Project	**Tentative agenda decisions**
Topic	**IFRS 2 *Share-based Payments* – Vesting Conditions**

Objective of this paper

1. The objective of this paper is to document the staff's analysis and recommendations to clarify the definition of vesting conditions (especially performance conditions) and non-vesting conditions in IFRS 2.

Background

2. In May 2009, the staff received a request to add to the IFRIC's agenda a project to clarify the basis on which vesting conditions, especially performance conditions, can be distinguished from non-vesting conditions. This request arises because constituents are interpreting differently the principle set out in IFRS 2 that the vesting conditions should be those that determine whether the entity receives the required services from the counterparty. At the July 2009 meeting, the IFRIC decided that further research and analysis were needed to determine the main issues arising from the request.

3. The staff received some feedback from a few IFRIC members and large accountancy firms. Also, the staff has met with interested constituents to discuss these issues.

4. Results of the staff research indicate that principally the issues arise because of the uncertainty regarding the distinction between vesting and non-vesting conditions, especially between non-market performance conditions and non-vesting conditions.

Issue

Distinction between vesting conditions and non-vesting conditions

5. The amendments to IFRS 2 *Share-based Payment – Vesting Conditions and Cancellations* (January 2008) sought to clarify the distinction between vesting and non-vesting conditions. A non-vesting condition is neither a service condition nor a performance condition but is a feature of the award (eg determines the number of shares options that the employee receives). Thus, a clear understanding of the distinction between a service condition, a performance condition and a non-vesting condition is essential for management to classify the conditions in a share-based payment award and for its subsequent measurement.

6. However, there is inconsistency in the determination of whether a condition is a vesting condition or a non-vesting condition. This is the core issue and results from the lack of clarity in the current definition of vesting conditions in IFRS 2, which is:

> **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 are either service conditions or performance conditions. Service conditions require the counterparty to complete a specified period of service. Performance conditions require the counterparty to complete a specified period of service and specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time). A performance condition might include a market condition. [emphasis added]

7. With this regard, constituents are also unclear about the meaning of implicit service requirements in determining a performance condition discussed in BC171A which explains:

> In particular, a share-based payment may vest even if some non-vesting conditions have not been met. The feature that distinguishes a performance condition from a non-vesting condition is that the former has an explicit or **implicit service requirement** and the latter does not**.** [emphasis added]

8. Clarity on whether a condition is a vesting or non-vesting is important because this classification determines measurement. For example, non-vesting conditions are included in the measurement of the grant fair value of equity-settled share-based payment award whereas vesting conditions (other than market conditions) are not included. Also, failure to meet vesting conditions (other than market conditions) is accounted for as a forfeiture which results in reversal of expenses whereas failure to meet non-vesting conditions is not.

9. In addition, there are two key application issues surrounding the definition of vesting conditions.

   (a) Application issue 1 – Does there need to be a direct link between a performance target and an individual employee's service in order for that condition to be a performance condition?

   (b) Application issue 2 - When determining whether the target qualifies as a performance condition, does it matter whether the specified service period is shorter or longer than the period over which the performance target is should be met?

Staff analysis

Lack of clarity in definition of vesting conditions

10. IFRS 2 contains the definition that vesting conditions are 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. It is a compound definition, which includes descriptions of service and performance conditions (set out in paragraph 6). However, lack of a clear definition of performance conditions makes it difficult to distinguish between performance conditions and non-vesting conditions, given there is no definition of non-vesting conditions. The following paragraphs discuss staff's views on conditions that could be performance conditions.

(1) direct linkage between performance target and an individual employee's service

11. The reference to "conditions that determine whether the entity receives the services" in the first sentence of the definition of vesting conditions is difficult to apply. Some read this as requiring that a performance condition relate directly to the services being provided in order to qualify as a vesting condition. Others, including the staff, read this requirement more broadly. The staff thinks that as long as the performance target refers to a performance specific to the entity and occurs during the required service period, it can be assumed that an employee is contributing towards meeting that target and is incentivised to offer services for the entity.

