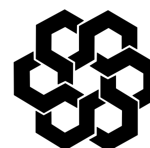

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International Accounting Standards Board

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

IASB Meeting: **18 September 2008, London (Agenda Paper 12B)**

Project: **IFRS 2: Category B Issues**

Introduction

1. This paper sets out a summary of the Category B IFRS 2 issues that have arisen. These are the issues that constituents have asked the IASB to consider on the grounds that the accounting requirements specified in IFRS 2 are unclear.

Staff Recommendation

2. The staff has split Category B issues into three sections:

   - Those for which no further action is required.
   - Those that should be referred to the annual improvements project.
   - Those that should be referred to another project.

3. In summary, therefore, the staff does not recommend that the Board add any of these issues to its agenda.

4. A summary of the staff views on each of these issues is set out below.

Analysis of Category B issues

5. A list of the Category B issues is set out below and an analysis of each of these issues is set out in the following section.

- Awards that can unvest and 're-vest' eg limited exercise window when a performance condition is met.
- Matching share awards:
- Investment Manager fees
- Distinguishing between service and performance conditions in the non-employee model.
- Can service and performance conditions be non- contemporaneous?
- Accounting for continuous service in the non-employee model.
- Multiple interactive vesting and non-vesting conditions.
- Modification- interaction of multiple changes where some are beneficial to the employee and some are not.
- Accounting for deferred tax liabilities
- Retiree eligible and similar awards
- Accounting for tax reimbursement rights
- Accounting for deferred taxes on share-related payments that are not within the scope of IFRS 2

6. The analysis of issues is subdivided into the three subcategories set out in paragraph 2.

ISSUES FOR WHICH NO FURTHER ACTION IS REQUIRED

7. There are a number of issues which no longer require further consideration because of the Board's clarifications in the 2008 amendment to IFRS 2 – *Vesting Conditions and Cancellations*. In particular, that amendment clarified the definition of 'vest' and the distinction between vesting and non-vesting conditions.

8. The staff analysis of the issues for which no further action is required are set out below.

- **Awards that can unvest and 're-vest'**

9. 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.

10. Questions have arisen regarding the determination of the vesting date for these types of options. The previous definition of vest stated that the counterparty's rights vest when specified vesting conditions are satisfied. However, it was not clear, in the example above, whether the vesting date is the date the vesting conditions are first met or a later date.

11. The 2008 amendment of IFRS 2 – *Vesting Conditions and Cancellations* changed the definition of vest to state that the counterparty's rights vests when entitlement to the share-based payment is no longer conditional on specified vesting conditions.

12. This revised definition clarifies that, in the example above, the share-based payment vests the first time the performance hurdle is met. In this case, entitlement is conditional on exercising within a limited period but it is not conditional on any further vesting conditions being met. The staff does not recommend any further changes to the proposed definition in respect of this.

- **Matching Share Awards**

13. Matching share awards are typically those where the entity grants a given number of shares to an employee with a promise of additional shares after a specified period if the counterparty holds the initial shares. The main question that has arisen in practice regarding these types of shares is whether the requirement to hold the initial grant of shares is a vesting or a non-vesting condition.

14. If the requirement is a vesting condition, then a failure of the employee to continue holding the shares would be accounted for as a forfeiture. In this case the entity revises the expense to reflect the best available estimate of the number of equity instruments now expected to vest.

15. If it is a non-vesting condition, then a failure of the employee to continue holding the shares would be accounted for as a cancellation. In this case, the entity accelerates the recognition of the expense that would otherwise have been recognised over the remainder of the vesting period.

16. The 2008 amendment to IFRS 2 clarified that all vesting conditions must include an implicit or explicit service requirement. More specifically vesting conditions are those that determine whether the entity receives the services that entitle the counterparty to the equity instruments.

17. The staff thinks that the requirement to hold the initial grant of shares is not one that determines whether the entity receives the services that entitle the counterparty to the equity instruments. The counterparty may hold or sell the shares for a number of reasons that do not affect the nature, quantity or quality of service rendered to the entity.

