IFRIC Meeting Agenda reference **3A**

Staff Paper Date **July 2009**

Project **Tentative agenda decisions**

Topic **IFRS 2 *Share-based Payments* – Vesting Conditions**

Introduction

Objective of this paper

1. The objective of this paper is to document the staff's analysis and recommendation on the issues arising on paragraph IG24 of IFRS 2. As such, this paper:
   (a) provides background information on these issues
   (b) analyses these issues within the context of IFRS 2
   (c) analyses whether these issues meet the criteria for inclusion on the IFRIC's agenda
   (d) sets out the staff recommendation
   (e) asks the IFRIC whether they agree with the staff recommendation.

Background

2. In May 2009, the staff received a request to add to the IFRIC's agenda a project to clarify non-vesting conditions. This request arises because constituents are interpreting differently paragraph IG24 (reproduced in Appendix B for convenience). Paragraph IG24 was introduced by the amendments to IFRS 2 issued in January 2008 that were intended to clarify, among other things, vesting conditions.
3. The issues are:
   (a) Is a condition non-vesting because

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The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

(i) there is no service condition, or

(ii) there is a service condition but it is dependent on another condition that does not relate to the performance of the entity?

(b) When a ‘condition’ affects the timing of the vesting, but not whether the share-based payment vests,

(i) should it be treated as a vesting or non-vesting condition?

(ii) if the condition is a non-vesting condition, should it be treated as a service performance condition or as affecting the length of the service condition?

4. The agenda request is set out in Appendix A.

Staff analysis

Question (a)

Non-vesting conditions

View 1

5. The example non-vesting conditions in paragraph IG24 are:

(a) neither the entity nor the counterparty can choose whether the condition is met (eg target based on a commodity index)

(b) the counterparty can choose whether to meet the condition (eg paying contributions towards the exercise price of a share-based payment)

(c) the entity can choose whether to meet the condition (eg continuation of the plan by the entity).

Some are of the view that these are non-vesting conditions *only if no service conditions are attached*.

View 2

6. Some conclude that the same example conditions in paragraph IG24 are non-vesting conditions because they do not relate to the performance of the entity. Hence, neither the entity nor the counterparty can choose whether the condition is met. Put another way, vesting performance conditions under IFRS 2 include only performance targets relating to the performance of the entity.

7. In summary, the question is when an award scheme has multiple conditions that include one of the example non-vesting conditions illustrated in IG24, does IFRS 2 treat that condition as a non-vesting condition? The submitter provides a scenario to illustrate the question. For example, an unlisted entity grants 100 share options to its employees conditional on (1) the FTSE 100 reaching 6500 at any point in the next three years and (2) the employees remaining in service up to the date of that target. In this case, the entity does not have control over whether the FTSE 100 target is met.

Staff analysis

8. Staff notes that paragraph IG24 is not part of IFRS 2's mandatory guidance. Therefore, the implementation guidance accompanying IFRS 2 should be read in the context of the mandatory guidance of IFRS 2 (ie the standard and the application guidance). When inconsistencies are perceived between the implementation guidance and the mandatory guidance, the mandatory guidance overrules the implementation guidance.

9. Therefore, the examples of non-vesting conditions in paragraph IG24 are not a de facto definition of non-vesting conditions. In accordance with IFRS 2, non-vesting conditions are those that do not meet the definition of vesting conditions.

10. Staff thinks that the principle for determining whether conditions are vesting or non-vesting conditions is whether 'the conditions 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* definition from IFRS 2).

11. Once a condition meets the definition of a vesting condition, the next step is to assess if the condition is a service or performance condition as defined in IFRS 2 to determine the appropriate measurement. These steps are indicated by the flowchart in paragraph IG4A.

12. Hence, the fact that the examples of non-vesting conditions in IG24A are described as non-vesting conditions must mean they do not meet the definition of vesting conditions under IFRS 2. This is consistent with view 1 in the agenda request.