12. For example, it is easy to see how a sales volume target for a salesperson or a production volume target for a plant manager could be linked to the individual employee's service. However, performance metrics such as EPS or return on capital have a more distant or indirect relationship with individual employees. Determining whether performance targets with such distant / indirect relationships to individual employees qualify, is causing application difficulties.

13. The staff believes that clarifying how close or otherwise the link needs to be between the performance target and the employee's service would help address this application issue.

(2) 'mismatch' in service and performance periods

14. The definition of vesting conditions specifies that:

    (a) "service conditions require the counterparty to *complete a specified period of service*" (emphasis added); and

    (b) "performance conditions require the counterparty to *complete a specified period of service* and specified performance targets to be met…" (emphasis added)

15. The staff thinks that it is clear that a performance target must be linked to a specified period of service for it to qualify as a performance condition. What is not clear is whether the performance target can be met over a shorter or longer

period of time than the service that must be completed. In particular, can a performance target with a period that is longer or shorter than the specified service period be said to "determine whether the entity receives the services"?

16. For example, if a sales target must be met over a three year period, but the employee must remain employed for four years, then how does the sales target "determine whether the entity receives the services" in the fourth year? Contrast this with a sales target that must be met over a four year period, but for where the employee need only be employed for three years. If the employee leaves after three years but is still entitled to receive the award provided the sales target is met in the fourth year, then the entity would not be receiving services in the fourth year.

17. The staff thinks that a performance target must be met during the specified period of service for it to qualify as a performance condition. That is, the service period may be longer than or equal to the period over which the performance target must be met, but cannot be shorter. Otherwise, every kind of performance target would be considered a performance condition even if it occurs after a service requirement (or even if there is no specified service requirement). The definition of vesting conditions in IFRS 2 indicates that the specified service received from the employee should determine vesting of the share-based payment award granted, and may include performance conditions as well.

18. The staff believes that clarifying the relationship between the period of employee service and the period for the performance target, would help address this application issue.

Agenda criteria assessment

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

    (a) *Is the issue widespread and practical?*
    Yes. The issue is observed in practice and could arise in many jurisdictions in which entities adopt share-based payment transactions as remuneration to employees.

(b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*
Yes. In the staff's view, there are divergent interpretations on the definition of vesting conditions.

(c) *Would financial reporting be improved through elimination of the diversity?*
Yes. Clarifying the distinction between vesting conditions and non-vesting conditions, and hence eliminating the diversity would help financial reporting become more reliable and comparable among companies.

(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?*
Yes. The issue is sufficiently narrow in scope to be dealt with in a timely fashion by the IFRIC.

(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.

20. Based on the assessment of the agenda criteria in paragraph 19, the staff recommends that the issue should be added to the IFRIC's agenda. Proposed wording for the tentative agenda decision is set out in Appendix A.

Questions for the IFRIC
1. Does the IFRIC agree with the staff recommendation that the issue should be added to the IFRIC's agenda?
2. Does the IFRIC have any comments on the proposed wording for the tentative agenda decision (see Appendix A)?
3. If the IFRIC agrees to add a project to clarify the definition of vesting and non-vesting conditions on its agenda; does the IFRIC agree to further development of an Interpretation based on the views expressed in paragraphs 10-18?

Appendix A— Proposed wording for the tentative agenda decision

The IFRIC received a request to clarify the basis on which vesting conditions, especially performance conditions can be distinguished from non-vesting conditions.

The IFRIC noted that there is such a lack of clarity on the definition of vesting condition that divergent practices may result with regard to distinction between vesting conditions and non-vesting conditions.

The IFRIC concluded that the consistency of application would be improved by clarifying the distinction between service conditions, performance conditions and non-vesting conditions. Therefore, the IFRIC [decided] to add the issue to its agenda.