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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: 15 November 2007, London

Project: IFRS 2 *Share-based Payments*

Subject: Vesting Conditions and Cancellations
(Agenda paper 9)

Background

1. IFRS 2 and SFAS 123 (r) have very similar definitions of grant date. Both definitions state that a grant date occurs when the entity and the counterparty have a shared (or mutual) understanding of the terms and conditions of the share-based payment arrangement. However, the meaning of “a shared understanding” of the terms and conditions might be unclear in some circumstances.
2. At the July meeting, the Board discussed the differences that have appeared to arise in practice in the way in which the definition of a grant date is interpreted under IFRS 2 and SFAS 123 (r). In particular the Board discussed, but did not come to a conclusion on, whether it is necessary for the exercise price to be known in order for a grant date to have occurred.
3. The Board noted that the proposed amendment to IFRS 2 does not address the definition of a grant date and therefore that the determination of the grant date could be investigated independently of the finalisation of the amendment on vesting conditions and cancellations.
4. However, the Board also noted that there is an important interaction between the determination of the grant date and the proposed cancellation requirements. A

cancellation cannot occur before the grant date and if the grant dates in IFRS 2 and SFAS 123(R) are interpreted differently, the same event could be treated as a reversal of expense by one standard (because grant date has not yet occurred) and an acceleration of expense by the other standard (because grant date has occurred).

5. Therefore, the Board asked the staff to investigate further:
 - a. the extent of the diversity in interpretation in practice; and
 - b. whether any further clarification of the determination of the grant date is needed, either as part of the proposed Amendment or as a separate project.
6. To that end, the staff asked a number of preparers, auditors and benefit consultants to explain how they would determine the grant date in three cases and to indicate the rough percentage of share-based payment plans for which they think there is a difference in the interpretation of grant dates under IFRS2 and SFAS 123 (r).
7. This paper sets out a brief analysis of the responses received and the staff comments on the possible ways forward.

Summary

8. The staff notes that it is not necessary for the determination of the grant date to be deliberated in order for the proposed Amendment to IFRS 2 to be finalised and, further, that a ballot draft of the Amendment has already been issued (May 2007).
9. However, the staff notes also that responses from constituents indicate that it would be useful to address urgently a number of other issues that have arisen in IFRS 2 that are in need of clarification, including issues concerning complexity and rules-based accounting as well as areas of divergence with SFAS 123 (r).
10. Therefore the staff would like to ask the Board whether it wishes to defer any action on the current proposed Amendment and proceed with investigating a potential new project to review IFRS 2 and areas of divergence with SFAS 123 (r). The staff would bring an agenda proposal to a future meeting on this if the Board so directs.

Determination of the grant date

11. The staff asked a number of constituents how they would determine the grant date in three cases.

Example 1 – Exercise price set at a future date

On 1 January 2007, an entity enters into an employment contract with its chief executive officer (CEO) that entitles the CEO to 100,000 options that will vest on 31 December 2010. The exercise price will be set equal to the share price on 1 January 2008. The options expire 10 years after vesting.

Example 2 – Multiple tranches and exercise price set at a future date

On 1 January 2007, an entity enters into an employment contract with its CEO that entitles the CEO to 5 tranches of 10,000 options each, which will vest on 31 December every year for five consecutive years starting 31 December 2007. The exercise price will be set equal to the share price on 1 January of the year in which the options vest. The options expire 10 years after vesting.

Example 3 – Multiple tranches, exercise price is fixed at issue date and number of options is linked to future salaries

On 1 January 2007, an entity enters into an employment contract with its CEO that entitles the CEO to options for each year the CEO remains in employment. The number of options is equal to 20% of the employee's salary in the relevant year divided by the exercise price. The exercise price is the share price at 1 January of the year in which the options vest. The options expire 10 years after vesting.

12. For each example above, the staff asked the following three questions:

Question 1 - What is the grant date in accordance with IFRS 2?

Question 2 - What is the grant date in accordance with FAS 123 (r)?

Question 3 – In some cases there are significant unknowns, for instance, future volatility in 15 years' time in Example 2. How would you determine the relevant assumptions needed to calculate the grant date fair value in these cases?

13. In general, most respondents believed that there was a difference between IFRS 2 and SFAS 123 (r) on the determination of the grant date.

"I believe that the emphasis under IFRSs is whether the outcome is based primarily on objective or subjective factors. This is contrasted with US GAAP for which the emphasis may be on whether the employee is exposed to movements in the share price (i.e. whether the employee begins to benefit from, or be adversely affected by, changes in the share price)."

14. These respondents thought that a shared understanding under IFRS 2 does not require the exercise price to be known. It is sufficient to know how the exercise price will be determined providing that determination is an objective one (for instance with reference to changes in market prices) that is not within the control of the entity.

15. However, most respondents thought that the types of arrangements where these differences would arise are relatively rare.

“In our experience, arrangements where there is a difference in grant date between FAS 123R and IFRS 2 that would have a material effect on the accounting are very rare.”

