantity or quality of service that entitles ~~for~~ the counterparty ~~to become entitled~~ to receive cash, other assets or **equity instruments** of the entity under a **share-based payment arrangement**. Vesting conditions are either ~~include~~ service conditions, which require the other party to complete a specified period of service, or ~~and~~ **performance conditions.** ~~, which require …(. specified time)~~.

Wider application of proposed definition

12. The proposed definition of a vesting condition identifies typical service and performance conditions such as a requirement to stay in employment for three years or an earnings per share target. They also clarify that conditions that do not determine whether the counterparty provides the services required to become

entitled to the share-based payment are not vesting conditions, eg when the number of shares to be granted depend on the price of crude oil.

13. The staff notes that it is important to determine whether these definitions are adequate for identifying vesting conditions amongst the wide range of other conditions that determine whether or not a counterparty receives a share-based payment that was granted.

14. A number of more complex cases have been put forward by respondents to the Exposure Draft to indicate that further clarification of the definition of a vesting condition is required. Many of these examples are not related to the question of the adequacy of the definitions.

15. However, there are some conditions that indicate that further clarification of the definition may be required. The paragraphs below discuss the application of the proposed definitions to two less straightforward cases.

Restricted Shares

16. Shares may be restricted by different types of conditions. Restricted shares are usually designed so that, over time, the restrictions fall away and the counterparty becomes entitled to unrestricted shares after a specified period (the restricted period). For example, a share with a transfer restriction would allow the holder to gain from dividend payments and the increase in the value of the shares from the point at which they are issued, however the shares may not be sold or transferred for a specified period (the restricted period). Full ownership is transferred at the end of the restricted period.

17. The question arises as to whether the conditions that need to be satisfied during the restricted period (typically service conditions) are vesting conditions. Put another way, the question is whether the vesting date is the date the shares are acquired or the date the counterparty becomes entitled to unrestricted ownership.

18. During its deliberations on IFRIC 8, the IFRIC considered whether transfer restrictions on a share affect the vesting period of that share. The IFRIC concluded that the restricted conditions affect the fair value of the equity instrument but do not affect the vesting. The IFRIC reasoned that vesting

conditions comprise service or performance conditions that must be satisfied for the counterparty to become entitled to the equity instruments. Since the counterparty is not required to satisfy a service or performance condition to become entitled to the shares, but is only prohibited from selling the shares for a specified period, that prohibition represents a post-vesting transfer restriction and not a vesting condition.

19. There is a similar argument for non-compete agreements as explained below.

Non-compete agreements

20. A non-compete agreement is generally a contract in which one party agrees not to compete with another party in exchange for some consideration. Under a non-compete clause the counterparty usually has a direct or indirect obligation to refrain from dealing in competing goods or services for a specified period. They are commonly included in employment contracts in some jurisdictions. In recent years, more employers have written them into option grants so that employees who enter into competitive activity lose options which have not yet been exercised. In some cases, they may also lose equity instruments resulting from options that have already been exercised. Less frequently, there are non-compete provisions which prohibit any competitive activity until retirement date.

21. The question arises as to whether a non-compete provision is a vesting condition and, if so, what is the vesting period of an option with a non-compete provision? Using the revised definition in paragraph 6 above, it would appear that non-compete provisions, like restrictive conditions, do not ensure the counterparty *provides the services required in order to become entitled to* the instrument and are therefore not vesting conditions.

22. In order to ensure that the definition is robust, the staff considered how the point at which the counterparty becomes entitled to the equity instrument should be determined.

Not conditional on future service?

23. The staff considered an analogy to the concept of vesting in IAS 19. Vested employee benefits are benefits that are not conditional on future service. A

pension benefit is assumed to vest when there is an irrevocable right to the benefit whether or not the employee continues in service.

24. The staff notes that the analogous definition for a share-based payment is not fully captured in the proposed revised definition if vesting conditions are conditions that determine whether the counterparty provides the quantity or quality or services required that entitle the counterparty to the share-based payment.

25. However, using only the portion of the definition which relates to the unconditionality feature would not help differentiate between those features that are vesting conditions and those non-vesting conditions that must be completed in order for the share-based payment to become payable, particularly if the non-vesting condition must be met over the same period as the vesting condition. Therefore the staff proposes adding to the proposed definition to allow for the unconditionality feature (rather than simply using the IAS 19 definition) as follows:

The conditions that ~~must be satisfied,~~ determine whether the entity receives the quantity or quality of service that entitles ~~for~~ the counterparty ~~to become entitled~~ to receive cash, other assets or **equity instruments** of the entity under a **share-based payment arrangement** without providing future service. Vesting conditions are either ~~include~~ service conditions, which require the other party to complete a specified period of service, or ~~and~~ **performance conditions.** ~~, which require …(. specified time)~~.

