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

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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:	**16 May 2007, London**
Project:	**IFRS 2 *Share-based Payment* – Vesting Conditions and Cancellations**
Subject:	**Comparison of SFAS 123 (r) and IFRS 2 (Agenda paper 4A)**

Objective

1. This paper summarises the effect of the proposed Amendment to IFRS 2 – *Vesting Conditions and Cancellations* on the convergence of US and International Financial Reporting Standards for share-based payment transactions.

Background

2. The Board agreed to finalise its Amendment to IFRS 2 – *Vesting Conditions and Cancellations* in October 2006. Some Board members have asked whether the proposed Amendment would create new divergences between SFAS 123 (revised 2004) and IFRS 2.

3. There are a number of differences between IFRS 2 and SFAS 123 (revised 2004)[1] (SFAS 123 (r)). The staff has determined that no new divergences have been created by the Amendment. However, the staff concedes that the clarifications in the proposed

[1] These arise, for example, because of differences in: scope; in distinguishing between liabilities and equity; and income tax differences.

Amendment may highlight existing divergences between the two standards and wishes to make the Board aware of this.

4. The key issues raised were in respect of the:

    a. treatment of some non-vesting conditions;

    b. determination of the grant date.

5. A brief summary of the issues raised and explanation of the requirements of IFRS 2 and SFAS 123 (r) before and after the proposed Amendment is set out below.

6. The key areas addressed by the Amendment are: vesting conditions and cancellations. [Sentence omitted from observer note].

Staff Recommendation

7. The clarification in the Amendment highlights some of the divergences between IFRS 2 and SFAS 123 (r) – particularly in respect of the treatment of non-vesting conditions and determination of the grant date.

8. However, these differences are not new and information provided to the staff (for example at the 2006 IFRS 2 roundtable) indicates that most constituents are already aware of them. As a result, we do not expect the Amendment to create any new implementation difficulties. Therefore, the staff recommends that the IASB proceeds with the proposed Amendment to IFRS 2.

9. The staff also recommends that a small change is made to the table in IG24 of the Implementation Guidance to confirm that the required treatment of a 'counterparty cancellation' only applies after the grant date ie a share-based payment cannot be cancelled before it is granted.

10. The staff would like to ask the Board whether it wishes to consider adding a project to its agenda in respect of the determination of the grant date under SFAS 123 (r) and IFRS 2.

Treatment of non-vesting conditions

SFAS 123 (r)

11. Under SFAS 123 (r), there are three possible types of non-vesting conditions. They are either market conditions, 'other' conditions, or contingent features.

12. In general, market conditions are included in the grant date fair value and no adjustment is made to the compensation expense recognised if the condition is subsequently not met (assuming the vesting conditions are met). This is consistent with IFRS 2.

13. 'Other' conditions are typically included in the grant date fair value. However, SFAS 123 (r) classifies share-based payments with these conditions as liability awards and the compensation expense recognised is adjusted if the condition is subsequently not met. This may be inconsistent with IFRS 2 in some circumstances.

14. An example would be an award of shares to employees that will vest based on the appreciation in the price of a commodity such as gold and the issuing entity's share price. SFAS 123 (r) would treat this as a liability award because it is indexed to a factor that is not a market, service or performance condition. The grant date fair value would include the probability of the price of gold meeting the required target and if the price of gold did not reach this target, the compensation expense recognised would be adjusted, even if this occurs after the vesting date.

15. This is inconsistent with IFRS 2. In particular, IFRS 2 would treat this as an equity-settled share-based payment because it is settled in the entity's shares. In this case, the grant date fair value would include the probability of the price of gold meeting the required target. If the price of gold did not reach the required target no subsequent adjustment to the compensation expense is made, assuming all the vesting conditions are met.

16. Contingent features are features of an award *that might cause an employee to return to the entity either equity instruments earned or realized gains from the sale of equity instruments earned*. An example of a contingent feature would be a non-compete agreement included in an employment contract that states employees who enter into competitive activity, within a specified period of time after leaving service, would lose options that have not yet been exercised.

17. Under SFAS 123 (r), such a provision is not included in the grant date fair value and, if the non-compete provision is breached, the compensation cost previously recognised is

adjusted, even if the breach occurs after the vesting date. As discussed below, this is inconsistent with IFRS 2.

IFRS 2

18. The proposed Amendment to IFRS 2 clarifies that all non-vesting conditions (including market conditions) are treated the same. The probability of the condition being met is included in the grant date fair value and no adjustment is made to the compensation expense recognised if the non-vesting condition is subsequently not met (unless it is a cancellation). In particular, the notion of a contingent feature does not exist in IFRS 2. The rationale for the IFRS 2 approach is explained below.