13. For the scenario provided by the submitter, the staff thinks that the conditions of issuing the share options (1) the FTSE 100 reaching 6500 at any point in the next three years and (2) the employees remaining in service up to the date of that target are vesting conditions. In the staff's view, these conditions cannot be considered independently due to their interaction. Vesting occurs on fulfilment of both of these conditions simultaneously. Consequently, these conditions interact in such away that combined they meet the definition of *vesting conditions* in IFRS 2. The employee is likely to be motivated to stay with the entity during the estimated length of when the FTSE is to hit the set target to receive the share options.

14. Those conditions together are vesting performance conditions because (1) the counterparty must complete a specified period of service (ie the employees remaining in service up to the date of that FTSE target is met) and (2) there are specified performance targets (ie the FTSE 100 reaching 6500 at any point in the next three years). They do not include a market condition because the condition that the FTSE 100 reaches 6500 at any point in the next three years does not meet the definition of market conditions in IFRS 2 as it is unrelated to the market price of entity's equity instruments.

Question (b)

15. The same analysis can be applied to question (b) raised by the submitter (see paragraph 3(b) above). The effect of a condition that affects the timing of the vesting, but not whether the share-based payment vests, depends on whether the

condition meets the definition of a vesting condition. Such conditions may interact with service or performance conditions so that they meet the definition of vesting conditions.

16. The submitter also requests guidance on whether such a non-vesting condition should be treated as a service performance condition or as affecting the length of the service condition.

View 2(a)

17. For a non-vesting condition that affects the timing of the vesting, but not whether the share-based payment vests, some constituents support a true up for changes in the expected service period and expected rate of forfeiture. This approach would be consistent with IFRS 2.IG Example 2 for a performance condition that is not a market condition.

View 2(b)

18. Other constituents would account for the effect of a non-vesting condition that affects the timing of the vesting in the same way as a market-based vesting condition, with the vesting period estimated on day 1 and not trued up. This approach is consistent with IFRS 2.IG Example 6. If employees leave prior to the expected vesting date as determined on grant date, there will be a truing up of the IFRS 2 expense for them. If employees leave after the expected vesting date as determined on day one, the expense for them will not be trued up.

Staff analysis

19. Staff assumes that the facts and circumstances are such that the condition that affects the timing of the vesting does not meet the definition of vesting conditions. (As discussed before, such a condition would not interact with other service and performance conditions in such a way that it does not meet the definition of vesting conditions.) When such conditions do not meet the definition of vesting conditions, they do not determine the vesting period under IFRS 2 as a vesting period is defined as 'the period during which all the

specified *vesting conditions* of a share-based payment arrangement are to be satisfied.'

20. Depending on the facts and circumstances of the share-based arrangement, such a condition may mean that there is no vesting period ie the counterparty is not required to complete a specified period of service before becoming unconditionally entitled to those equity instruments. In such circumstances IFRS 2 paragraph 14 requires the entity to recognise the services received in full on grant date. Also, non-vesting conditions shall be taken into account when estimating the fair value of the equity instrument granted as required by IFRS 2 paragraph 21A.

21. When there is a vesting period (as defined in IFRS 2), such a non-vesting condition shall be taken into account in estimating the fair value of the equity instrument granted as required by IFRS 2 paragraph 21A. After the grant date fair value measurements, a non-vesting condition has no further effect unless the entity or the counterparty can choose whether to meet a non-vesting condition. In this case, failure to meet a non-vesting condition during the vesting period shall be treated as a cancellation as required by IFRS 2 paragraph 28A.

22. Therefore, for a non-vesting condition that affects the timing of the vesting, but not whether the share-based payment vests, staff thinks that both views suggested in the submission are inconsistent IFRS 2:

View 2(a) a true up for changes in the expected service period and expected rate of forfeiture

View 2(b) treatment in the same way as a market-based vesting condition, with the vesting period estimated on day 1 and not trued up.

Staff disagrees with view 2(a) because IFRS 2 does not permit a true-up based on changes in non-vesting conditions. Staff disagrees with view 2(b) because IFRS 2 does not permit non-vesting condition that affects the timing of the vesting condition to be taken into account in estimating the vesting period under IFRS 2 on day 1. However, the staff does accept that IFRS 2 prohibits trueing up for non-vesting conditions.

Agenda criteria assessment

23. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *Is the issue widespread and practical?*
    No. The staff understands that share-based arrangements:

        (i) in which neither the entity nor the counterparty can choose whether the vesting conditions are met; or

        (ii) with conditions that affect the timing of the vesting that are non-vesting conditions;

    are uncommon.