26. The staff notes that there is an argument that restrictive covenant provisions, such as non-compete provisions, ensure that the entity receives goods in the form of intangible assets and, as a result, should qualify as vesting conditions.

27. The revised definition resolves this issue by effectively fixing the vesting date as the date at which the counterparty first becomes entitled to the instrument granted and no future service needs to be rendered. This would result in non-compete and restrictive conditions being non-vesting conditions as the counterparty's entitlement is not conditional on future service, although it may be conditional, for instance, on the counterparty complying with the non-compete provision in the future.

Application to more complicated vesting patterns

28. This approach would also have positive implications for more complicated vesting structures. For example, some option plans have performance measures that are tested on an annual basis (after a minimum service period). If the performance hurdle is met then the option becomes exercisable for a limited window. If the option is not exercised during that window then it cannot be exercised until the hurdle is met again and will be forfeited if the employee leaves service between windows. Using the proposed solution, the vesting date would be the date at which the option first becomes exercisable.

Consistency with US GAAP

29. The staff believes this approach is consistent with the requirements of US GAAP in respect of restrictive conditions and more complicated vesting patterns. In particular Appendix E of FAS 123 (revised 2004) refers to restricted shares *as fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time*. Further, it defines a share-based payment as becoming vested *at the date that the employee's right to receive or retain shares, other instruments, or cash under the award is no longer contingent on satisfaction of either a service condition or a performance condition*. Both these definitions lead to conclusions consistent with the recommended approach above.

30. This approach would also be largely consistent with the conclusions reached by the FASB Resource Group in respect of non-compete agreements. The Group decided that in most cases an option with a non-compete provision is granted for services expected to be received and the non-compete agreement acts simply as a 'back stop', so that the non-compete period should not affect the period during which it is assumed that the services in return for the option are rendered. That is, the non-compete provision should not affect the vesting period. The Group also agreed that a non-compete provision is a contingent feature and so should not be taken into account in the calculation of the grant date fair value.

31. In most cases, the staff believes that the impact of the non-compete provision on the fair value of the equity instrument would be minimal as the non-compete provision is either unlikely to be breached or may not be enforceable even if it is

breached. Therefore although IFRS 2 does not allow the notion of a contingent feature, the results of applying the proposed revision to IFRS 2 and FAS 123 (revised 2004) should give consistent results in most cases. The staff notes also that no formal staff position or Board decision was arrived at in respect of this issue at the FASB. The staff understands that this approach is also consistent with comments made by the SEC in a public meeting[2].

32. The staff proposes to include a separate definition of performance conditions in Appendix A of IFRS 2, thus negating the need for any further explanation in the definition of vesting conditions.

Performance Conditions

33. Appendix A of IFRS 2 describes performance conditions as vesting conditions that *require specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time).*

34. IFRS 2 does not define performance conditions. As the staff working on the Presentation of Financial Statements project noted, "the term *performance* is an elusive term that means different things to different people". In particular, many think of performance only in terms of the income statement/statement of recognized income and expense. However, even broadening the term to encompass all elements of other financial statements may not suffice for the purposes of IFRS 2. An entity may set a performance target based on management specific ratios or on non-financial items such as environmental or ethical targets.

35. The staff notes that the current description of performance conditions in IFRS 2 is somewhat circular – performance conditions *require specified performance targets to be met.* This is unhelpful as it appears that it is the definition of what constitutes a performance which constituents found most troubling. The general

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[2] The staff understands that the SEC suggested that non-compete agreements should be evaluated to determine the effect on requisite service periods. Consideration should be given to the company's history relating to enforcement of non-compete provisions and past employees' actions in regard to the terms of the non-compete provisions. If the terms of share-based payments contain provisions that allow an employee to continue to "vest" in a share-based payment after they are no longer providing services to the employer (e. g. after retirement or termination), the compensation cost related to that share-based payment should be recognized over the substantive requisite service period. *SOURCE: Highlights of 2005 AICPA National Conference on Current SEC and PCAOB Developments (KGA Group)*

use of the term performance would normally refer to a specific act or acts that must be completed, eg a sales target, or a specific state that must be achieved, eg a specified profitability level. Further, the staff notes that for the purposes of IFRS 2, performance targets are only those targets that are also vesting conditions. In particular if a performance target does not determine whether the entity has received the quantity or quality of services required in order for the counterparty to become entitled to the share-based payment, it is not a performance condition under IFRS 2.

