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

Topic **Vesting and non-vesting conditions – Cover paper**

Introduction

1. At the January 2010 meeting, the Committee decided to add to its agenda a request to clarify the basis on which a vesting condition, especially a performance condition, can be distinguished from a non-vesting condition. Specifically, the Committee was asked how to distinguish between a service condition, a performance condition and a non-vesting condition. Additionally, the Committee was asked for clarification on the interaction of multiple vesting conditions.

2. At the March 2010 meeting, the Committee began preliminary deliberations on the scope of this project and asked the staff to consider whether there was guidance in US GAAP on this matter that would be helpful.

Structure of agenda papers

3. The staff analysis is split into 4 agenda papers with each agenda paper covering the following aspects of the project:

   (a) 3A – (this agenda paper) overall introduction, background, items to be addressed and an overview of the current IFRS 2 classifications and proposed classifications consistent with staff recommendations;

   (b) 3B – detailed analysis of vesting condition, non-vesting condition, service condition, performance condition, market condition, other vesting condition, contingent feature, and different accounting treatments for different types of conditions;

(c) 3C – detailed analysis of vesting period, attribution period and the interaction of multiple vesting conditions; and

(d) 3D – Summary paper of the staff recommendations for this project.

Objective for this agenda paper

4. The objective of this Agenda Paper 3A is to:

   (a) summarise the **background** of the project;

   (b) remind the Committee of the **items to be addressed**; and

   (c) provide a **summary of the current and staff's proposed IFRS 2 classifications** (of vesting and non-vesting conditions). This summary is based on staff analyses and recommendations in the accompanying agenda papers.

Background

Original submissions to the Committee

5. In May 2009, the Committee received an agenda request about a case in which the share-based payment transaction is conditional on a specific equity market price index reaching a specified target at any point during the specified period and the employees remaining in service up to the date the target is met. The issue was whether the equity market price index should be treated as:

   (a) a vesting condition, because the target determines how long the entity receives the service from the employees; or

   (b) a non-vesting condition, because the target does not relate to the performance of the entity.

6. In December 2009, the Committee received another agenda request for clarification of the distinction between a vesting condition and a non-vesting condition. The request included the following issues requested for clarification:

   (a) Whether a non-compete provision represents a vesting condition.

   (b) Whether a performance target needs to be specific to the performance of the entity.

   (c) Whether the specified service period must be at least as long as the period required to satisfy the performance target.

January 2008 Amendment to IFRS 2

Background to the January 2008 Amendment to IFRS 2

7. Both of the agenda requests included within this project also relate to a prior Board project that resulted in the issue of *Vesting Conditions and Cancellations* (Amendment to IFRS 2) in January 2008. The objective of that Amendment to IFRS 2 was to clarify the distinction between vesting and non-vesting conditions. In its exposure draft, the amendment would have sought only to restrict vesting conditions to a service condition and a performance condition (inclusive of both non-market performance conditions and market performance conditions), particularly with a view to excluding a contribution requirement in a Save-As-You-Earn plan[1]. Additionally, the Board identified and considered additional issues raised as a result of the comments received on the exposure draft that lead to the final Amendment to IFRS 2. Some of those additional issues have been reflected in the final Amendment to IFRS 2. The additional issues raised and conclusions thereof are noted in Appendix A to this agenda paper.

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

8. In the final Amendment to IFRS 2, the definition of 'vesting conditions' was revised as follows [new text is underlined and 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.

9. Additionally, implementation guidance illustrating the definition was incorporated through the addition of paragraphs IG4A and IG24 of IFRS 2. These paragraphs of IFRS 2 are reproduced in Appendix B and Appendix C, respectively, of this agenda paper.

Link between the Amendment to IFRS 2 and this project

10. Constituents continue to interpret differently the principle set out in IFRS 2 that a vesting condition should be any condition that determines whether the entity receives the required services from the counterparty (and results in entitlement of the award to the counterparty). Also, the concept of the non-vesting condition itself is not clear and therefore questions remain about what constitutes a vesting condition vs a non-vesting condition. As a result, there continues to be inconsistency in the determination of whether a condition is a service condition, non-market performance condition, market performance condition, non-vesting condition or contingent feature of the share-based payment arrangement.

