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Staff Paper | Date | March 2010

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

Topic **Vesting conditions and non-vesting conditions**

*[**NOTE**: Agenda Papers 3A and 3B (previously referenced in the IFRIC Agenda dated 17/02/10) will not be used at the March 2010 IFRIC meeting.]*

Objective and introduction

1. The objective of this Agenda Paper is to provide the IFRIC with an update on the staff's research and analysis to date on the IFRIC's agenda issue addressing vesting conditions and non-vesting conditions as used in IFRS 2 *Share-based Payment*. Additionally, the staff seeks to obtain preliminary views and guidance from the IFRIC to assist the staff.

2. This Agenda Paper includes:

   (a) **background** information of the issue;

   (b) a **staff analysis to date**;

   (c) **staff recommendations** on next steps; and

   (d) **questions for the IFRIC**.

Background

3. In May and December 2009, IFRIC received requests to clarify the distinction between a service condition, performance condition and non-vesting condition. The issue within these requests arises because constituents are interpreting differently the principle set out in IFRS 2 that the vesting conditions should be those 'conditions that determine whether the entity receives the services that

entitle the counterparty to receive cash, others assets or equity instruments of the entity, under a share-based payment arrangement.'

4. At its January 2010 meeting, the IFRIC discussed this issue and decided to add the issue to its agenda.

Staff analysis to date

Overview

5. In the staff's opinion, the primary causes of the requests received on this issue include:

   (a) a **lack of clarity in existing guidance** for some aspects of share-based payment arrangements;

   (b) a **lack of guidance** for other aspects of share-based payment arrangements; and

   (c) the amendment/ revision of aspects and new introduction of other aspects of share based arrangements as a result of *Vesting Conditions and Cancellations* (**Amendment to IFRS 2**) issued in January 2008.

Lack of clarity in existing guidance

Current definitions

6. In general terms, in Appendix A *Defined terms* of IFRS 2:

   (a) vesting conditions are defined on a broad basis to accommodate both service conditions and performance conditions;

   (b) service conditions and performance conditions are not separately defined, but described with a few features within the definition of vesting conditions;

   (c) market conditions, which are a subset of performance conditions, are separately defined; and

   (d) non-vesting conditions are neither defined nor described.

Accounting treatment and impact

7. Market conditions and non-vesting conditions are included in the measurement of the grant date fair value of equity-settled share-based payments (with no ‘true-ups’ for revisions to forfeiture estimates). In contrast, service conditions and non-market performance conditions are excluded from the measurement of the grant date fair value and instead are reflected in management’s estimate of the number of awards expected to vest (with ‘true-ups’ at each reporting period).

8. The differentiation between the two groups (conditions that do vs. do not ‘true-up’) has a significant impact on the financial statements, because, on a cumulative basis, only one of the two following results is achieved based on the determination of the ‘condition’, either:

    (a) no amount is recognised for goods or services received if service conditions and/or performance conditions are not met, or

    (b) the grant date fair value amount is recognised for goods or services received irrespective of whether market conditions or non-vesting conditions are met.

Preliminary staff views

9. In the staff’s opinion, the current definitions and guidance in IFRS 2 are not sufficiently clear for the conditions to be consistently applied because the guidance on service conditions and performance conditions does not provide a definitive principle rather these conditions are described and illustrated.

10. The staff thinks that providing clearer descriptions of service and performance conditions, or by providing definitions of these conditions, would improve consistency of application.

11. The staff is also of the opinion that the reference to ‘conditions that determine whether the entity receives the services that entitle the counterparty to receive…’ in the definition of vesting conditions is too ambiguous. This wording was introduced as part of the amendment to IFRS 2 issued in January 2008 and is described further in paragraphs 16 to 21 below.

Lack of guidance

'And' vs 'or'

12. In the staff's opinion, there is a lack of guidance in some aspects of IFRS 2 that create diversity in the issue of this Agenda Paper. One of the questions raised by constituents relates to a condition that has a target linked to the entity's performance. The question is whether the condition is a 'performance condition' (i.e. vesting condition) or a non-vesting condition in situations where the condition is measured at a date subsequent to the explicit service period included in the share-based payment arrangement. That is, can a 'performance condition' have a longer vesting period than the explicit service period?

13. The staff note a diversity of views in determining whether the definition of vesting conditions requires that:

    (a) 'some' specified period of service be performed by the counterparty (and therefore the performance condition period could be longer or shorter than the service condition period), or

    (b) the specified service period is the exact period of time over which the counterparty must perform service (and therefore any condition that is longer than the service condition is deemed to be a non-vesting condition).