16. The answers given to the specific questions posed are summarised in Appendix B. In addition some respondents raised further questions on other issues in IFRS 2 that cause a significant divergence between IFRS 2 and SFAS 123 (r). This is discussed further below.

The Way Forward

17. There are three possible ways of going forward:

- a. The Board proceeds with the proposed Amendment with no further work on the other issues;
- b. The Board proceeds with the Amendment and adds a separate new project to its agenda to consider other critical issues, including the determination of the grant date;
- c. The Board does not finalise the amendment and, instead, adds a new project to its agenda to consider a range of critical issues, including the determination of the grant date and the issues addressed in the proposed Amendment.

Amendment only

18. The Board has already voted in favour of the Amendment subject to some small editorial changes. Therefore it is certainly possible for the Board to proceed with the Amendment as balloted.
19. Discussions with constituents and the specific responses to the specific questions asked indicate that the Board’s discussions on grant date have not caused any new divergence in the interpretation of grant date under IFRS 2. Therefore the Amendment is not expected to create any new implementation difficulties and the due process criteria for re-exposure have not been met.
20. Further, the questions regarding the treatment of vesting conditions and cancellations first started as an IFRIC project in 2005 because clarification was urgently needed and any further delay in finalisation of the Amendment may be difficult to justify.

21. However, as one respondent pointed out, there are other significant differences between IFRS 2 and SFAS 123(R) with similar results to the interaction of the grant date and the treatment of cancellations. That respondent noted the following difference in respect of service inception date:

“One example we have seen of a difference in this area was reported by Fiat S.p.A. in its Form 20-F for the year ended 31 December 2006. The relevant extract from note 42 of their accounts states:

During 2006 the Group issued a new stock option plan subject to shareholders’ approval in the general meeting on April 4, 2007. Under IFRS ... employees began rendering services from the date the plan was approved by the Board of Directors (November 3, 2006), even though the grant date occurred at the Shareholders’ Meeting upon approval (April 4, 2007). As a consequence, under IFRS the Group estimated the fair value at December 31, 2006, recognizing the compensation cost for services received during the period from the commencement of the service period to year end. Under SFAS 123R the award service period begins before the grant date only if specific conditions are met. In the case of the 2006 stock option plan, such conditions were not satisfied, therefore under US GAAP the Group reversed the 6 million euros of compensation expense recorded under IFRS on this plan.”

22. The staff notes that, in this case, the compensation cost recognised in accordance with US GAAP in future years would be higher than the IFRS 2 cost, all other things being equal, so that the total compensation cost recognised over the relevant periods would be the same.
23. There are many other significant differences between IFRS 2 and SFAS 123 (r). For example, SFAS 123(R) does not include within its scope share-based payment transactions with non-employees and the classification of share-based payments as liabilities or equity is different under the two standards. Other issues include the clarification of the treatment of some vesting and non-vesting conditions, deferred bonus plans, modification treatment and the determination of the grant date.
24. There are, to date, more than 20 issues that constituents have asked to have clarified. The staff does not think that all of these issues would necessarily be included in a published document. Nevertheless, the Board may wish to consider whether some of these other issues should be addressed, either as part of the Amendment on vesting conditions and cancellations or as a separate project. There may be other problem areas or areas of divergence that may be uncovered on further research. [Part of paragraph omitted from Observer Notes].

Proceed with Amendment as balloted and add separate project

25. The staff notes that many constituents have called for the IASB to finalise the proposed Amendment urgently. However many of these respondents also asked for urgent attention to be given to some of the other issues currently causing difficulty in IFRS 2.
26. Some argue that the Board should finalise the Amendment as soon as possible and begin work on the remaining issues immediately, but as a separate project. This way, the outstanding issue on the treatment of cancellations would be resolved and there would be no adverse effect on the timing of the deliberations for the other issues.
27. Proponents of this approach argue further that the Board had previously decided to consider a second phase of work on convergence of the two standards after the project on distinguishing between liabilities and equity is completed. It is doubtful, therefore, whether much progress could be made in advance of the clarification of the liabilities and equity issue and the clarification of the issues already decided by the Board (as included in the proposed Amendment) should not be delayed as a result of this.
28. In any case, they would argue, any further work in respect of the determination of the grant date and other issues should be considered as part of a separate project, since a decision on these issues would not affect the Board's decision on the treatment of vesting conditions and cancellations.

New project to the Board's agenda to include proposed Amendment

29. Some staff and Board members argue that issuing the proposed Amendment now and a second Amendment or series of further amendments at a later date is an inefficient way of improving the standard.
30. They suggest that this is a time to take a different look at IFRS 2. The standard is nearing its third anniversary, and now may be a good time to consider repairs and maintenance more generally. Those who take this view argue:
 - a. There are some fundamental differences between IFRS 2 and FASB Statement 123R -- far more fundamental than differences over the definition of grant date. Some have suggested that these differences arise from differences in the way the two Boards distinguish debt and equity. That argument is hard to reconcile with the fact that our frameworks define liabilities in the same way. We ought to investigate

whether we can reduce these differences without waiting on the broader liability/equity project. We can do this without triggering the kind of full-scale exercise found in the taxes project.