11. The Amendment to IFRS 2 may have introduced new areas of potential diversity because vesting conditions are restricted to a service condition and a performance condition (inclusive of a non-market performance condition and a market performance condition). Thus not all conditions that determine whether a counterparty becomes entitled to an equity instrument granted as part of a share-based payment arrangement are classified as vesting conditions even if they are combined with a service requirement (implicitly or explicitly). For example, a share-based payment arrangement that entitles the employee to an

award dependant on the price of gold increasing 10% at any time during the next three years provided the employee is in employment at the date the target is met. As a result, the notion of 'vest' under IFRS 2 is confusingly different from its common interpretation.

Items to be addressed

12. Consistent with the request of the Committee at the March 2010 meeting to research potential paths forward to clarify existing IFRS 2 and reduce diversity in practice, the staff has performed analyses on the following items:

    (a) Vesting conditions,

    (b) Non-vesting conditions,

    (c) Service condition,

    (d) Performance condition,

    (e) Market condition, and

    (f) Other vesting conditions.

13. For completeness of deliberation by the Committee, the staff has also analysed contingent features (inclusive of a non-compete provision) and the different accounting treatments for different types of vesting conditions.

14. In addition, the staff has performed analyses on the following items, in order to clarify the period over which the grant date fair value of a share-based payment award that is subject to one or more vesting conditions should be attributed:

    (a) Vesting period,

    (b) Attribution period, and

    (c) The interaction of multiple vesting conditions.

Summary of the current and staff's proposed IFRS 2 conditions

15. The staff has created two summary charts intended to be used solely for discussion purposes by the Committee in analysing the underlying items in this project. These charts, located at Appendix D and Appendix E of this agenda paper, summarise the current IFRS 2 conditions and staff's proposed IFRS 2 conditions, respectively. These charts are summaries only should not be used to address specific fact patterns.

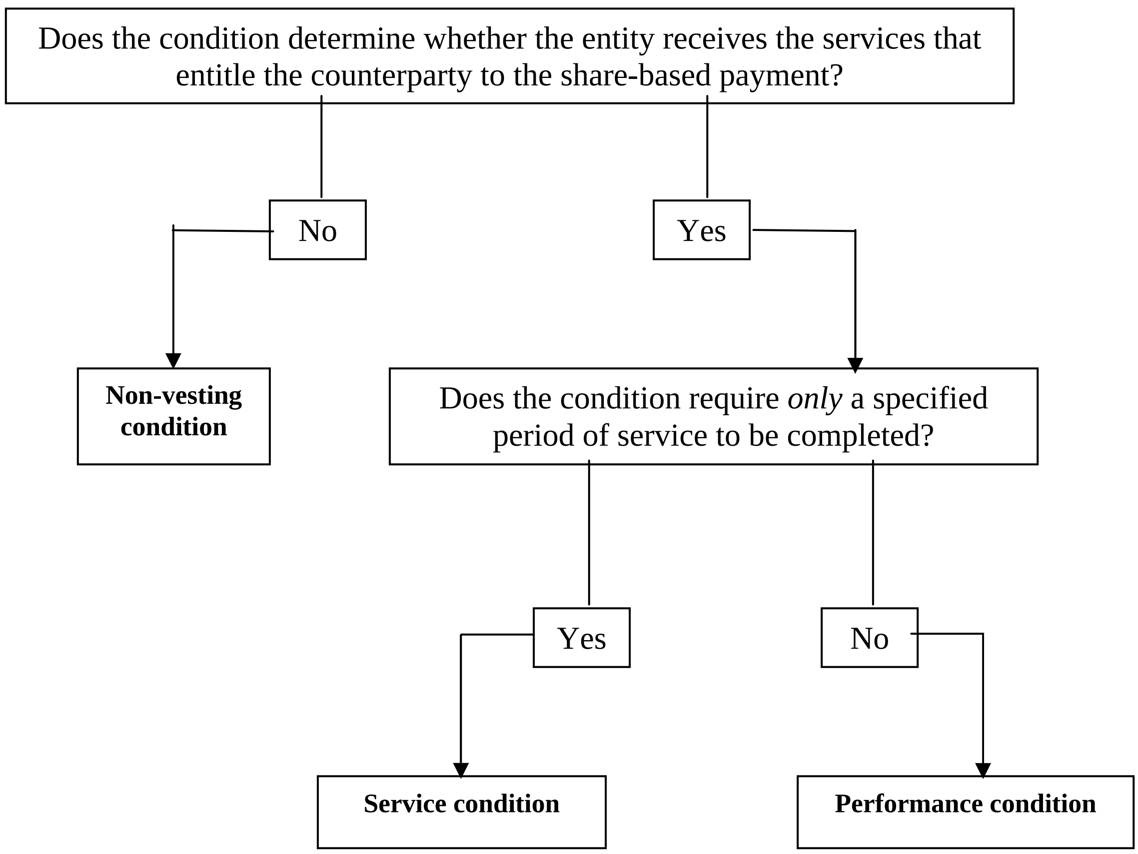
Appendix A — The Board's discussion behind the January 2008 Amendment to IFRS 2