    (b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*
    No. Although the submission indicates that there is divergence in practice, as a whole, IFRS 2 provides sufficient guidance on:

        (i) the definition of vesting conditions, and therefore, non-vesting conditions; and

        (ii) the treatment of non-vesting conditions.

    Also, the Board issued amendments to IFRS 2 *Vesting Conditions and Cancellations* which among other things sought to clarify the definition of vesting conditions in January 2008. Therefore, development of an interpretation, particularly of examples provided in non-mandatory implementation guidance, would result in providing further implementation guidance, rather than an interpretation.

    (c) *Would financial reporting be improved through elimination of the diversity?*
    N/A. The staff does not anticipate diversity in practice.

    (d) *Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?*
    No. These issues are considered to be too narrow to develop an interpretation.

    (e) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the*

IASB project? (The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC would require completing its due process.)
No. The Board does not have any projects on its agenda to revise IFRS 2.

24. Based on the assessment of the agenda criteria in paragraph 23, the staff recommends that the IFRIC not add these issues to its agenda. Proposed wording for the tentative agenda decision is set out in Appendix C.

Questions for the IFRIC
1. Does the IFRIC agree with the staff recommendation that the issues should not be added to the agenda? If not, on what basis should they be added?
2. Does the IFRIC have any comments on the proposed wording for the tentative agenda decision (see Appendix C)?

[Appendix C has been omitted from this Observer note]

Appendix A— IFRIC agenda request

A1. The following IFRIC agenda request was received.

The issue

A2. The table in IFRS 2.IG 24, introduced by the January 2008 amendments to IFRS 2 *Vesting Conditions and Cancellations*, does not specify, in its illustrative list of non-vesting conditions, whether these are non-vesting solely where they have no service condition attached (although some read it that way) or whether they are always non-vesting since they do not relate to the performance of the entity.

A3. Additionally, it is not clear, where the ‘condition’ affects the timing of vesting, but not whether the share-based payment vests or not, whether it should be treated as a non-vesting condition; and if so, should it impact the length of the service condition, or should it be treated as a service performance condition?

A4. Consider a scenario where an unlisted entity grants 100 share options to 10 of its employees. The grant is conditional on the FTSE 100 reaching 6500 at any point in time in the next three years and the employees remaining in service up to the date that the FTSE 100 target is met. The entity is not listed and its securities do not form part of the FTSE 100 share index.

Alternative views:

View 1

A5. The FTSE 100 index target being met determines whether the employees become unconditionally entitled to the awards. As there is a requirement for employees to remain in employment until such time as the index target is met (if indeed it is), together the index target and service requirement is a performance condition. This is not reflected in the grant date fair value, but instead will lead to a truing-up of the IFRS 2 expense for actual results.

View 2

A6. The FTSE 100 index target being met is a non-vesting condition, because it is not related to the performance of the entity. The service condition is a separate vesting condition. The entity's pricing model to determine the fair value of the options will incorporate the possibility of the FTSE 100 index target of 6500 being met.

A7. There is a further uncertainty for those constituents who support this view. That is, how to account for any changes in expectation on when the FTSE 100 index target is to be met.

View 2(a)

A8. Some constituents support a true up for changes in the expected service period, and expected rate of forfeiture, consistent with IFRS 2.IG Example 2 for performance condition that is not a market condition.

View 2(b)

A9. Other constituents would account for the effect of the non-vesting condition in the same way as a market-based vesting condition, with the vesting period estimated on day 1 and not trued up, consistent with IFRS 2.IG Example 6. If employees leave prior to the expected vesting date as determined on grant date, there will be a truing up of the IFRS 2 expense for them. If employees leave after the expected vesting date as determined on day one, the expense for them will not be trued up for.

A10. To illustrate the impact on the financial statements of these views consider the following additional facts:

- At grant date, using a pricing model, the entity determines that the grant date fair value of the options is:

  - £30 incorporating the requirement for the FTSE 100 index target of 6500 being met,

  or

- £45 excluding the requirement for the FTSE 100 index target of 6500 being met.

