IFRS Interpretations Committee Meeting

Staff Paper

Agenda reference 3B

Date July 2010

Project	**IFRS 2 *Share-based Payment***
Topic	**The attributes of a performance condition**

Objective and introduction

1. The objective of this Agenda Paper is to provide the Committee with a staff analysis on the attributes of a performance condition. Specifically, the analysis is focused on the proximity between a performance target and an individual employee's service to the entity, ie how close the performance target needs to be to the individual employee's actions for it to be considered a performance condition.

2. This Agenda Paper includes:

   (a) **background** information;

   (b) a **staff analysis**;

   (c) **consideration of contentious examples**;

   (d) **staff recommendations** on the attributes of a performance condition; and

   (e) **questions for the Committee**.

Background

3. Among the original questions underlying the Committee's agenda item on vesting and non-vesting conditions is what, if any, level of linkage (correlation)

is required between a performance target and an individual employee's actions in order for that condition to be a performance condition. At its May 2010 meeting, the Committee asked the staff to develop an analysis on that specific issue as well as to lay out the general attributes of a performance condition.

Staff analysis

Current IFRS 2 guidance

4. Current IFRS 2 does not specify what attributes a performance condition should have. Current IFRS 2 describes the performance condition within the definition of vesting conditions as follows [emphasis added]:

> 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.

5. Paragraph BC171 of IFRS 2 provides some explanation about the reason a performance condition is imposed as follows [emphasis added]:

> Vesting conditions ensure that the employees provide the services required to 'pay' for their share options. For example, the usual reason for imposing service conditions is to retain staff; **the usual reason for imposing other performance conditions is to provide an incentive for the employees to work towards specified performance targets**.

6. The staff thinks that performance conditions are considered to be those that are imposed to ensure that ***the entity receives a <u>quality</u> of service from the employee (or the employee provides a <u>quality</u> of service to the entity[1])*** whereas service conditions are considered to be those imposed to ensure only that the

[1] At the May 2010 Committee meeting, the staff recommended a change in perspective back to the employee (as included in the original IFRS 2), because it is consistent with the rest of IFRS 2 and current US GAAP.

entity receives a quantity of service (or the employee provides a quantity of service to the entity). The staff reminds the Committee that performance conditions, like all vesting conditions, require an explicit or implicit service requirement as well as the performance target. The above comparison is only meant to highlight the primary difference between a performance condition and a service condition.

7. In the staff's opinion:

   (a) the incentive exists only if the **employee is able to influence** whether the target will be met; and

   (b) the performance target is **in the interest of the entity**.

Attribute 1 - Employee is able to influence

8. Examples of performance targets given by IFRS 2 include the entity's profit and a sales department's sales volume (non-market performance targets) and the entity's share price (market performance target)[2]. While a sales department's sales volume is likely to be within the direct influence of the employee and hence likely to incentivise an individual employee's actions, the entity's profit and especially the entity's share price are less likely to be directly influenced by the actions of the employee and hence less likely to incentivise an individual employee's actions.

9. Some argue that if share based payment awards are granted to employees conditional on the entity-wide profit, it is not clear that the profit target constitutes a performance condition. Those supporting this view believe that the employee has so little influence on the entity-wide profit that it is not clear that the target is able to sufficiently incentivise an individual employee's actions.

10. Others believe that because the entity is in business in order to make a profit, it is reasonable to assume that all employees contribute directly or indirectly to the entity-wide profit, ie that the employees have an influence on the entity-wide

[2] These examples are referred to in the description of performance conditions, IG Example 3 and the definition of market conditions, respectively.

profit. The staff agrees with this second view and therefore agrees that the entity-wide profit provides a sufficient incentive for an individual employee.

11. Conversely, the entity's share price (a market performance target) may be affected not only by the entity's own profit but also by many other variables including macroeconomic factors such as the risk-free interest rate or foreign exchange rates. Based on this, the staff believes that the entity's share price is remote from the influence of the employee because of the additional external factors in determining the entity's share price and hence does not provide a sufficient link between the target and an individual employee's actions.

