Project **IFRS 2 *Share-based Payment***

Topic **Preliminary drafting of staff recommendations for proposed amendments to the authoritative guidance of IFRS 2**

Purpose of this paper

1. The staff approach that has resulted in the staff recommendations at the May 2010 Committee meeting and the complementary recommendation on a performance condition in agenda paper 3B for this meeting, entails some modest changes to current IFRS 2.

2. The objective of this paper is to present the draft amendments to the authoritative sections of IFRS 2 in line with the staff approach, which is outlined in the next section. **The drafting included in this agenda paper is preliminary drafting and should be used for preliminary review purposes only. The drafting in this agenda paper is not intended to impact conclusions reached on the underlying technical matters.**

Staff approach

3. The staff believes that all conditions included within a share-based payment arrangement should be classified into one of three groups:

   (a) Vesting condition

   (b) Non-vesting condition

   (c) Contingent feature

4. In addition, the staff suggests that the accounting mechanics applied to vesting conditions should be based on whether the condition is able to be influenced by the employee:

   (a) Conditions that are broadly within the employee's influence are either:

      (i) **service conditions**; or

      (ii) **performance conditions**

      depending on whether they include performance targets apart from explicit or implicit service requirements or not.

   (b) Conditions that are broadly outside the employee's influence are **market or other vesting conditions**.

5. Additionally, **non-vesting conditions** (that do not have an explicit or implicit service requirement) should apply the accounting mechanics that are applied to market or other vesting conditions.

6. The staff suggests that the two different types of accounting mechanics should be aligned with the two different accounting mechanics (treatments) set out in current IFRS 2:

   (a) Conditions that are **broadly within the employee's influence** should be **excluded from the measurement of the grant date fair value** of equity-settled share-based payments. Instead these conditions are reflected in management's estimate of the number of awards expected to vest, with **'true-ups'** at each reporting period for revisions to these estimates.

   (b) Conditions that are **broadly outside the employee's influence** (or that do not have an explicit or implicit service requirement) should be **included in the measurement of the grant date fair value** of equity-settled share-based payments, with **no 'true-ups'** at each reporting period for revisions to the estimate of the number of awards expected to vest.

Proposed Amendments to IFRS 2 *Share-based Payment*

Equity-settled share-based payment transactions

Paragraphs 15, 19-21A, the heading before paragraph 22, paragraphs 22, 24, 25, 27, 43B and 47 are amended (new text is underlined and deleted text is struck through). Paragraph 15A is added and paragraph 28A is deleted.

Transactions in which services are received

15 If the equity instruments granted do not vest until the counterparty completes a specified period of service, the entity shall presume that the services to be rendered by the counterparty as consideration for those equity instruments will be received in the future, during the *vesting period*. The entity shall account for those services as they are rendered by the counterparty during the vesting period, with a corresponding increase in equity. For example:

(a) if an employee is granted share options conditional upon completing three years' service, then the entity shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over that three-year vesting period.

(b) if an employee is granted share options conditional upon the achievement of a performance condition and remaining in the entity's employ until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the entity shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over the expected vesting period. The entity shall estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition~~. If the performance condition is a *market condition*, the estimate of the length of the expected vesting period shall be consistent with the assumptions used in estimating the fair value of the options granted, and shall not be subsequently revised. If the performance condition is not a market condition, t~~ <u>T</u>he entity shall revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates.

(c) <u>if an employee is granted share options conditional upon the achievement of a market or other vesting condition and remaining in the entity's employ until the market or other vesting condition is satisfied, and the length of the vesting period varies depending on when the market or other vesting condition is satisfied, the entity shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over the expected vesting period. The entity shall estimate the length of the expected vesting period at grant date, based on the most likely outcome of the market or other vesting condition. The estimate of the length of the expected vesting period shall be consistent with the assumptions used in estimating the fair value of the options granted, and shall not be subsequently revised.</u>

15A If the vesting of the equity instruments granted is subject to the interaction of multiple vesting conditions, the entity shall presume that the services to be rendered by the counterparty as consideration for those equity instruments will be received in the future, during the *attribution period*. Appendix B contains further guidance on the determination of the attribution period.