- b. IFRS 2 is often criticized as "rule based." There is, no doubt, a large measure of "I don't like it, so it must be rules-based" in those criticisms. That said, there are exceptions and anti-avoidance provisions in IFRS 2 that make it more complicated than it might otherwise be. We ought to investigate whether we can simplify the standard.
- c. There seems to be a constant flow of interpretive questions surrounding IFRS 2, including those found in this paper and in the recent Board discussions of Group Cash-Settled Share-Based Payments. We ought to take the opportunity to accumulate those questions, look at them as a group, and see if they reveal problems in the standard.

31. These staff and Board members propose that the Board defer any action on the current exposure draft and other amendments and interpretations. Instead, they recommend that the staff and selected Board advisors spend the next 3 months or so examining IFRS 2 issues, potential convergence between IFRS 2 and FAS 123R, and possible simplifications and streamlining. If there is a potential project here, it would enter the cycle for consideration in June/July 2008. To make the deadlines inherent in that cycle, the staff would need to begin work now.

Question:

Does the Board wish to defer any action on the current exposure draft and other amendments and interpretations and proceed with investigating a potential new project as outlined above? The staff would bring an agenda proposal to a future meeting on this if the Board so directs.

Examples of common interpretations of mutual/shared understanding

Example 1

On January 1 2007, an entity enters into an employment contract with its chief executive officer (CEO) to issue 100,000 share-based payment awards on 31 December 2010 if the CEO is still in service at that date.

The exercise price will be set by a compensatory committee on 1 January 2010.

Under both IFRS 2 and SFAS 123 (r), the grant date does not occur until 1 January 2010 when the exercise price is set by the compensation committee.

Consider the next example. This is the same as Example 1 except that the exercise price is set equal to the lower of the share price on 1 January 2007 and the share price on 1 January 2010.

Example 2

On January 1 2007, an entity enters into an employment contract with its chief executive officer (CEO) to issue 100,000 share-based payment awards on 31 December 2010.

The exercise price will be set as the lower of the share price on 1 January 2007 and the share price on 1 January 2010.

Under both IFRS 2 and SFAS 123 (r), the grant date is 1 January 2007.

Example 1 – Exercise price set at a future date

On 1 January 2007, an entity enters into an employment contract with its chief executive officer (CEO) that entitles the CEO to 100,000 options that will vest on 31 December 2010. The exercise price will be set equal to the share price on 1 January 2008. The options expire 10 years after vesting.

Most respondents believed that the grant date under IFRS 2 would be 1 January 2007 while the grant date under SFAS 123 (r) would be 1 January 2008. The rationale for this was that while SFAS 123 (r) specifically requires the exercise price to be known (in most cases), IFRS 2 does not. Under IFRS 2, it is argued that it is sufficient to know how the exercise price will be determined providing that determination is an objective one that is not within the control of the entity.

A small minority of respondents thought that the grant date would be 1 January 2008 under IFRS 2, because the exercise price should be known in order for the terms and conditions to be agreed.

Example 2 – Multiple tranches and exercise price set at a future date

On 1 January 2007, an entity enters into an employment contract with its CEO that entitles the CEO to 5 tranches of 10,000 options each, which will vest on 31 December every year for five consecutive years starting 31 December 2007. The exercise price will be set equal to the share price on 1 January of the year in which the options vest. The options expire 10 years after vesting.

Most respondents believed that the grant date under IFRS 2 would be 1 January 2007 with tranching vesting, while the grant date under SFAS 123 (r) would be 1 January 2007, 1 January 2008 and so on with each tranche being granted in each of the five years.

A small minority of respondents thought that the grant date under IFRS 2 would be the same as SFAS 123 (r) with each tranche being granted in each of the five years, because the exercise price should be known in order for the terms and conditions to be agreed

Example 3 – Multiple tranches, exercise price is fixed at issue date and number of options is linked to future salaries

On 1 January 2007, an entity enters into an employment contract with its CEO that entitles the CEO to options for each year the CEO remains in employment. The number of options is equal to 20% of the employee's salary in the relevant year divided by the exercise price. The exercise price is the share price at 1 January of the year in which the options vest. The options expire 10 years after vesting.

All respondents agreed that the grant date would be 1 January 2007, 1 January 2008 and so on consecutively. The rationale given under IFRS 2 was that salary increases are subjective and therefore no shared understanding can be determined until the

salary increases have been set. The rationale given under SFAS 123 (r) is no mutual understanding could be had until the exercise price has been set.

Finally, with respect to the assumptions to be used, most respondents said that while they acknowledge that some assumptions would be significantly more difficult to estimate, that a best estimate is usually made with reference to the past history, current market conditions and expectations for the future.