Internal vs external targets

12. To summarise, the staff thinks that performance targets referring to the entity may be categorised into two types:

    (a) **Internal target –** Performance targets whose achievement is determined predominantly by internal forces within the entity. Among the examples are the entity's sales volume, profit and EPS. In the staff's opinion, successful completion of an IPO, change of control and savings in a SAYE plan are also internal targets.

    (b) **External target –** Performance targets whose achievement is not determined predominantly by internal forces within the entity. External targets may be influenced by internal forces, but are also significantly affected by external forces. Therefore, external targets are not deemed to be 'influenced by the employee'. Among the examples of external targets is the entity's share price, changes is commodity prices, etc.

Attribute 2 - In the interest of the entity

13. An incentive for the employee to achieve any target is not sufficient to ensure that the entity receives a specified quality of service from the employee (or the employee provides a quality of service for the entity). It is because the incentive has yet to result in a specified quality of service towards the entity.

14. For example, if the entity imposes a target to incentivise the employee to bear more children at the instruction of the government, the target is only in the interest of the employee (and the government) but not in the interest of the entity. The target is unlikely to drive up the quality of service the employee provides to the entity.

15. By contrast, a target that is in the interest of the entity, such as the entity's profit, EPS or sales volumes, can be seen to incentivise the employee to improve the quality of his or her service to the entity. These targets are internal targets of the entity, which are defined by reference to the operation or activities of the entity and permit the specified target to be measured to ensure that the entity receives a specified quality of service from the employee (or the employee provides a specified quality of service for the entity).

16. The staff believes that an incentive may result in a quality of service towards the entity only if the incentive originates from a performance target that is in the interest of the entity.

Assessing the attributes: individual entity vs group

17. Although the analysis above is limited to the level of an individual entity, its reasoning may be expanded to the level of the group. Paragraphs 43A–43D of IFRS 2 requires that:

    (a) services rendered in share-based payment transactions among group entities, such as those transactions that the parent has the obligation to settle, are within the scope of IFRS 2; and

    (b) the services rendered in those transactions should be recognised in the separate or individual financial statement of the entity receiving the services.

18. This indicates that receiving the services and paying the consideration are transacted in the interest of the consolidated 'group'[3]. Also, it indicates that the employee may be incentivised by, for example, a group-wide profit target. To put it another way, <u>the employee is deemed to have an influence on the group-wide performance targets for IFRS 2 purposes</u>.

19. In the light of that, the staff thinks that a target that is in the interest of another group entity (or entities) should be considered to be:

    (a) concurrently in the interest of the entity receiving services; and

    (b) also influenced by the employee serving the entity as if it were a performance target that could be influenced by the employee serving the other group entity (or entities).

Combination of both attributes

20. In order for a target to constitute a performance condition, the target needs not only to be 'within the influence of' (that is, able to be influenced by) the employee but also to be in the interest of the entity. The staff believes that this combination results in a robust principle.

21. As far as those example targets in paragraph 8 are concerned:

    (a) the entity's profit and a sales department's sales volume (both internal targets of the entity) are considered to be both within the influence of the employee and in the interest of the entity, and hence they constitute performance conditions.

    (b) the entity's share price (an external target of the entity) is not considered to be within the influence of the employee even though it is in the interest of the entity, and hence it does not constitute a performance condition.

[3] Paragraph BC22E of IFRS 2 states that 'the Board clarified the boundaries of a 'group' by adopting the same definition as in paragraph 4 of IAS 27 *Consolidated and Separate Financial Statements,* which includes only a parent and its subsidiaries'.

22. The staff believes that a target defined by reference to the operation or activities of the entity may faithfully represent the dual criteria reasoning. Therefore, the staff believes it is appropriate to presume all internal targets of the entity are performance targets and provided there is a related explicit or implicit service requirement, an entity shall presume it is a performance condition. The staff believes the dual criteria reasoning should be used as the Committee's justification for this treatment and not that the dual criteria should be reviewed and applied by an entity to each share-based payment transaction.