Treatment of vesting conditions

19 A grant of equity instruments might be conditional upon satisfying specified *vesting conditions*. For example, a grant of shares or share options to an employee is typically conditional on the employee remaining in the entity's employ for a specified period of time. There might be performance conditions that must be satisfied, such as the entity achieving a specified growth in profit or a specified increase in the entity's share price. ~~Vesting conditions, other than market conditions,~~ <u>Service conditions and performance conditions</u> shall not be taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, ~~vesting conditions~~ <u>service conditions and performance</u>

conditions shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. Hence, on a cumulative basis, no amount is recognised for goods or services received if the equity instruments granted do not vest because ~~of failure to satisfy a vesting condition, eg~~ the counterparty fails to complete a specified service period, or a performance condition is not satisfied~~, subject to the requirements of paragraph 21~~.

20 To apply the requirements of paragraph 19, the entity shall recognise an amount for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested~~, subject to the requirements of paragraph 21~~.

21 Market or other vesting conditions, such as a target share price or a target commodity index upon which vesting (or exercisability) is conditioned, shall be taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with market or other vesting conditions, the entity shall recognise the goods or services received from a counterparty who satisfies all ~~other vesting conditions (eg services received from an employee who remains in service for the specified period of service)~~ specified service conditions and/or performance conditions, irrespective of whether that market or other vesting condition is satisfied.

Treatment of non-vesting conditions

21A Similarly, an entity shall take into account all non-vesting conditions, such as a restriction on post-vesting transfer, when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with non-vesting conditions, the entity shall recognise the goods or services received from a counterparty that satisfies all ~~vesting conditions that are not market conditions (eg services received from an employee who remains in service for the specified period of service)~~ specified service conditions and/or performance conditions, irrespective of whether those non-vesting conditions are satisfied.

Treatment of a ~~reload feature~~ contingent feature

22 For options with a contingent feature such as a *reload feature* or a clawback provision, the ~~reload~~ contingent feature shall not be taken into account when estimating the fair value of options granted at the measurement date. Instead, the effect of such a contingent feature shall be accounted for if and when the contingent event occurs. For example, a *reload option* shall be accounted for as a new option grant, if and when a reload option is subsequently granted.

If the fair value of the equity instruments cannot be estimated reliably

24 The requirements in paragraphs 16–23 apply when the entity is required to measure a share-based payment transaction by reference to the fair value of the equity instruments granted. In rare cases, the entity may be unable to estimate reliably the fair value of the equity instruments granted at the measurement date, in accordance with the requirements in paragraphs 16–22. In these rare cases only, the entity shall instead:

(a) measure the equity instruments at their intrinsic value, initially at the date the entity obtains the goods or the counterparty renders service and subsequently at the end of each reporting period and at the date of final settlement, with any change in intrinsic value recognised in profit or loss. For a grant of share options, the share-based payment arrangement is finally settled when the options are exercised, are forfeited (eg upon cessation of employment) or lapse (eg at the end of the option's life).

(b) recognise the goods or services received based on the number of equity instruments that ultimately vest or (where applicable) are ultimately exercised. To apply this requirement to share options, for example, the entity shall recognise the goods or services received during the vesting period or (where applicable) attribution period, if any, in accordance with paragraphs 14 and 15, except that the requirements in paragraph 15(b) concerning a market condition do not apply. The amount recognised for goods or services received during the vesting period or (where applicable) attribution period shall be based on the number of share options expected to vest. The entity shall revise that estimate, if necessary, if subsequent information indicates that the number of share options expected to vest differs from previous estimates. On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested. After vesting date, the entity shall reverse the amount recognised for goods or services received if the share options are later forfeited, or lapse at the end of the share option's life.

25 If an entity applies paragraph 24, it is not necessary to apply paragraphs 26–29, because any modifications to the terms and conditions on which the equity instruments were granted will be taken into account when applying the intrinsic value method set out in paragraph 24. However, if an entity settles a grant of equity instruments to which paragraph 24 has been applied:

(a) if the settlement occurs during the vesting period or (where applicable) attribution period, the entity shall account for the settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that would otherwise have been recognised for services received over the remainder of the vesting period or (where applicable) attribution period.

(b) any payment made on settlement shall be accounted for as the repurchase of equity instruments, ie as a deduction from equity, except to the extent that the payment exceeds the intrinsic value of the equity instruments, measured at the repurchase date. Any such excess shall be recognised as an expense.