18. The staff notes that this issue was addressed in the Basis for Conclusions of the Exposure Draft of the proposed amendment on vesting conditions and cancellations. Therefore the staff thinks that no further clarification is required in this instance.

- **Investment Manager Fees**

19. Investment manager fees may be paid to a manager if the total return on the fund exceeds a specified benchmark level. Some fees are paid in units which are equity instruments.

20. Some maintain that the service being delivered in this case is the investment management service and the performance target is a performance condition. Others argue that the outperformance of the benchmark is the service being delivered and there is no performance condition. This raises two key issues:

- How to distinguish between service and performance conditions in the non-employee model.
- How to account for continuous service in the non-employee model.

21. The staff thinks that the issue of accounting for investment manager fees is not widespread enough to warrant consideration. However, the two issues highlighted are more general issues which the Board or the IFRIC may wish to investigate further.

22. The staff's view on the distinction between service and performance conditions is set out below. The accounting for continuous service in the non-employee model is dealt with in the section covering issues to be referred to the IFRIC.

- **Distinguishing between service and performance conditions in the non-employee model**

23. The question of how to distinguish between service and performance conditions is important because it affects the allocation of costs over the vesting period of the share-based payment. Using the case of investment manager fees as an example there are at least two possible views on the distinction between service and performance conditions.

24. One view is that some performance targets may be service conditions. In this case, the outperformance is the service being provided by the investment manager. In this case it would be difficult to know when the service has been delivered and how the costs should be allocated. The other view is that the performance target must be related to some service condition. In this case, the investment manager provides a service and outperformance of the benchmark is the performance condition attached to that service.

25. The staff prefers the latter view. Typically an investment manager would charge a small fee which is payable regardless of whether or not a specified performance target is reached. This is evidence that a service is being provided and that the specified outperformance is a performance target. Moreover, the staff does not think that a performance target can of itself be a service condition. It can only be a qualification of

the service that is required. This is consistent with the Board's views in the 2008 amendment of IFRS 2 – *Vesting Conditions and Cancellations,* which specifies that performance conditions require both service to be completed and specified performance targets to be met.

26. The staff does not recommend that any further work be done on this issue.

- **Can service and performance conditions be non-contemporaneous?**

27. The above issue is concerned with how to distinguish between service and performance conditions. Some also question whether some share-based payments could have service and performance conditions that are non-contemporaneous. If this is the case, then the accounting guidelines in IFRS 2 are incomplete as they all implicitly assume that service and performance conditions are contemporaneous.

28. Consider a project for the development and installation of bespoke software paid for using shares with a performance condition based on the success of the software over a period after installation. For example the developer gets 100 shares on completion of the installation and a further 50 shares if the software meets a number of performance metrics measured over the following 12 months.

29. The 2008 amendment of IFRS 2 – *Vesting Conditions and Cancellations* specifies that performance conditions require both service to be completed and specified performance targets to be met. In the example above, the question has arisen as to whether the performance metrics post-installation are examples of performance conditions that are not service conditions.

30. The staff does not think that this is the case. It is difficult to envisage the counterparty agreeing to such an arrangement unless it also had the ability to provide ongoing services to maintain the right level of performance.

31. In the unlikely event that there is no implicit or explicit service agreement for the post-installation phase, it would be reasonable to assume that both the service and

performance are given during the installation process, but the performance is only measured after the end of the service period.

32. In both interpretations, therefore, both service and performance are contemporaneous. The staff does not recommend any further action in respect of this.

ISSUES THAT COULD BE REFERRED TO ANNUAL IMPROVEMNETS

- **Accounting for continuous service in the non-employee model**

33. Paragraph 13 of IFRS 2 allows services received to be measured at the fair value of the equity instruments granted at the date at which the services are received. Paragraphs IG 5 – 7 of the Implementation Guidance state that an approximation could be used when the entity receives services continuously eg the average of share prices over the service period.