US GAAP

23. US GAAP sets out detailed guidance on the attributes of a performance condition. The FASB ASC Master Glossary (and ASC 718-10-20 Glossary) defines 'performance condition' as follows [emphasis added]:

> A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to **both of the following**:
>
> (a) An employee's **rendering service for a specified (either explicitly or implicitly) period of time**.
>
> (b) achieving a specified **performance target that is defined solely by reference to the employer's own operations (or activities).**
>
> Attaining a specified growth rate in return on assets, obtaining regulatory approval to market a specified product, selling shares in an initial public offering or other financing event, and a change in control are examples of performance conditions. **A performance target also may be defined by reference to the same performance measure of another entity or group of entities.** For example, attaining a growth rate in earnings per share (EPS) that exceeds the average growth rate in EPS of other entities in the same industry is a performance condition. **A performance target might pertain either to the performance of the entity as a whole or to some part of the entity, such as a division or an individual employee.**

24. Also, ASC Topic 718 (formerly FAS 123R) explains the conceptual distinction of a performance condition in the basis for conclusions to FAS 123R as follows [emphasis added]:

> B173. In discussing the treatment of various conditions that can affect the vesting, exercisability, or exercise price of an award, paragraph 26 of Statement 123 provided that:

> No compensation cost is recognized for awards that employees forfeit either because they fail to satisfy a service requirement for vesting, such as for a **fixed award,** or because the entity does not achieve a **performance condition,** unless the condition is a target stock price or specified amount of intrinsic value on which vesting or exercisability is conditioned. For awards with the latter condition, compensation cost shall be recognized for awards to employees who remain in service for the requisite period regardless of whether the target stock price or amount of intrinsic value is reached. [Footnote reference omitted.]

A fixed award was defined as one for which vesting is based solely on an employee's continuing to render service to the employer for a specified period of time. A performance award was defined as one for which vesting depends on both (a) an employee's rendering service for a specified period of time and (b) the entity's achievement of a specified performance target, such as attaining a specified growth rate for return on assets or a specified increase in market share for a specified product.

B174. The Board concluded that Statement 123's definitions might not clearly classify some conditions that affect vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award included in instruments awarded under share-based payment arrangements. Thus, this Statement revises the definitions of those conditions to more clearly distinguish between them, although the accounting effects of the revised conditions are not significantly different from the effects of those conditions in Statement 123. The most significant clarification is to separately define *market condition,* which Statement 123 included as one type of performance condition. This Statement defines market condition as a condition affecting the exercise price, exercisability, or other pertinent factors used in determining the fair value of an award that relates to the achievement of (a) a specified price of the issuer's shares or a specified amount of intrinsic value indexed solely to the issuer's shares or (b) a specified price of the issuer's shares in terms of a similar (or index of similar) equity security (securities).

B175. This Statement continues Statement 123's different accounting for market conditions and performance conditions. That is, no compensation cost is recognized for awards that do not vest because a performance condition is not achieved, even though employees remain in service for the requisite service period. However, compensation cost is recognized for awards to employees who remain in service for the requisite service period regardless of whether (or when) a market condition is satisfied. Some respondents to the Exposure Draft objected to that provision, suggesting that performance and market conditions should be treated the same. Those respondents generally favored recognizing no cost for either if the condition is not satisfied.

B176. The Board decided to maintain the distinction between performance and market conditions, in part due to concerns about the measurability at the grant date of the expected outcomes associated with performance conditions. That is, the Board concluded that it would not be feasible to eliminate the distinction by reflecting the effects of both performance conditions and market conditions in an award's grant-date fair value and recognizing compensation for both if the requisite service is rendered. Although it would be possible, in theory, to estimate the grantdate fair value of an award with a performance condition, to do so would involve developing a probability distribution reflecting the likelihood that the entity will, for example, achieve a specified percentage increase in return on assets in a specified period of time.An entity might have little, if any, data on which to base such a probability distribution, and it would be unlikely to be able to obtain adequate pertinent information about similar awards made by similar entities. Also, the IASB proposed in ED2 a requirement to take into account the effects of performance conditions in estimating an award's fair value at the grant date. Respondents to ED2, as well as to the FASB's Invitation to Comment, generally objected to that proposal on the grounds that it would not be feasible to develop sufficiently reliable estimates of the probability of achieving performance conditions. The Board also was concerned about the potential inconsistency if the effects of performance conditions were taken into account in measuring fair value at the grant date unless the effects of service conditions were treated similarly.