36. A corollary of this is that a performance target must be entity specific. This is consistent with the definition of performance conditions that are market conditions. Market conditions are defined as conditions that are related to the price of the entity's equity instruments. The staff maintains that non-market performance conditions, by definition, would not be related to the price of the entity's equity instruments, but must be directly related to the performance of the entity.

37. In light of the above comments, the staff proposes the following definition of a performance condition:

Recommendation

Performance conditions are **vesting conditions,** other than service conditions. They may be **market conditions** or non-**market conditions**

38. This definition allows 'performance' to be entity specific and does not restrict the definition to financial or other specific types of targets.

39. Some respondents argue that there are cases when options are granted to certain grades of employees based on the profitability of the company, when it is not clear that the profitability target is a performance condition. The reason is that the employee roles have only such an indirect link to the profitability of the company, that it is not clear that the services rendered in those roles contribute towards the performance required to become entitled to the share-based payment and therefore, for these employees, the performance target is not a vesting condition.

40. The staff disagrees. It is not possible to determine in a rational, consistent manner, the extent to which different roles contribute to the profitability of a company (or to other performance target measures). Since the company is in business in order to make a profit, it is reasonable to assume that all employees contribute directly or indirectly to the profitability of the company. Therefore the staff considers that any targets linked to the performance of an entity which are included as conditions in share-based payments issued to employees, are performance targets to which the employees to whom the share-based payment are issued are expected to contribute, either directly or indirectly.

41. The staff considers that typical performance conditions such as a profit target would meet the description of a performance condition (and, by corollary, the proposed definition of vesting conditions) as they ensure, either directly or indirectly, that a minimum level and/or quality of service is provided in return for the share-based payment.

42. For transactions with parties other than employees, the staff believes that it is also reasonable to assume that the performance target included in a share-based payment is included to ensure that the counterparty provides the right level or quality of goods or services.

Consistency with FAS 123 (revised 2004)

43. The staff notes that under FAS 123 (revised 2004), *obtaining regulatory approval to market a specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions*. The staff does not believe that it is clear that the success of an IPO or obtaining regulatory approval or a change in control would normally be seen as conditions that would determine whether the entity receives the quality or quantity of services required in order for the counterparty to become entitled to the share-based payment, except perhaps for a selected group of relevant individuals. However it is arguable that the entity does receive services from the counterparty in these cases, for example the success of an IPO could be linked to the profitability of the company which is linked to employee performance.

44. More importantly, the staff notes that maintaining consistency with FAS 123 (revised 2004) is a key consideration for both Boards. Accordingly, the staff recommends that these conditions are also included as performance conditions under IFRS 2. This is illustrated in Appendix A.

Treatment of conditions that are not vesting conditions

45. There are a number of other conditions that do not meet the definition of a vesting condition given above. Non-vesting conditions are those conditions that do not determine whether the entity receives the required services.

46. For instance, the price of gold is not a condition that would normally determine whether the entity receives the services required in order for the counterparty to become entitled to the share-based payment.

47. Another example (and the one which initiated discussion of these issues) is the requirement for the counterparty to make regular contributions to an SAYE plan.

48. The treatment of these conditions has important accounting and practical implications. The key questions which arise in respect of the treatment of non-vesting conditions are whether they should be reflected in the grant date fair value and how a failure to meet such conditions should be treated.

Grant date fair value

49. In developing IFRS 2, the Board initially proposed that the costs of share-based payment be recognised on a units of service approach. In this case, all conditions are taken into account in the measurement of the grant date fair value and the cost is spread per unit of service. No adjustments are subsequently made if the condition is not met.

50. Thus, the Board's original intention was for all conditions to be taken into account in the grant date fair value. However, the Board considered the practical concerns raised by respondents about the practicality and subjectivity of including these conditions in the grant date fair value and exceptions were made for service conditions, non-market performance conditions and reload options.