19. In developing IFRS 2, the IASB had initially proposed using a units of service method, in which the grant date fair value included all features of a share-based payment. Some respondents raised practical concerns about applying the units of service method to grants with service and performance conditions. Some also expressed concerns about the practicality of including the reload feature in the grant date valuation.

20. After reconsidering this issue, the IASB decided to adopt the modified grant date method applied in SFAS 123. Under this method, service conditions and non-market performance conditions are excluded from the grant date valuation. The IASB also decided that the reload feature should not be included in the grant date valuation.

21. The staff notes that the Board considered all the features that should be included in the grant date fair value and excluded only service conditions, non-market performance conditions and reload features. It follows therefore that all other features of a share-based payment should be included in the grant date fair value.

22. Since IG 24 of the proposed Amendment states specifically that all non-vesting conditions are treated the same under IFRS 2 (apart from when there is a cancellation), the clarification would highlight the difference between IFRS 2 and SFAS 123 (r).

23. However, given that the responses to the Exposure Draft of the Amendment indicate that further clarification of the treatment of non-vesting conditions is needed, the staff recommends that the Board proceeds with the clarification of the treatment of non-vesting conditions.

Does the Board agree that clarification of the treatment of non-vesting conditions is necessary and that no changes should be made to the Amendment in this respect?

Cancellations before the grant date

24. SFAS 123 (r) treats counterparty 'cancellations' before the grant date differently from counterparty cancellations after the grant date. The IASB staff agrees with this. Strictly speaking, a counterparty cannot cancel a share-based payment before it is granted.

25. Therefore if an entity or counterparty fails to meet a non-vesting condition before a share-based payment has been granted and either the entity or counterparty could choose whether that condition is met (ie there is a ‘cancellation’ before the grant date), this should not be treated the same as a cancellation.

26. The staff thinks that the appropriate treatment in this case is set out in IG 4 of IFRS 2:

> IG4 In some cases, grant date might occur after the employees to whom the equity instruments were granted have begun rendering services. For example, if a grant of equity instruments is subject to shareholder approval, grant date might occur some months after the employees have begun rendering services in respect of that grant. The IFRS requires the entity to recognise the services when received. In this situation, the entity should estimate the grant date fair value of the equity instruments (eg by estimating the fair value of the equity instruments at the end of the reporting period), for the purposes of recognising the services received during the period between service commencement date and grant date. Once the date of grant has been established, the entity should revise the earlier estimate so that the amounts recognised for services received in respect of the grant are ultimately based on the grant date fair value of the equity instruments.

27. If an entity or counterparty chooses not to meet a non-vesting condition before the grant date, that would imply that the grant date fair value of the award would be zero. In accordance with IG 4, therefore, the entity would revise earlier estimates to reflect the grant date value of zero upon ‘cancellation’ before the grant date. This approach would be consistent with the treatment of ‘cancellations’ before the grant date under SFAS 123 (r).

The staff recommends a small change to the table in IG24 of the Implementation Guidance to confirm that the required treatment of a true cancellation by the counterparty or the entity only applies if the cancellation occurs after the grant date. Does the Board agree?

Determination of the grant date

28. The definition of grant date was not addressed by the proposed Amendment to IFRS 2. Therefore the Amendment does not create a new divergence in this respect.

29. However, the staff mentions it here because, as mentioned above, there is an important interaction between the determination of the grant date and the cancellation requirements. A cancellation cannot occur before the grant date. Therefore, if the grant dates are different, the same event could be treated as a reversal of expense in one standard (because it occurs before the grant date) and an acceleration of expense in the other standard (because it occurs after the grant date and is therefore a cancellation).

30. IFRS 2 and SFAS 123 (r) have similar definitions of grant date. Both definitions state that a grant date only occurs when there is a mutual understanding of the terms and conditions of the share-based payment.

31. This means that both standards often have the same grant date. Consider the following example:

Example 1

On January 1 20X7, an entity enters into an employment contract with its chief executive officer (CEO) to issue 500,000 share-based payment awards over the course of the next 5 years. 100,000 awards will vest at the end of each of the succeeding 5 years. The exercise price for each tranche of 100,000 awards will be set by a compensatory committee on 1 January of the year in which that tranche vests. For example, the exercise price of the first tranche will be set on January 1 20X7, the exercise price of the second tranche will be set on January 1, 20X8, and so on.

Under SFAS 123 (r), there would be 5 separate grant dates at the end of each year when the exercise price is known.

Under IFRS 2, it is not necessary for the exercise price to be known, it would suffice to have an understanding of how the exercise price would be determined. However, in this case it is not possible to determine what the exercise price would be until it is set by the compensatory committee so there will also be 5 separate grant dates at the end of each year when the exercise price is known.