B177. The Board also considered eliminating the different accounting for performance and market conditions by requiring recognition of no compensation cost if either type of condition is not satisfied, regardless of whether the requisite service has been rendered. However, based on discussions with members of the Options Valuation Group, the Board understands that the fair value of a share option with a market condition can be estimated at the grant date using valuation techniques developed for similar options that trade in external markets. The Board concluded that it would be inappropriate and illogical not to take advantage of relatively well-developed valuation techniques for those traded options in accounting for awards with market conditions. Therefore, this Statement continues to require recognition of compensation cost for awards with market conditions based on the fair value at the grant date, provided that the requisite service is rendered.

B178. The Board also notes that **performance and market conditions are conceptually distinct. Including a performance condition in an award of share-based compensation requires an employee to contribute to achieving an increase in a specified measure of the entity's performance regardless of the extent to which that increase is reflected in the entity's share price.** For example, a performance condition may require an increase of 15 percent in market share over a 2-year period. But **the entity's share price may not increase accordingly, and may even decrease, even though that condition is achieved**.

B179. Market conditions, on the other hand, pertain to the interaction between an entity's individual performance as reflected in its share price and changes in the environment in which it operates. For example, an award of share options with a market condition might have an exercise price that changes in accordance with (that is, is indexed to) changes in the relationship between the entity's share price and an index of the share prices of other entities in the same industry. Changes in measures of the entity's individual performance, such as achieving or not achieving a 15

> percent increase in market share, will affect that award only to the extent that the increase is reflected in changes in the entity's share price relative to those of its competitors.
>
> B180. Eliminating the distinction between performance conditions and market conditions would result in only one class of performance-related conditions. That is, a performance condition would be defined to include both a performance condition and a market condition as defined in this Statement. In view of both the conceptual differences and the differences in measurability of those conditions, the Board concluded that providing different accounting for them continues to be appropriate.

25. The staff thinks that the US GAAP guidance is consistent with the principle explored in this agenda paper on the general basis. It is particularly noteworthy that paragraph B178 of FAS 123R explains that a market condition is conceptually distinct from a performance condition and implies that a market condition is not within the influence of the employee as opposed to a performance condition that is within the influence of the employee.

26. Some vesting conditions are less clear than others. Whether an initial public offering and a change of control constitute performance conditions need to be examined under the principle explored in this agenda paper. Although these conditions are specified as examples of a performance condition in US GAAP, it remains in question whether (a) they can fit within the proposed principle of IFRS 2 or (b) they should be listed as explicit examples of a performance condition regardless of their ability to fit within the proposed principle. Also, a saving requirement in a Save-As-You-Earn plan[4], which is currently considered in IFRS 2 to be a non-vesting condition, needs to be revisited. These three contentious conditions are discussed in more detail in the next section.

Consideration of contentious examples

27. In this section, the following three examples are explored against the proposed principle:

[4] In a SAYE plan, employees are required to make regular savings to the exercise price of share options granted. The employees may use the accumulated savings to exercise their options at the end of a specified period or take a refund of their savings at any point during the period with their options invalidated.

(a) Initial Public Offering (IPO)

(b) Change of control

(c) Save-As-You-Earn (SAYE) plan

Consideration in terms of the employee's influence

28. Comparing these specific examples with typical performance targets, the employee may have even stronger influence on whether the saving requirement in a SAYE plan is met, because the satisfaction of that target is totally dependant on the employee's decision to continue saving. In contrast, the employee is not likely to have as strong of an influence on whether the IPO or change of control is achieved. While the IPO and often change of control are affected by internal circumstances of the entity, they are also affected to some degree by external factors such as regulatory environments or the agreement of the counterparty to the transaction. Nonetheless, in the staff's opinion, the employee can be seen to have some influence over the internal factors that are necessary to achieve these targets.

Consideration in terms of the entity's interest

29. While the IPO and the change of control are not wholly internal targets of the entity, the staff believes they are considered to be in the interest of the entity. These conditions are determined by the entity and the staff thinks that the management of an entity would set those targets in expectation that they will benefit the entity if the target is met.