51. Respondents to the Exposure Draft have also raised concerns about the feasibility of including non-vesting conditions in the grant date fair value of equity instruments. The staff notes the Board considered whether there are share options with such unusual or complex features that it is too difficult to make a reliable estimate of their fair value and concluded in BC 197 that *it is unlikely that entities could not reasonably determine the fair value of share options at grant date, particularly after excluding vesting conditions and reload features.*

52. The staff does not believe that there have been any new types of plans or new valuation information presented to us since the Board's deliberations that would negate this conclusion. Further the staff notes that paragraph 24 of IFRS 2 allows entities, in the rare circumstances when the fair value cannot be reliably estimated, to use an intrinsic value measure.

53. Therefore, the staff recommends that all non-vesting conditions are taken into account in the grant date fair value.

Treatment of failure to meet a non-vesting condition

54. The staff notes that the principle underlying IFRS 2 is that the total compensation expense represents the actual grant date fair value of the share-based payment. Either the condition is taken into account in the grant date fair value and no subsequent adjustments are made, or no allowance is made for that condition in the grant date fair value and the amount of compensation expense recognised is 'trued up' to reflect actual events.

55. Therefore, since non-market vesting conditions are not incorporated in the grant date fair value, when such a condition is not met, this is treated as a forfeiture under IFRS 2 and the compensation expense recognised to date is reversed.

56. When a share-based payment is not issued because a non-vesting condition is not met, IFRS 2 is silent on the required treatment. It is not clear whether this should be treated as a reversal of expense, continuation of expense as if the event had not occurred or an acceleration of vesting. An issue similar to this prompted the development of the draft IFRIC interpretation (D11) and the recent Exposure Draft.

57. The staff considers that if the non-vesting condition is incorporated into the grant date fair value, this implies that there should be no subsequent adjustment to the transaction costs if a non-vesting condition is not met. In order to be consistent with the principles underlying IFRS 2, either the event (failure to meet a non-vesting condition) should be ignored and the entity should carry on expensing for the share-based payment as if the event had not occurred, or there should be an acceleration of recognition of the cost when the event occurs.

58. The staff notes that, since IFRS 2 requires the recognition of the costs in respect of a share-based payment over the vesting period of the instrument, the appropriate accounting treatment of failure to meet a non-vesting condition would be to carry on expensing over the vesting period as if the event had not occurred. This would also be consistent with the treatment of market conditions.

SAYE plans

59. A number of constituents questioned whether SAYE plans should be exempt from the normal requirements of IFRS 2 as these plans are unusual. In SAYE plans, employees are granted options if they agree to save a monthly amount for a fixed period (typically a three, five or seven year period) to match the cost of exercising those options. Employees may choose whether to use the savings proceeds to exercise their options within a fixed six-month exercise period, or to retain the money.

60. The Board decided that all share-based payment plans should be subject to the requirements of IFRS 2. However, the Board asked the staff to consider whether SAYE plans have features that are not covered under IFRS 2. In particular, the Board asked the staff to consider whether the cessation of contributions to an SAYE plan is a new type of event, not covered by the requirements of the standard.

61. There are five events identified in IFRS 2: a share-based payment may vest, be forfeited, lapse (forfeiture after the vesting date), be cancelled or a choice can be exercised for one of two alternatives.

62. If the employee decides to cease contributions to the SAYE plan, the treatment options under IFRS 2 are a lapse, forfeiture, cancellation or exercise of choice.

63. Lapses may only occur after the vesting date so a cessation of contributions cannot be treated as a lapse. Also, a forfeiture is a failure to meet a vesting condition so a cessation of contributions cannot be treated as a forfeiture.

64. IFRS 2 specifies the treatment of share-based payment with cash alternatives where the entity settles the transaction in cash (or other assets) at the employee's choice. Some respondents believed that SAYEs are akin to a share-based payment with a cash alternative. Therefore, if the employee chooses to stop paying contributions (ie take the cash alternative) this should be treated in accordance with paragraphs 34 – 43 of IFRS 2. The staff disagrees with this. Share-based payment with cash alternatives are those where the counterparty may receive cash or shares in return for services rendered. However, the cash component here is simply a return of the employee's savings rather than a payment made by the entity to settle the transaction in return for services received.

65. Moreover, the staff notes that the ED also addresses cases where employees may not have a cash alternative if they cease to pay contributions. In particular, it is the cessation of contributions that triggers the accounting event, not the election to take cash.

66. The remaining option is therefore to treat the cessation of contributions as a cancellation. The Basis for Conclusions of the ED describes cessation of contributions to an SAYE as a cancellation by the counterparty as this is the only other option under IFRS 2.