32. However, in some cases, there are divergent interpretations of whether a grant date has occurred under SFAS 123 (r) and IFRS 2. Consider the next example. This is the same as Example 1 except that the exercise price is equal to the share price at the issue date:

Example 2

On January 1 20X7, an entity enters into an employment contract with its chief executive officer (CEO) to issue 500,000 share-based payment awards over the course of the next 5 years. 100,000 awards will vest at the end of each of the succeeding 5 years. The exercise price for each tranche of 100,000 awards will be set equal to the entity's share price on 1 January of the year in which that tranche vests. For example, the exercise price of the second tranche will be set on January 1, 20X8 based on the share price on that day, and so on.

33. Under SFAS 123 (r) if the exercise price for an option is equal to a future share price, then a grant date has not occurred until that future share price is known. Therefore at 1 January 2007, only the first tranche has been granted. The compensation expense in respect of this first tranche will be recognised in the year that it vests. No compensation expense would be recognised for the other tranches.

34. Under IFRS 2, it is not necessary for the exercise price to be known in order for a grant date to have occurred in IFRS 2. It would suffice to have an understanding of how the exercise price would be determined. In this case, it is clear how the exercise price is determined so all 5 tranches are granted as at 1 January 2007, although each tranche has a different vesting period. The compensation expense in respect of each tranche will be recognised over the relevant vesting periods eg first tranche over one year, second tranche over two years and so on.

Different grant dates imply different cancellation treatments

35. This difference in the determination of the grant dates has an impact on the cancellation treatment. If the CEO in Example 2 cancels his share-based payment as at 30 June 2007, the accounting treatment would be as follows:

SFAS 123 (r)

The entity recognises immediately the amount of the expense that would otherwise have been recognised in respect of the first tranche in the first year. No compensation expense is recognised in respect of the other tranches.

IFRS 2

The entity recognises immediately the amount of the expense that would otherwise have been recognised in respect of each tranche.

36. Therefore, the same event requires very different accounting even though both standards require the same cancellation treatment.

The way forward

37. There are at least two approaches available to the Board. The first would be to consider creating a limited scope Amendment that clarifies the treatment of cancellations by the counterparty for Save As You Earn (SAYE[2]) plans but does not discuss vesting conditions or the treatment of non-vesting conditions or cancellations by the counterparty in more generic terms.

38. The second approach would be to proceed with the Amendment, with the suggested change in paragraph 26 to clarify that a cancellation cannot occur before the grant date.

39. The first approach would avoid the problem concerning divergent interpretations of grant dates because SAYE plans typically specify the exercise price at the issue date and so the grant date would be the same under both standards. It could also potentially avoid highlighting the differences in the requirements for non-vesting conditions (although these differences will, of course, still exist).

40. The staff disagrees with this approach. The staff understands that share-based payments where the exercise price is variable rather than fixed at the issue date are becoming increasingly common in many jurisdictions (eg look-back options). Inevitably, the question of how to account for cancellations by the counterparty of other types of share-based payments will arise.

41. The staff also thinks that it would be difficult to justify the treatment of a cessation of contributions to an SAYE without clarifying the definition of vesting conditions and treatment of non-vesting conditions. In fact this issue was originally raised with the IFRIC because constituents disagreed over whether or not a given condition was a vesting condition.

[2] This issue began as an IFRIC project that attempted to determine the accounting for cessation of contributions to an SAYE plan. The Board decided that the contribution requirement is a non-vesting condition that the counterparty could choose not to meet. Therefore failure to meet that condition should be treated as a cancellation.

42. Further the issue of divergent interpretations of grant dates and the effect of that on cancellations already exists for cancellations by the entity. The Amendment addresses cancellations by the counterparty only.

43. The staff favours the second approach. The responses to the Exposure Draft confirmed that the clarification of the treatment of non-vesting conditions and cancellations by the counterparty is needed.

44. Moreover, the Amendment does not create any new divergences between SFAS 123 (r) and IFRS 2. Information provided to the staff (for example at the 2006 IFRS 2 roundtable) indicates that most constituents are already aware of the differences between the two standards. As a result, we do not expect the Amendment to create any new implementation difficulties.

45. Given the above, the staff recommends that the Board proceeds with the Amendment with the suggested change in respect of cancellations before the grant date.

46. In order to reduce divergence between the two standards, the Board may also wish to consider adding a project to its agenda in respect of the determination of the grant date under both standards.

Does the Board wish to proceed with the Amendment with the suggested change in respect of the treatment of cancellations after the grant date? Does the Board wish to explore the possibility of adding a project to its agenda in respect of the determination of the grant date under SFAS 123 (r) and IFRS 2?