27 The entity shall recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy ~~a vesting condition (other than a market condition)~~ service conditions and/or performance conditions that was specified at grant date. This applies irrespective of any modifications to the terms and conditions on which the equity instruments were granted, or a cancellation or settlement of that grant of equity instruments. In addition, the entity shall recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee. Guidance on applying this requirement is given in Appendix B.

~~28A If an entity or counterparty can choose whether to meet a non-vesting condition, the entity shall treat the entity's or counterparty's failure to meet that non-vesting condition during the vesting period as a cancellation.~~

43B The entity receiving the goods or services shall measure the goods or services received as an equity-settled share-based payment transaction when:

(a) the awards granted are its own equity instruments, or

(b) the entity has no obligation to settle the share-based payment transaction.

The entity shall subsequently remeasure such an equity-settled share-based payment transaction only for changes in ~~non-market vesting conditions~~ service conditions or performance conditions in accordance with paragraphs 19–21. In all other circumstances, the entity receiving the goods or services shall measure the goods or services received as a cash-settled share-based payment transaction.

47 If the entity has measured the fair value of goods or services received as consideration for equity instruments of the entity indirectly, by reference to the fair value of the equity instruments granted, to give effect to the principle in paragraph 46, the entity shall disclose at least the following:

(a) for share options granted during the period, the weighted average fair value of those options at the measurement date and information on how that fair value was measured, including:

(i) the option pricing model used and the inputs to that model, including the weighted average share price, exercise price, expected volatility, option life, expected dividends, the risk-free interest rate and any other inputs to the model, including the method used and the assumptions made to incorporate the effects of expected early exercise;

(ii) how expected volatility was determined, including an explanation of the extent to which expected volatility was based on historical volatility; and

(iii) whether and how any other features of the option grant were incorporated into the measurement of fair value, such as a market condition or other vesting condition.

(b) for other equity instruments granted during the period (ie other than share options), the number and weighted average fair value of those equity instruments at the measurement date, and information on how that fair value was measured, including:

   (i) if fair value was not measured on the basis of an observable market price, how it was determined;

   (ii) whether and how expected dividends were incorporated into the measurement of fair value; and

   (iii) whether and how any other features of the equity instruments granted were incorporated into the measurement of fair value.

(c) for share-based payment arrangements that were modified during the period:

   (i) an explanation of those modifications;

   (ii) the incremental fair value granted (as a result of those modifications); and

   (iii) information on how the incremental fair value granted was measured, consistently with the requirements set out in (a) and (b) above, where applicable.

Appendix A Defined terms

In Appendix A, the following definitions are amended or added (new text is underlined and deleted text is struck through).

vesting conditions ~~The~~ A condition~~s~~ that determines whether ~~the entity receives~~ the counterparty provides the entity with 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 or market or other vesting 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**.~~

non-vesting condition A condition that does not determine whether the counterparty **vests** in a **share-based payment arrangement**.

service condition A condition that affects the vesting, exercise price, or other pertinent factor used in determining the fair value of an award that depends solely on a counterparty rendering service to the entity for the vesting period.

performance condition A condition affecting the vesting, exercise price, or other pertinent factors used in determining the fair value of an award that relates to both:

(a) a counterparty's rendering service for a specified (either explicitly or implicitly) period of time, and

(b) achieving a specified performance target that is defined by reference to (1) the employer's own operations (or activities), or (2) the same performance measure of another entity or group of entities.

market or other vesting condition A condition affecting the exercise price, or other pertinent factors used in determining the fair value of an award under a **share-based payment arrangement** that requires:

(a) a counterparty's rendering of service for a specified (either explicitly or implicitly) period of time; and

(b) the achievement of a specified target other than such a performance target (as described in the definition of performance condition.

contingent feature A feature that is subsequently activated only if a related event occurs.

vesting period The implicit or explicit required service period during which ~~all the~~ a specified **vesting condition~~s~~** of a **share-based payment arrangement** ~~are~~ is to be satisfied.

attribution period (and required service) The period during which an employee is required to provide service in exchange for an award under a share-based payment arrangement. The service that a counterparty is required to render during that period is referred to as the *required service*. The attribution period is the period over which the required combination of vesting conditions is to met.