30. Some believe that the saving requirement in a SAYE plan is not considered to be in the interest of the entity but only in the interest of an individual employee. They believe that whether the saving requirement is met does not make any difference to the service the entity receives (or the employee provides). Others believe that the saving requirement in a SAYE plan is in the interest of the entity since the entity has created this plan as a means for: (1) the employee to save and hopefully invest in the entity through exercise of the share-based payment awards resulting in broader ownership of the entity by employees, (2) tax

advantageous compensation to the entity and/ or the employee and (3) the entity to obtain a source of capital funding in lieu of an IPO or other financing transaction.

31. The staff has differing views and believes that both of the above views of the saving requirement in a SAYE plan are supportable.

Possible accounting treatment

32. According to the above analysis:

    (a) the IPO and the change of control could be viewed to be short on Attribute 1, ie ‘the employee’s ability to influence’; and

    (b) the saving requirement in a SAYE plan could be viewed to be short on Attribute 2, ie ‘in the interest of the entity’.

33. Taking a narrow view of a performance condition, all three of these examples may not constitute performance conditions, but fall into the category of ‘market or other vesting condition’ in accordance with the classifications proposed by the staff at the May 2010 Committee meeting. This means that:

    (a) those conditions would be reflected in the grant date fair value of an equity-settled share-based payment; and

    (b) failure to meet those conditions would not be accounted for as a forfeiture and the previously recognised compensation expense would not be reversed if that condition is not met (provided the employee remained in service throughout the attribution period).

34. Nonetheless, the staff notes that each of the three examples obviously bears one of the two attributes. In the staff’s opinion, these three examples should be accounted for as performance conditions for the following reasons:

    (a) A saving requirement in a SAYE plan is similar to a service condition in that whether it will be met is controlled by the employee. However, given the staff recommendation at the May 2010 Committee meeting that a service condition should be confined to a condition that requires only service over a specified period of time, the saving requirement in a

SAYE plan may not be treated as a service condition. Instead, it may be accounted for as a performance condition if the Committee elects the broader notion of performance condition and that the savings requirement in a SAYE plan does benefit the entity. If the Committee agrees with the staff recommendation, this will be a change from current IFRS 2 as current paragraph IG24 of IFRS 2 that includes this as an explicit example of a 'non-vesting condition'.

(b) An IPO is currently listed in paragraph IG24 of IFRS 2 as an explicit example of an 'other performance condition'. Additionally, US GAAP specifies an IPO and a change of control as examples of a performance condition. If those conditions are treated as a 'market or other vesting condition', this would create a change from existing IFRS 2 and divergence from US GAAP. In the staff's opinion, IPO and change of control provisions can continue to be classified as performance conditions if the Committee confirms that these conditions are able to be influenced by the employee and do benefit the entity.

35. The staff thinks that although there is a less clear classification of these three examples under the principle explored in this agenda paper (as compared to other examples), they should be enclosed within a performance condition in order to secure an consistent accounting treatment both within IFRS 2 and with US GAAP. This may appear to be a rule for these three examples, but in the staff's opinion it does not compromise the principle of current IFRS 2 or the principle proposed by the staff.

Staff recommendation

36. The staff recommends that:

(a) the rationale included in the Basis for Conclusions to IFRS 2 for a performance target should explain two attributes in order to constitute a performance condition in combination with an appropriate service condition:

(i) the employee is able to directly or indirectly influence the achievement of the target; and

(ii) achievement the target is in the interest of the entity;

(b) the combination of the two attributes should be represented by a performance target defined by reference to the operation or activities of the entity; and

(c) a saving requirement in a SAYE plan, an IPO and an change of control should be deemed to constitute a performance condition.

Questions for the Committee

37. The staff requests the Committee answer the following questions:

Questions for the Committee
1. Does Committee agree with the two attributes of a performance condition proposed by the staff as a rationale to define a performance condition? i) Attribute 1 – Employee is able to influence ii) Attribute 2 – In the interest of the entity 2. Does the Committee agree with the staff recommendation that the combination of the two attributes should be represented by a <u>performance condition defined by reference to the operation or activities of the entity (and an implicit or explicit service requirement throughout the attribution period)</u>? 3. Does the Committee agree with the staff recommendation that a saving requirement in a SAYE plan, an IPO and a change of control should be deemed to constitute a performance condition and should be listed as explicit examples of a performance condition?