Is cessation of contributions a cancellation?

67. About 50% of respondents disagreed with the proposal that the cessation of contributions to an SAYE should be treated as a cancellation. The underlying question initially appears to be whether the accounting is in respect of the entire SAYE arrangement or in respect of the share-based payment component of the plan only.

68. Proponents of the proposal in the Exposure Draft argue that an SAYE has a salary sacrifice component which should be recognised as a compensation expense outside IFRS 2 and a share-based payment component which should be recognised in accordance with IFRS 2. Under this approach, the cessation of contributions, though permitted in the SAYE plan rules, results in a cancellation of the share-based payment component. Therefore a cessation of contributions should be treated as a cancellation.

69. Opponents of this approach argue that the entire arrangement falls under IFRS 2. Under the terms of the arrangement, the employee is simply exercising a choice to cease contributions at any point during the term of the plan. Therefore this should not be treated as a cancellation. In this case, the arrangement is no different from a counterparty saving towards the exercise price in a private arrangement and deciding not to exercise the option at the end of the term. Therefore, it is argued that the cessation of contributions should be treated the same as other non-vesting conditions.

70. Cancellations are not defined under IFRS 2 and the staff does not recommend that a definition of the term is included in the standard. However, if the common understanding of the term would apply, a cancellation would be a termination of participation in a plan as a result of a failure to comply with one or more of the terms and conditions of the agreement.

71. The staff has reconsidered whether, if a share-based payment arrangement gives an employee a choice and the employee exercises that choice, that election constitutes a cancellation, ie a failure to comply with the terms and conditions of the plan. The staff does not believe that this is the case.

72. However, the staff notes that the key question is not whether this event can be typified as a cancellation but whether it is distinguishable from a cancellation by the entity. The main reason given in the Basis for Conclusions of the Exposure Draft for treating such an event the same as a cancellation by the entity was that no unambiguous or non-arbitrary criteria exists in order to make such a distinction. Some constituents argued that it was possible to differentiate between

this type of event and a cancellation by the entity by examining the motivating factor or factors. The staff notes that this may be theoretically correct but the motivating factors for such an event are likely to be a combination of financial, social, psychological and other concerns, most of which are outside the remit of an accounting standards setting body.

73. More generally, the staff notes that no unambiguous or non-arbitrary criteria exist to distinguish the difference between the failure to meet any non-vesting conditions when the counterparty can choose whether or not that condition is met and a decision to cancel a plan by an entity.

74. The staff notes, however, that a small majority of constituents disagree with the proposed approach. Further, the staff acknowledges that there is conceptual merit in an approach that would require the same treatment for all non-vesting conditions, whether or not the counterparty has a choice of whether the condition is met.

75. A number of suggestions were made to help resolve this. The staff believes that the most plausible solution to this problem is to leave the distinction to professional judgement. In this case, there would be a rebuttable presumption that a failure to meet a non-vesting condition, when the counterparty can choose whether that condition is met, is a cancellation by the entity unless it can be demonstrated that the entity had no influence over the counterparty's decision.

76. Such an approach would avoid violating the recognition principle under IFRS 2, but limit the opportunity for accounting arbitrage. If it can be demonstrated that the entity had no influence over the counterparty's decision, the staff recommends that the failure to meet the non-vesting condition when the counterparty can choose whether or not the condition is met, is treated as a continuation of recognition of expense over the vesting period as if the event had not occurred.

77. The result of such an approach would be that the treatment of cessation of contributions to an SAYE plan is different from that implied in the ED. The ED implies that this should be treated as an acceleration of vesting. Therefore,

adopting the staff position would require a re-exposure of the Board's proposals, which would delay implementation of the correct accounting treatment.

78. The staff acknowledges further, the total compensation expense to be recognised in either approach would be the same, although the current proposals require an acceleration of recognition in all cases.

79. Overall the staff believes that re-exposure and clarification of the recommended approach would be a conceptually more robust option.

Recommendation

The staff recommends that the Board issues a revised Exposure Draft which adds a rebuttable presumption that a failure to meet a non-vesting condition, when the counterparty can choose whether that condition is met, is a cancellation by the entity, unless it can be demonstrated that the entity had no influence over the counterparty's decision.

