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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **25 January 2007, London**

Project: **IFRS *2 Share-based Payment* – Exposure Draft: Vesting Conditions and Cancellations**

Subject: **Sweep Issues (Agenda paper 9)**

BACKGROUND

1. The Exposure Draft of the proposed amendment to IFRS 2 – vesting conditions and cancellations was published for comment on 2 February 2006. The comment period closed on 2 June and just over 50 comment letters were received.

2. Most respondents agreed with the restriction of vesting conditions to service and performance conditions only. However some respondents asked for further clarification of the definitions. A small majority of respondents disagreed with the proposed treatment of cancellations.

3. In its re-deliberations, the Board reaffirmed its proposal to restrict vesting conditions to service conditions and performance conditions and to require the same accounting treatment for all cancellations. However, noting that the rationale for the 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.

4. The Board also asked the staff to clarify the categorisation of conditions that affect whether an equity instrument could be received by a counterparty and the accounting treatment of SAYE plans.

5. The pre-ballot draft of the final amendment was issued for fatal flaw review on Thursday 23 November 2006. As a result of this review, the staff has identified two sweep issues which the Board may wish to address before finalising the Amendment. The first issue is the accounting treatment for the liability component of a share-based payment arrangement with combined features and the second is in respect of the definition of vesting conditions.

6. [Paragraph omitted from Observer Notes].

Summary of Staff Recommendations

7. The staff recommends:

(a) Some small amendments to the additional paragraph 28 (ba) included in the pre-ballot draft:

(shown as marked-up from the proposed wording in the revised pre-ballot draft).

28(ba)	**however, if the ~~grant~~ arrangement included a liability component, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement. ~~and~~ Any payment made to settle the liability component shall be accounted for as an extinguishment ~~reduction in~~ of the liability.**

(b) The following definition of a *vesting condition:*

(shown as marked-up from the proposed definition in the revised pre-ballot draft):

Vesting conditions The conditions that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or **equity instruments** of the entity under a **share-based payment arrangement**. Therefore, service conditions ~~include~~ ~~service conditions~~, which require the other party to complete a specified period of service, are vesting conditions. All other vesting conditions are performance conditions which require specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time). Performance conditions may be **market conditions** or other conditions.

the following addition to BC 171A;

BC 171 A The term *services* refers to the quantity (service condition) or quality (performance condition) of the service received by the entity.

and the following addition to BC 171B

The Board also noted that since vesting conditions determine whether the entity receives the services that entitle the counterparty, then vesting conditions must have an explicit or implicit requirement for an employee to remain in service (for transactions with employees).

(c) The staff has also incorporated some editorial changes to the proposed wording to clarify the Board's intentions.

Accounting treatment for the liability component

8. The Board asked the staff to clarify the accounting treatment of SAYE plans. The staff included an illustrative example to show this in IG 14 of the pre-ballot draft

and a new paragraph, paragraph 28 (ba) to clarify the accounting treatment required. The proposed wording in the revised draft was as follows:

28(ba) if the grant included liability components, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement and any payment made to settle the liability component shall be accounted for as a reduction in the liability.

9. The staff argues that this paragraph is required because paragraph 28(b) requires any payment on cancellation to be treated as a repurchase of an equity interest. In other words, there is an implicit assumption in paragraph 28(b) that any payment on cancellation would be in respect of the equity component of a share-based payment arrangement.

10. In the case of SAYEs and similar arrangements, however, the payment on cancellation may be in respect of the liability component of the share-based payment arrangement (eg the repayment of employee contributions on cancellation).

11. One respondent thought that since paragraph 28(b) would normally be read as referring to the accounting treatment of the equity component and the accounting treatment of a payment made to settle a liability is clear, then this paragraph may not be necessary. However, other constituents thought the paragraph is needed for clarity and completeness. The staff agrees with the latter view but has suggested some small amendments for clarity. The first change is the change of the term 'grant' to 'arrangement' as it is the share-based payment arrangement that may include a liability component rather than grant. The second is the change from a 'reduction in the liability' to 'an extinguishment of the liability' as the entire liability is extinguished when a payment is made to settle it.