34. In the case of investment manager fees described above, if the service is provided continuously over a long period, some constituents argue that using the weighted average of the share prices over the service period is an onerous task and one that is unlikely to present significantly better information to users. They argue that a period end valuation of the shares would be more appropriate in this case.

35. The staff recommends that this issue is referred to the annual improvements project for further consideration of what approximations are appropriate in the non-employee model.

- **Multiple interactive vesting and non-vesting conditions:**

36. Some share-based payments have market, non-market and non-vesting conditions. The award vests if either one or more of the conditions are met. Sometimes the terms stipulate that all the conditions must be met.

37. An example can be found in retiree eligible awards. These are share-based payments where the counterparty may be entitled to an award subject to certain performance conditions. However if the employee retires before a given period then the share-based

payment vests immediately. In some cases vesting may be subject to Board discretion on retirement while in other cases it is automatic on retirement.

38. When vesting is subject to Board discretion, the staff's view is that the change of the vesting period on retirement should be accounted for as a modification of the share-based payment when the Board agrees the change.

39. When vesting is automatic on retirement, there are two main views about how to account for such a grant:

- View 1 - each possible outcome should be valued separately and the employee compensation expense recognised based on the best estimate of the expected outcome.

- View 2 - a single valuation should be obtained that seeks to impound in the grant date measurement of fair value the different possible outcomes and the grant date estimate of the relative probabilities of each outcome.

40. The staff agrees with View 2 since this is the most consistent with a grant date fair value model. During its deliberations of the 2008 amendment – *Vesting Conditions and Cancellations*, the Board agreed that non-vesting conditions should be treated the same as market conditions. In particular, they should be included in the grant date fair value.

41. Further, if it is not possible to separate the market from the non-market conditions, the staff thinks that this gives the best result. The Board may wish to clarify the appropriate accounting methodology in this case.

- **Modification- interaction of multiple changes where some are beneficial to the employee and some are not**

42. Paragraph 27 of IFRS 2 specifies the accounting for modifications of the terms of equity-settled share-based payments. In particular, it requires that, as a minimum, the entity should recognise the services received measured at the grant date fair value of the equity

instruments granted. In addition, the entity should recognise the effects of modifications that increase the total fair value of the share-based payment arrangement. The incremental value is recognised over the remainder of the vesting period. In particular, if a modification is made that is not beneficial to the employee this does not need to be taken into account.

43. The question has arisen regarding the accounting for multiple changes, some of which are beneficial to the employees and some of which are not. One view would be that only the effect of the changes that increase the fair value of the share-based payment should be taken into account. Another view would be that it is the net total effect of the modifications that should be taken into account.

44. The staff agrees with the latter view. This approach would be more consistent with the underlying principle of recognising the incremental value of the share-based payment. Otherwise, an entity could make two changes that were intended to offset each other and be forced to measure the incremental effect only. Also, if the multiple changes were to be accounted for individually, it might then make it possible for the entity to split any modification arbitrarily into several individual modifications.

45. If the Board agrees a small change to the wording in paragraph 27 and B44 of IFRS 2, as an annual improvement, would clarify that where there are multiple simultaneous changes, the net total effect of the modifications should be calculated.

- **Accounting for deferred tax liabilities**

46. In some jurisdictions, a tax may be payable by the entity based on the difference between the fair value of the share-based payment and the exercise price on vesting date.

47. IAS 12 clarifies the accounting for future tax deductions but not future taxes payable. Constituents have asked for clarification of the accounting for these types of taxes. There are two possible views:

View 1: The liability for tax payable should be recognised on the date the tax is payable (generally the exercise date). There should be no accrual before the date the tax is payable.

View 2: The tax payable should be accounted for using the same principles as for accounting for future tax deductions. In particular, a liability is recognised during the accrual period for amounts payable with the costs recognised over the period to which the employee service relates.

48. Paragraph 68C of IAS 12 refers explicitly to future tax deductions receivable. However, it is reasonable to assume that the same principles would apply to future tax charges. In particular, there is a temporary difference between the tax payable in the future and the carrying amount of nil that results in a deferred tax liability. Therefore, the staff agrees with the accounting treatment proposed in View 2.