Definition of a cancellation

80. Some respondents asked for clarification of the definition of a cancellation. The staff notes that cancellations are not explicitly defined in other IFRSs although many other types of contracts, apart from share-based payments, may be cancelled. 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. Also, there are a large number of ways in which a plan could be cancelled in different types of arrangements and it is neither expedient nor necessary (usually) to attempt a generic definition. In particular, the precise meaning of cancellation is usually explicitly stated in the terms of the contract.

81. However, the staff notes that the Board's proposals in the Exposure Draft would mean that a failure to meet a non-vesting condition when the counterparty could have chosen to meet that condition is a cancellation. This definition of a

cancellation appears to be somewhat unique to share-based payment arrangements, may not be explicitly stated in the terms of the arrangement and is also, it appears, not intuitive to all. Therefore it may be useful for constituents to have the term more clearly defined.

82. On the other hand, the staff notes that the main source of confusion appears to lie in the treatment of all the different types of events that may occur in a share-based payment arrangement, rather than in the definition of a cancellation per se.

83. The staff does not believe that it would be appropriate to define cancellations by a counterparty and not define cancellations by the entity (particularly as the key argument put forward by the Board is that cancellations by a counterparty cannot be distinguished from cancellations by an entity). However, as explained above, the staff does not recommend putting forward a definition of a cancellation. Moreover, the staff does not believe that such a definition would be useful in solving the difficulties which constituents face. A focus on the treatment of all the types of events that may occur under a share-based payment arrangement would be more useful to constituents as set out in Appendix A and described below.

84. The analysis below describes the appropriate accounting treatment for the different types of conditions:

    (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) Non-market 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 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 can choose whether or not the condition is met (eg the employee chooses to cease contributions), and it cannot be demonstrated that the entity had no influence over the decision, this should be treated as a cancellation. Otherwise no adjustment shall be made and the entity shall continue recognising the expense as if the event had not occurred.

2. If neither the entity nor the counterparty can choose whether the condition will be met (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.

Recommendation

The staff recommends that the organisation table set out in Appendix A is added to the Implementation Guidance for IFRS 2. The staff does not recommend that a definition of a cancellation is included in the final amendment.

Accounting for the salary sacrifice element of an SAYE plan

85. Regardless of the decision the Board makes in respect of the treatment of the cessation of contributions to an SAYE plan, the staff understands that there is some variation in practice in respect of accounting for an SAYE plan. Some entities account for the salary sacrifice separately as a compensation cost and recognise a liability in respect of the salary withheld (plus accruing interest). The equity component of the arrangement is recognised as an expense under IFRS 2.

Others recognise a compensation expense in respect of the salary sacrifice but assume that the liability is settled once the contributions are transferred to the savings arrangement, for instance, and so recognise, on the balance sheet, only the equity component.

86. The staff believes that the entity has an obligation to the employee in respect of the salary sacrifice amount until the option to receive cash is taken or the proceeds are used towards the exercise price of the share option. Therefore, a liability for the salary sacrifice component of the plan should be recognised.

87. More generally, the staff notes that when a share-based payment arrangement is part of a plan which includes share-based payment and other remunerative elements, it should be clarified that all elements of the plan must be accounted for appropriately.

The staff recommends the following addition to the Implementation Guidance.

Recommendation

IG Example 13

Combined plans and failure to meet a non-vesting condition when the counterparty has a choice.

- Background

An entity grants an employee the opportunity to participate in a plan in which he obtains share options if he agrees to save 25% of his monthly salary of CU 400 for a three year period. The monthly payments are made by salary sacrifice and the accumulated savings will be used to match the cost of exercising the options. The employee may choose whether to use the savings proceeds to exercise their options at the end of three years, or to take a refund of their contributions at any point during the three year period. The estimated annual expense for the share-based payment arrangement for each year is CU 120.

After 18 months, the employee decides to stop paying contributions to the plan and takes a refund of contributions paid to date of CU 1800. It cannot be demonstrated that the entity had no influence over the counterparty’s decision to cease contributions.

Application of Requirements

There are three components to this remunerative plan: paid salary, the salary sacrifice component and the share-based payment component.

The entity shall recognise an expense in respect of each component and a corresponding increase in liability or equity as appropriate.

Further, in accordance with paragraph [xx] of IFRS 2, the cessation of contributions in year 2 shall be treated as an acceleration of vesting.