Appendix B Application guidance

Paragraphs B3, B7, B8, B18, B33 and B34 are amended (new text is underlined and deleted text is struck through). A header and paragraphs B41A–B41C, a header and paragraphs B41D and B41E are added after paragraph 41.

B3 For example, if the employee is not entitled to receive dividends during the ~~vesting~~ attribution period, this factor shall be taken into account when estimating the fair value of the shares granted. Similarly, if the shares are subject to restrictions on transfer after vesting date, that factor shall be taken into account, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares. Restrictions on transfer or other restrictions that exist during the ~~vesting~~ attribution period shall not be taken into account when estimating the grant date fair value of the shares granted, because those restrictions stem from the existence of vesting conditions, which are accounted for in accordance with paragraphs 19–21.

B7 Other factors that knowledgeable, willing market participants would consider in setting the price shall also be taken into account (except for vesting conditions and ~~reload~~ contingent features that are excluded from the measurement of fair value in accordance with paragraphs 19–22).

B8 For example, a share option granted to an employee typically cannot be exercised during specified periods (eg during the ~~vesting~~ attribution period or during periods specified by securities regulators). This factor shall be taken into account if the option pricing model applied would otherwise assume that the option could be exercised at any time during its life. However, if an entity uses an option pricing model that values options that can be exercised only at the end of the options' life, no adjustment is required for the inability to exercise them during the ~~vesting~~ attribution period (or other periods during the options' life), because the model assumes that the options cannot be exercised during those periods.

B18 Factors to consider in estimating early exercise include:

(a) the length of the vesting period, because the share option typically cannot be exercised until the end of the ~~vesting~~ attribution period. Hence, determining the valuation implications of expected early exercise is based on the assumption that the options will vest. The implications of vesting conditions are discussed in paragraphs 19–21.

(b) the average length of time similar options have remained outstanding in the past.

(c) the price of the underlying shares. Experience may indicate that the employees tend to exercise options when the share price reaches a specified level above the exercise price.

(d) the employee's level within the organisation. For example, experience might indicate that higher-level employees tend to exercise options later than lower-level employees (discussed further in paragraph B21).

(e) expected volatility of the underlying shares. On average, employees might tend to exercise options on highly volatile shares earlier than on shares with low volatility.

B33 Similarly, when the grant date fair value of shares granted to employees is estimated, no adjustment is required for expected dividends if the employee is entitled to receive dividends paid during the ~~vesting~~ attribution period.

B34 Conversely, if the employees are not entitled to dividends or dividend equivalents during the ~~vesting~~ attribution period (or before exercise, in the case of an option), the grant date valuation of the rights to shares or options should take expected dividends into account. That is to say, when the fair value of an option grant is estimated, expected dividends should be included in the application of an option pricing model. When the fair value of a share grant is estimated, that valuation should be reduced by the present value of dividends expected to be paid during the ~~vesting~~ attribution period.

Vesting conditions

B41A A condition that results in the acceleration or vesting in the event of an employee's death, disability or termination without cause is a service condition.

B41B 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, a change in control and a condition to make savings towards a Save-As-You-Earn plan are examples of performance conditions for purposes of this Standard. 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 that exceeds the average growth rate in earnings per share of other entities in the same industry is a performance condition for purposes of this Standard. A performance target might pertain either to the performance of the reporting entity as a whole or to some part of the reporting entity, such as a division or an individual employee.

B41C Attaining a minimum share price by a specified date, achieving a total shareholder return target, outperform a share price index and achieving a commodity index or market index target are examples of market or other vesting conditions for purposes of this Standard.

Interaction of multiple vesting conditions and the attribution period

B41D An award with a combination of service, performance or market or other vesting conditions may contain multiple explicit or implicit service periods. For such an award, the estimate of the attribution period shall be based on an analysis of all of the following:

(a) All vesting conditions

(b) All explicit and implicit service periods, ie vesting periods

(c) The probability that service or performance conditions will be satisfied.

B41E If vesting of the equity instruments granted is based on satisfying both a service or performance condition and a market or other vesting condition and it is probable that the service or performance condition will be satisfied, the initial estimate of the attribution period generally is the longest of the explicit or implicit service periods. If vesting of the equity instruments granted is based on satisfying either a service or performance condition or a market or other vesting condition and it is probable that the service or performance condition will be satisfied, the initial estimate of the attribution period generally is the shortest of the explicit or implicit service periods.