49. The staff notes that the IFRIC dealt with a similar question in IAS 19 and concluded as follows:

A wide variety of taxes on pension costs could exist worldwide, each specific to its own jurisdiction, and it is a matter of judgement whether they are income taxes within the scope of IAS 12, costs of employee benefits within the scope of IAS 19, or other costs within the scope of IAS 37. Given the variety of tax arrangements, the IFRIC believed that guidance beyond the above observations could not be developed in a reasonable period of time. The IFRIC therefore decided not to take the issue onto its agenda.

50. The staff thinks that the same rationale could apply to social charges and payroll taxes due on equity-settled share-based payments. However, the staff notes that a small change to the wording in paragraph 68c of IAS 12 would clarify that the accounting for future tax liabilities should mirror that for future tax deductions.

ISSUES THAT COULD BE REFERRED TO ANOTHER PROJECT

Retiree eligible awards and other cases where conditions appear to change from being vesting conditions to being non-vesting conditions.

51. Another issue that arises in relation to retiree eligible and similar awards is the classification of conditions that are initially service-related and then cease to be service-related.

52. For instance consider a share-based payment that grants an employee 500 options that vest if a specified target profit is reached within 3 years or the employee retires before the end of the 3 year period. The options are exercisable at the end of 3 years. If the employee retires before the end of the initial vesting period does the non-market performance condition (specified profit target) cease to be a performance condition? If that is the case, then how should it be valued?

53. The FASB's draft conclusion[1] on this issue was that once the employee's right to the instrument is no longer contingent on the employer-employee relationship, the non-market performance condition (specified profit target) ceases to be a performance condition and the award should be accounted for in the same way as other freestanding financial instruments. However the FASB decided to defer making a pronouncement on this until the current project on liabilities and equity is completed.

54. The IASB staff view is that a share-based payment that falls within the scope of IFRS 2 should continue to be so classified throughout the life of the instrument. In this case, the probability of retirement before the end of the initial vesting period should be included in the grant date value of the share-based payment and recognised over the estimated vesting period. If the employee retires before the end of the vesting period, there would be accelerated vesting of the compensation cost that had not yet been recognised. Therefore the question of the classification of conditions that are no longer service-related does not arise.

[1] FSP FAS 123® - 1 Status. August 31 2005.

55. However, given that the current project on liabilities and equity may have a significant effect on the accounting in these circumstances, the staff recommends that the Board addresses this issue after the liabilities and equity project is completed.

- **Accounting for tax reimbursement rights**

56. In some cases, the tax payable on exercise is recoverable by the entity from the employee. In this case, the entity has an obligation to pay tax but also has the right to vary the terms of the share-based payment agreement to recover that cost of the tax payable from employees.

57. On the one hand, it seems that until the entity makes the change to the terms of the share-based payment to recover the tax, there is nothing to account for. However, this could cause anomalous results in cases where it is virtually certain that the reimbursement will be received.

58. Also, it may seem odd for the entity to be required to recognise the liability for tax payable but not the corresponding asset for the right to reimbursement from the employee. It is not clear from IFRS 2 or IAS 12 what the accounting treatment should be for tax reimbursement rights related to share-based payments.

59. The staff suggests that this issue is considered during the redeliberation of the ED on IAS 12.

- **Accounting for deferred taxes on 'share-based payments' that are not within the scope of IFRS 2**

60. Some share-based [type] payments were granted before November 2002 and therefore do not fall within the scope of IFRS 2. However, the entity may still recognise a deferred tax asset. Under IAS 12, the deferred tax asset is recognised as a liability unless that liability exceeds the total compensation cost recognised to date, in which case the excess is recognised in equity.

61. Since the compensation cost recognised is nil, there seems to be general consensus in practice that the entire tax effect should be taken to equity. However, there is some uncertainty because this is different from FAS 123R. The staff suggests that this issue is considered during the redeliberation of the ED on IAS 12.

62. [Paragraph removed from the Observer Notes].