12. *The staff would like to ask the Board whether it wishes to include this paragraph in the final Amendment and, if so, whether it agrees with the suggested changes (shown as mark-up from the revised draft) below.*

28(ba) **however, if the ~~grant~~ arrangement included a liability component, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement. ~~and~~ Any payment made to settle the liability component shall be accounted for as an extinguishment ~~reduction in~~ of the liability.**

Definition of vesting conditions and performance conditions

13. 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”.

14. The revised pre-ballot draft proposed the following definition:

> The conditions that determine whether the entity receives the services that entitle-the counterparty to receive cash, other assets or **equity instruments** of the entity under a **share-based payment arrangement**.
>
> Vesting conditions include service conditions, which require the other party to complete a specified period of service. All other vesting conditions are **performance conditions** which require specified performance targets to be met (such as a specified increase in the entity’s profit over a specified period of time). Performance conditions may be **market conditions** or other conditions.

15. Two issues arose in respect of this. Firstly, one Board member thought that the proposed definition is potentially confusing. The main reason for this is that the term ‘service (s)’ is used in two different senses in the definition. Secondly one constituent noted that further clarification is still needed in respect of the treatment of conditions that are not dependent on service.

Use of the term service (s)

16. The proposed definition of vesting conditions refers to “the conditions that determine whether the entity receives the services...”. The term ‘services’ relates to the quantity or quality of the service the entity receives in return for the share-based payment.

17. The definition also states that "vesting conditions include service conditions". The term 'service' relates only to the quantity of service or specified period of employment.

18. The staff notes that the term 'services' is used to mean both the quantity and/or quality of service received by the entity. The term service could either be used to mean the quantity of service (service condition) or the state of being in employment (in service). In paragraph 21 of IFRS 2, the term is used in all three different senses in the same sentence without ambiguity:

    "Therefore, for grants of equity instruments with market conditions, the entity shall recognise the goods or services received from a counterparty who satisfies all other vesting conditions (eg services received from an employee who remains in service for the specified period of service) irrespective of whether that market condition is satisfied."

    This sentence could be rewritten to read: "Therefore, for grants of equity instruments with market conditions, the entity shall recognise the goods or *[quantity and/ or quality of services]* received from a counterparty who satisfies all other vesting conditions (eg *[quantity of service]* received from an employee who remains in *[employment]* for the specified period of *[employment]*) irrespective of whether that market condition is satisfied."

19. The staff thinks that the term 'services' in the context of share-based payment is typically understood to be the quantity and/or quality of services received. The term service condition is typically understood to mean a specified period of employment. Therefore the staff proposes to continue using these terms as such. However, it would be helpful to include a discussion in the Basis for Conclusions to clarify that services refers to the quantity of service (service condition) and/or the quality of service (performance condition). Some additional editorial amendments to the proposed definition would also help to clarify this further.