Discussion	Actual amendment	Reference
1. Explain that the notion of vesting under IFRS 2 is different from, ie narrower than, the common interpretation of the term	The following explanation has been added to Basis for conclusions on IFRS 2: **... a share-based payment may vest even if some non-vesting conditions have not been met.** [BC171A of IFRS 2]	par.5-7/ paper 4B/ May 2007
2. Incorporate the rationale of 'service implication' in existing BC171 into the definition of vesting conditions, and switch the focus from 'employee provide' to 'entity receive' in order to prevent any confusion with the employees' contribution obligation in a SAYE plan.	The definition of vesting conditions in IFRS 2 has been amended as follows: 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. …	par.2, 9-11/ paper 19/ Oct 2006 par.7(b), 19-20/ paper 9/ Jan 2007
3. Clarify whether a performance condition must include an explicit or implicit service requirement	Within the definition of vesting conditions in IFRS 2, the description of performance conditions is amended as follows: **(a) the counterparty to complete a specified period of service; and** (b) specified performance targets to be met. In the implementation guidance of IFRS 2, IG4A is added, describing: **(a) a vesting condition that requires only a specified period of service as a service condition; and** **(b) a vesting condition that requires something more than only service as a performance condition only, not as the combination of a service condition and a performance condition**	par.22-25/ paper 9/ Jan 2007 par.8-10/ paper 4B/ May 2007 IASB update Jan 2007
4. Clarify whether performance conditions encompass both: (a) a market-related	Within the definition of vesting conditions in IFRS 2, the following has been added: **A performance condition might include a**	par.13, 19(a)/ paper 6A/ Jul 2006

condition; and (b) a non-market related condition	**<u>market condition.</u>**	
5. Clarify whether a post-vesting restriction and a non-compete provision are vesting conditions	To allow for the 'unconditionality feature' by analogy with the concept of vesting in IAS 19(*), the definition of 'vest' in IFRS 2 is revised as follows: To become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets~~,~~ or equity instruments of the entity vests ~~upon satisfaction of any specified vesting conditions~~ **<u>when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions</u>**. (*) Vested employee benefits are defined as employee benefits that are not conditional on future employment. The following explanation has been added to Basis for conclusions on IFRS 2: **<u>The Board noted that a share-based payment vests when the counterparty's entitlement to it is no longer conditional on future service or performance conditions. Therefore, conditions such as non-compete provisions and transfer restrictions, which apply after the counterparty has become entitled to the share-based payment, are not vesting conditions. The Board revised the definition of 'vest' accordingly.</u>** [BC171B of IFRS 2]	par.23-27 / paper 19 / Oct 2006

Appendix B — Reproduction of implementation guidance on the definition of vesting conditions, IG4A of IFRS 2

IG4A IFRS 2 defines vesting conditions as 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. The following flowchart illustrates the evaluation of whether a condition is a service or performance condition or a non-vesting condition.