YEAR 1

	Expense (CU)	**Cash (CU)**	**Liability (CU)**	**Equity (CU)**
Paid salary	3,600 (*75% x 400 x 12*)	(3,600)		
Salary sacrifice	1,200 (*25% x 400 x 12*)		(1,200)	
Share-based payment	120			(120)
Total	**4,920**	**(3,600)**	**(1,200)**	**(120)**

YEAR 2

	Expense (CU)	**Cash (CU)**	**Liability (CU)**	**Equity (CU)**
Paid salary	4,200 (*75% x 400 x 6 + 100% x 400 x 6*)	(4,200)		
Salary sacrifice	600 (*25% x 400 x 6*)		(600)	
Refund of contributions		(1800)	1,800	
Share-based payment: (acceleration of remaining expense)	240 (*CU 120* 3 – CU120*)			(240)
Total	**5,040**	**(6,000)**	**1,200**	**(240)**

Consistency with FAS 123 (revised 2004)

88. Some respondents noted that there remain other areas of divergence between FAS 123 (revised 2004) and IFRS 2 in the accounting for certain types of transactions remain, in spite of the convergence on specific issues in the Exposure Draft.

89. For example, under US GAAP, while vesting conditions are restricted to service conditions and performance conditions (the same as the proposals), market conditions are not considered to be performance conditions under US GAAP (whereas they may be performance conditions under IFRS 2). Also, currently the two standards differ on various aspects of distinguishing between liabilities and equities and accounting for share-based payments with characteristics of both.

90. These areas of divergence are not a result of, and cannot be resolved by, the proposals in the Exposure Draft. However, the staff notes that these are issues which both Boards agreed to reconsider when the more fundamental differences between the two frameworks in respect of distinguishing between liabilities and equity are reconciled.

91. The staff notes further that FAS 123 (revised 2004) does not specify the treatment of non-vesting conditions when the counterparty can choose whether or not it wishes to meet the non-vesting condition. Therefore it is not clear that the proposed treatment would be inconsistent with FAS 123 (revised 2004). Constituents have varying opinions on this.

Recommendation

The staff does not believe that the current divergences between FAS 123 (revised 2004) and IFRS 2 are caused by, or are a sufficient justification for revising, the proposal. Therefore the staff recommends that the Board continues with its proposals in spite of the expected difference with FAS 123 (revised 2004).

Effective Date and Transition Requirements

92. Most respondents agreed the proposed effective date of 1 January 2007. However, if the Board agrees the staff proposals, the amendment is not likely to be finalised until late in the final quarter of 2006. If the Board requires some further changes, it may take longer. Therefore reporting entities would have very little time to make the administrative changes necessary in order to be compliant with the new amendments.

93. The staff notes also that the Exposure Draft proposes that the amendments are applied retrospectively. Three respondents disagreed with this on the grounds that the amount of work involved in the data collection and recalculation of the charge outweighs the benefits that will be achieved by restating the comparatives. One respondent noted that this problem is exacerbated by the fact that many of the share plans that would be affected by the proposed amendments are outsourced to third party administrators. These administrators are unlikely to know the reason that the employees ceased contributions to the plan. Therefore making the distinction between those employees that have ceased contributions as a result of leaving the company and those employees that have ceased contributions for other reasons would be extremely difficult.

94. Given the above the staff believes it would be more appropriate either to postpone the effective date or not require retrospective application.

95. The staff notes that IAS 8 allows an entity, in some circumstances, to avoid retrospective application when it is impracticable to recreate the necessary information. The staff suggests that whether it is impracticable to recreate the information should be left to professional judgement. More importantly, the staff does not believe that there is sufficient justification for requiring different transitional requirements than would normally be required for an amendment to a standard. However, the staff acknowledges that there was significant disagreement with the proposal and many reporting entities may not be geared up to implement the necessary changes so soon after the amendment is finalised.

96. If the amendments are made effective as at 1 January 2008, the reporting entity should have adequate time to put into place the necessary administrative procedures.

97. Further, in order to encourage consistent and rigorous application of IFRSs, the IASB agreed to allowing increased lead time to prepare for new standards.

    The IASB recognises that many countries require time for translations and implementation of new standards into practice and, where IFRSs are legally binding, into law. To accommodate the time required, the IASB intends to allow a minimum of one year between the date of the publication of wholly new IFRSs or major amendments to existing IFRSs and the date when implementation is required.

98. While the proposed amendment is mostly one of clarification rather than a major amendment, the staff believes that a lead time of approximately one year would still be appropriate in this case.

Recommendation

The staff proposes an effective date of 1 January 2008 and retrospective application of the proposals.