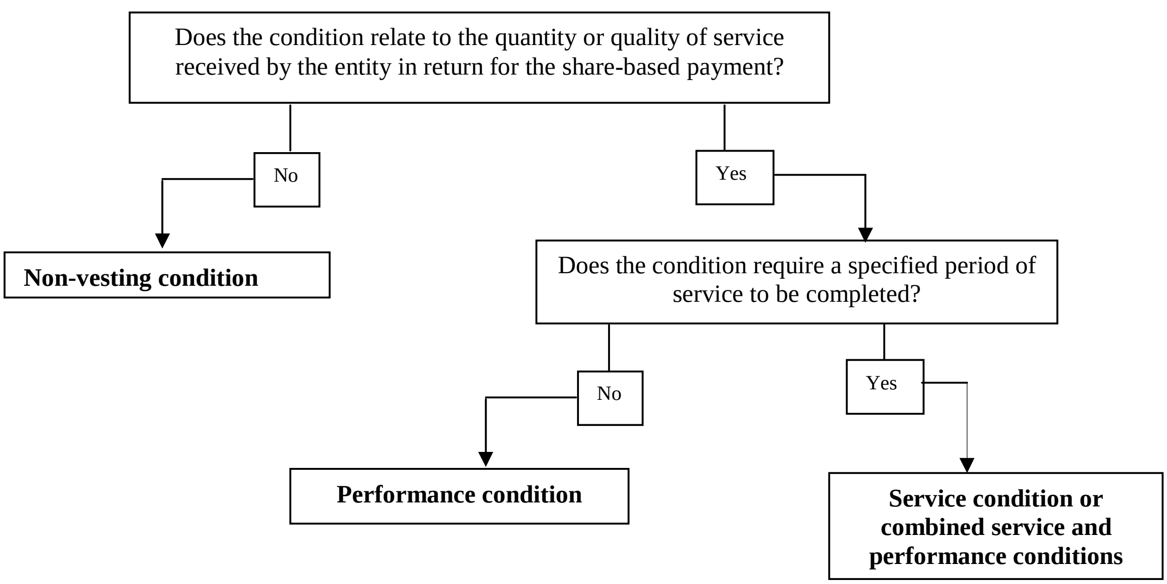
20. Accordingly, the staff proposes the following amendment to the definition of vesting conditions and the following addition to paragraph BC 171A of the Basis for Conclusions of the Amendment

    (shown as marked up from the proposed wording in the revised draft)

The conditions that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or **equity instruments** of the entity under a **share-based payment arrangement**. Therefore, service conditions ~~include~~ ~~service conditions~~, which require the other party to complete a specified period of service, are vesting conditions. All other vesting conditions are performance conditions, which require specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time). Performance conditions may be **market conditions** or other conditions.

BC 171 A The term *services* refers to the quantity (service condition) or quality (performance condition) of the service received by the entity.

21. The flowchart below illustrates the identification of vesting and non-vesting conditions.



Performance conditions and service requirements

22. One respondent to the fatal flaw review noted that the amendment does not clarify the treatment of conditions that are not dependent on service ie the treatment of conditions that do not require the employee to remain in employment. For

instance, shares may be awarded which are conditional on a successful IPO. The employee receives the shares on a successful IPO, even if the employee leaves service before the IPO occurs. The respondent did not believe that the success of an IPO, in this case, should be treated as a vesting condition as there is no explicit or implicit 'quantity or quality of service' requirement.

23. The staff agrees that since performance conditions relate to the quality of service rendered, a performance condition must also impute a requirement to be in employment even if there is no explicit requirement for a minimum period of service. This would imply that the successful IPO in the case above is not a vesting condition.

24. IG 24 of the pre-ballot draft included the 'success of an IPO' as an example of a performance condition. This is consistent with FAS 123 (revised 2004). However, the staff now believes that this is misleading as an example. Given the discussion in two paragraphs above, the staff thinks that there could be some cases when the success of an IPO is not a vesting condition. Accordingly, the staff has reverted to the example of a specified profit target in IG 24 of the pre-ballot draft, which is also the example used in the definition of vesting conditions in appendix B.

    Does the Board agree this change to the example of a performance condition in IG 24?

25. If the Board agrees with the principle that vesting conditions impute service, the staff proposes the following addition to paragraph BC 171B of the Basis of Conclusions.

    <u>The Board also noted that since vesting conditions determine whether the entity receives the services that entitle the counterparty, then vesting conditions must have an explicit or implicit requirement for an employee to remain in service for transactions with employees.</u>

Other changes

The staff has included some other suggested changes to the final amendment in respect of issues which would not be considered to be fatal, but which would clarify the intentions of the Board