Appendix C — Reproduction of illustrative example, IG24 of IFRS 2

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. (paragraph 19)	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.

Appendix D — Summary chart of current IFRS 2

D1. This chart is intended to be used solely for discussion purposes by the Committee in analysing the underlying items in this project. This chart is consistent with the distinctions currently in paragraph IG24 of IFRS 2.

<table>
<tr><th colspan="3">Vesting condition</th><th colspan="3">Non-vesting condition</th></tr>
<tr><td colspan="3">The conditions that determine whether the entity receives the services that entitle the counterparty to receive a share-based payment</td><td colspan="3">[not defined]</td></tr>
<tr><td rowspan="2">Service condition</td><td colspan="2">Performance condition</td><td rowspan="2">Neither party can choose whether the condition is met</td><td rowspan="2">Counterparty can choose whether to meet the condition</td><td rowspan="2">Entity can choose whether to meet the condition</td></tr>
<tr><td>Performance conditions that are market conditions</td><td>Other performance conditions</td></tr>
<tr><td>Target based solely on time</td><td>Target related to the market price of the reporting entity’s equity instruments</td><td>Target based on specified criteria in addition to a service requirement</td><td>[not defined]</td><td>[not defined]</td><td>[not defined]</td></tr>
<tr><td colspan="2">Impact of future variability captured in revisions to the estimate of forfeitures</td><td colspan="4">Impact of future variability included in grant date fair value (and not subsequently revised)</td></tr>
</table>

<table>
<tr><th colspan="6">Example conditions</th></tr>
<tr><td>Requirement to remain in service for three years</td><td>Target based on the market price of the entity’s equity instruments</td><td>Target based on a successful initial public offering with a specified service requirement</td><td>Target based on a commodity index</td><td>Paying contributions towards the exercise price of a share-based payment</td><td>Continuation of the plan by the entity</td></tr>
</table>

Appendix E — Summary chart of proposed classifications based on staff recommendations

E1. This chart is intended to be used solely for discussion purposes by the Committee in analysing the underlying items in this project.

<table>
<tr><th colspan="3">Vesting condition</th><th>Non-vesting condition</th><th>Contingent features</th></tr>
<tr><td colspan="3">Conditions that determine whether the counterparty becomes entitled to the share-based payment award</td><td>Conditions that do not determine whether the counterparty becomes entitled to the share-based payment award</td><td>Conditions that address future transactions</td></tr>
<tr><td colspan="3">All vesting conditions have an explicit or implicit service requirement</td><td>No related service requirement</td><td>No related service requirement</td></tr>
<tr><td colspan="3">Periodic re-estimation of estimated forfeitures to complete service requirement through the attribution period</td><td>Not applicable (as there is no service requirement)</td><td>Accounted for when condition occurs</td></tr>
<tr><td>Service condition</td><td>Performance condition</td><td>Other vesting condition</td><td rowspan="2"></td><td rowspan="2"></td></tr>
<tr><td>Target based solely on time</td><td>Target solely by reference to the entity’s operations</td><td>All vesting conditions that are not service or conditions</td></tr>
<tr><td colspan="2">Impact of future variability of individual condition excluded from grant date fair value</td><td colspan="2">Impact of future variability of individual condition included in grant date fair value</td><td>Not included in grant date fair value</td></tr>
<tr><td colspan="2">Conditions able to be influenced by the employee</td><td colspan="2">Conditions not able to be influenced by the employee</td><td></td></tr>
</table>

<table>
<tr><th colspan="5">Example conditions</th></tr>
<tr><td>Requirement to remain in service for three years</td><td>Target based on the entity’s revenue</td><td>(1) Target based on the market price of the entity’s equity instruments or (2) target based on a specified increase the price of a commodity</td><td>Post-vesting transferability restriction</td><td>(1) reload features or (2) clawback provisions (including non-compete provisions)</td></tr>
</table>