- At the end of year 1, the entity expects three employees to leave, and the FTSE 100 index target to be met at the end of year 3.
- At the end of year 2, the entity now expects that the FTSE 100 index target may be met half way through year 3. The entity continues to estimate that three employees will leave.
- During year 3, two employees leave in the first six months. The FTSE 100 target is met at the end of month six.

	View 1	**View 2 (a)**	**View 2 (b)**
Nature of condition (per IG 24 table)	Non-market based performance condition	Non-vesting condition	Non-vesting condition
Grant date fair value	£45 The fair value pricing model does not incorporate the possibility of the FTSE 100 index target of 6500 being met	£30 The fair value pricing model incorporates the possibility of the FTSE 100 index target of 6500 being met	£30 The fair value pricing model incorporates the possibility of the FTSE 100 index target of 6500 being met
Year 1 expense	£10,500 (£45 x 7 x 100 / 3 years)	£7,000 (£30 x 7 x 100 / 3 years)	£7,000 (£30 x 7 x 100 / 3 years)
Year 2 expense	£14,700 [(£45 x 7 x 100 x 24/30) - 10,500] In year 2 the entity revises its expectation of when the FTSE index target is to be met, so that the charge is trued up over the revised shortened vesting period.	£9,800 [(£30 x 7 x 100 x 24/30) - 7,000] In year 2 the entity revises its expectation of when the FTSE index target is to be met, so the charge is trued up over the revised shortened vesting period.	£7,000 (£30 x 7 x 100 / 3 years) While in year 2 the entity revises its expectation of when the FTSE index target is to be met, the entity does not revisit the estimated service period determined on day 1.
Year 3 expense in the first six months	£10,800 [(£45 x 8 x 100 x 30/30) - 25,200]	£7,200 [(£30 x 8 x 100 x 30/30) - 16,800]	£5,000 [(£30 x 8 x 100) -£14,000] /2
Year 3 expense in the second six months	0	0	£5,000 [(£30 x 8 x 100) -£14,000] /2
Total IFRS 2 expense	£36,000	£24,000*	£24,000*

* The total amount for view 2(a) and 2(b) is the same in this example, however that will not always be the case, dependent upon whether employees leave after the revised expected vesting date but before originally expected vesting date.

Appendix B— Illustrative example IG24

Summary of conditions for a counterparty to receive an equity instrument granted and of accounting treatments

IG24 The table below categorises, with examples, the various conditions that determine whether a counterparty receives an equity instrument granted and the accounting treatment of share-based payments with those conditions.

	Summary of conditions that determine whether a counterparty receives an equity instrument granted					
	VESTING CONDITIONS			**NON-VESTING CONDITIONS**		
	Service conditions	**Performance conditions**				
		Performance conditions that are market conditions	**Other performance conditions**	**Neither the entity nor the counterparty can choose whether the condition is met**	**Counterparty can choose whether to meet the condition**	**Entity can choose whether to meet the condition**
Example conditions	Requirement to remain in service for three years	Target based on the market price of the entity's equity instruments	Target based on a successful initial public offering with a specified service requirement	Target based on a commodity index	Paying contributions towards the exercise price of a share-based payment	Continuation of the plan by the entity
Include in grant-date fair value?	No	Yes	No	Yes	Yes	Yes[a]
Accounting treatment if the condition is not met after the grant date and during the vesting period	Forfeiture. The entity revises the expense to reflect the best available estimate of the number of equity instruments expected to vest. (paragraph19)	No change to accounting. The entity continues to recognise the expense over the remainder of the vesting period. (paragraph 21)	Forfeiture. The entity revises the expense to reflect the best available estimate of the number of equity instruments expected to vest. (paragraph 19)	No change to accounting. The entity continues to recognise the expense over the remainder of the vesting period. (paragraph 21A)	Cancellation. The entity recognises immediately the amount of the expense that would otherwise have been recognised over the remainder of the vesting period. (paragraph 28A)	Cancellation. The entity recognises immediately the amount of the expense that would otherwise have been recognised over the remainder of the vesting period. (paragraph 28A)

a In the calculation of the fair value of the share-based payment, the probability of continuation of the plan by the entity is assumed to be 100 per cent.