14. Additionally, the staff notes that US GAAP currently provides guidance on this item of 'and' vs. 'or' conditions (at ASC 718-10-55-73 and surrounding paragraphs). This may result in some, but not all, users of IFRSs applying the guidance in US GAAP (through application of paragraphs 10–12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*). ASC 718-10-55-72 and 73 state:

> 55-72 An award with a combination of market, performance, or service conditions may contain multiple explicit, implicit, or derived service periods. For such awards, the estimate of the requisite service period shall be measured on an analysis of all of the following:
>
> a. All vesting and exercisability conditions
>
> b. All explicit, implicit, and derived service periods

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

55-73 Thus, if vesting (or exercisability) of an award is based on satisfying both a market condition and a performance or service condition and it is probable that the performance or service condition will be satisfied, the initial estimate of the requisite service period generally is the longest of the explicit, implicit, or derived service periods. If vesting (or exercisability) of an award is based on satisfying either a market condition or a performance or service condition and it is probable that the performance or service condition will be satisfied, the initial estimate of the requisite service period generally is the shortest of the explicit, implicit, or derived service periods.

Preliminary staff views

15. In the staff's opinion, the current lack of guidance in this area does result in diversity in practice. The staff thinks that practice could be improved through the addition of guidance to address the interaction of multiple conditions.

Amendment to IFRS 2

16. The Amendment to IFRS 2 sought to clarify the distinction between vesting and non-vesting conditions. In that amendment, the definition of vesting conditions was revised as follows [new text is underlined an deleted text is struck through]:

> The conditions that ~~must be satisfied~~ determine whether the entity receives the services that entitle ~~for~~ the counterparty ~~to become entitled~~ to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. Vesting conditions ~~include~~ are either service conditions or performance conditions. Service conditions~~, which~~ require the ~~other~~ counterparty to complete a specified period of service.~~, and p~~ Performance conditions~~, which~~ 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.

17. Before the Amendment to IFRS 2, there was a risk that some conditions might improperly be considered vesting conditions because that definition indicated 'the conditions that must be satisfied for the counterparty to become entitled to receive…'. For example, some constituents were of the view that a contribution

requirement in a Save As You Earn plan[1] is a vesting condition because the counterparty cannot be entitled to the equity instrument until the employees contribution towards the exercise price is satisfied.

18. However, the Board considered that view was a result of misinterpretation because it was contradictory to paragraph 14 of IFRS 2 that provides that 'if equity instruments granted vest immediately, the counterparty is not required to complete a specified period of service before becoming unconditionally entitle to those equity instruments.' In order to prevent such misinterpretation, the Board amended IFRS 2 changed the focus in determining whether a condition is satisfied.

19. Prior to the Amendment to IFRS 2, the focus was on determining whether <u>the counterparty provided the requisite services</u> to the entity in order to obtain the benefits from the share-based payment. After the amendment, the focus is now on determining whether <u>the entity has received the services</u> that entitle the counterparty to obtain the share-based payment. This had the effect of implying that any vesting condition must implicate 'service'. In the staff's opinion, this change in focus is a key change that impacts the analysis of several aspects of this project.

20. As a consequence of the Amendment to IFRS 2, the contribution requirement in a Save As You Earn plan is now considered to be only an 'additional feature' (i.e. a non-vesting condition), and not a vesting condition. Also, this indicates that a share-based payment arrangement may vest in accordance with IFRS 2 even if a non-vesting condition has not been met.

21. The Amendment to IFRS 2 also added implementation guidance (paragraph IG24 of IFRS 2) in the format of a table that attempts to provide clarity between vesting conditions and non-vesting conditions. However, diversity has continued in practice despite the addition of this new implementation guidance.

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[1] A 'Save As You Earn' plan requires the employee to pay contributions towards the exercise price of a share-based payment.

Staff recommendations

22. In the staff's opinion, the IFRIC may address this issue by addressing one or more of the following components:

    (a) Revisiting the underlying rationale of the January 2008 Amendment to IFRS 2 and potential clarifications of that rationale

    (b) Revisiting the definitions of:

        (i) vesting conditions

        (ii) vesting period (i.e. 'requisite service period')

        (iii) market performance conditions (i.e. market conditions)

    (c) Exploring standalone definitions or clearer descriptions of:

        (i) service conditions

        (ii) non-market performance conditions (i.e. performance conditions)

        (iii) non-vesting conditions (i.e. 'other' conditions)

    (d) Exploring the interaction between multiple conditions ('and' vs. 'or' conditions)

23. In the staff's opinion, the determination of the appropriate scope of this project is related to the method of finalising this project (i.e. interpretation, annual improvements or separate amendment). In the staff's opinion, the IFRIC should first deliberate the technical merits of each component of this issue and then address the best method of finalising this project.

Questions for the IFRIC

24. Based on the research and analysis performed to date, the staff proposes to continue its research and analysis of the issues by focusing on the technical merits of each of the individual components of this issue that are listed in paragraph 22.

25. Additionally, the staff welcomes any preliminary views and guidance the IFRIC members can provide.

Questions for the IFRIC
1. Does the IFRIC agree with the staff proposal to continue research and analysis of the technical merits of the individual components of this issue?
2. Does the IFRIC have any preliminary guidance to assist the staff in the planned research and analysis?