**Committee Meeting**

Staff Paper

Agenda reference **3C**

Date **May 2010**

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| Project | **IFRS 2 *Share-based Payment*** |
| Topic | **Vesting and non-vesting conditions – Attribution period and interaction of conditions** |

## Objective

1. This May 2010 Committee Agenda Paper 3C (Agenda Paper 3C) is an integral component of the overall staff analysis of the Committee's agenda issue on Vesting and Non-vesting Conditions. Agenda Paper 3C should be read in conjunction with the three corresponding May 2010 Committee Agenda Papers 3A, 3B and 3D.

2. The objective of this Agenda Paper 3C is to analyse, provide staff recommendations and ask questions of the Committee to clarify the period over which compensation cost should be recognised for a share-based payment transaction that includes one or more vesting conditions. Specifically, this Agenda Paper 3C analyses the following items:

   (a) **Vesting period and attribution period**; and

   (b) interaction of **multiple vesting conditions**.

3. This agenda paper also includes **questions for the Committee**.

4. Each of the above items is analysed separately. Each analysis includes the following:

   (a) current guidance of IFRS 2;

   (b) potential diversity or confusion and tracing its cause;

   (c) comparison of the corresponding guidance in US GAAP;

   (d) possible remedies; and

   (e) staff recommendations.

## Staff analyses and recommendations

### *Vesting period and attribution period*

*Current guidance of IFRS 2*

5. Currently, IFRS 2 defines a vesting period as [emphasis added]:

> The period during which **all the specified vesting conditions** of a share based payment arrangement **are to be satisfied**.

6. The vesting period is considered the period over which service is rendered in accordance with paragraph 15 of IFRS 2 that states [emphasis added]:

> 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, the 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.

*Potential diversity or confusion and its cause*

7. The current definition in IFRS 2 of vesting period states that it is the period during which <u>all</u> specified vesting conditions are to be satisfied. This definition therefore, presumes that if a share-based payment arrangement has multiple

vesting conditions, the interaction must be an ‘and’ interaction. Said another way, the current definition of vesting period does not appropriately reflect share-based payment arrangements that vest at the earlier of different vesting conditions being satisfied (ie an ‘or’ interaction).

8. When the vesting of an award depends on satisfying ‘either’ of multiple vesting conditions (ie an ‘or’ interaction):

    (a) some might determine the vesting period as the period during which <u>all</u> the specified vesting conditions are to be satisfied in compliance with the literal reading, and

    (b) others might determine the vesting period in practical terms as the period during which a the minimum conditions are to be satisfied (resulting in the employee to become entitled to the award) before the other conditions.

9. Additionally, within a share-based payment arrangement that has multiple vesting conditions, the current definition of vesting period does not provide clear guidance on the length of time the employee is required to provide service. The interaction between multiple vesting conditions is the cause of diversity in practice because of this lack of guidance.

*US GAAP*

10. US GAAP does not use a formal definition for the term ‘vesting period’. Instead, US GAAP sets out the definitions of: explicit service period, implicit service period, derived service period, and requisite service period. The FASB ASC Master Glossary (and ASC 718-10-20 Glossary) defines those terms as [emphasis added]:

    **Explicit Service Period**

    **A service period that is explicitly stated in the terms of a share-based payment award**. For example, an award stating that it vests after three years of continuous employee service from a given date (usually the grant date) has an explicit service period of three years. See Derived Service Period, Implicit Service Period, and Requisite Service Period.

    **Implicit Service Period**

> **A service period that is not explicitly stated in the terms of a share-based payment award but that may be inferred from an analysis of those terms and other facts and circumstances**. For instance, if an award of share options vests upon the completion of a new product design and it is **probable** that the design will be completed in 18 months, the implicit service period is 18 months. See Derived Service Period, Explicit Service Period, and Requisite Service Period.
>
> **Derived Service Period**
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> **A service period for an award with a market condition that is inferred from the application of certain valuation techniques** used to estimate fair value. For example, the derived service period for an award of share options that the employee can exercise only if the share price increases by 25 percent at any time during a 5-year period can be inferred from certain valuation techniques. In a lattice model, that derived service period represents the duration of the median of the distribution of share price paths on which the market condition is satisfied. That median is the middle share price path (the midpoint of the distribution of paths) on which the market condition is satisfied. **The duration is the period of time from the service inception date to the expected date of satisfaction (as inferred from the valuation technique)**. If the derived service period is three years, the estimated requisite service period is three years and all compensation cost would be recognized over that period, unless the market condition was satisfied at an earlier date. **Compensation cost would not be recognized beyond three years even if after the grant date the entity determines that it is not probable that the market condition will be satisfied within that period**. Further, an award of fully vested, deep out-of-the-money share options has a derived service period that must be determined from the valuation techniques used to estimate fair value. See Explicit Service Period, Implicit Service Period, and Requisite Service Period.
>
> **Requisite Service Period**
>
> **The period or periods during which an employee is required to provide service in exchange for an award under a share-based payment arrangement.** The service that an employee is required to render during that period is referred to as the requisite service. The requisite service period for an award that has only a service condition is presumed to be the vesting period, unless there is clear evidence to the contrary. If an award requires future service for vesting, the entity cannot define a prior period as the requisite service period. Requisite service periods may be explicit, implicit, or derived, depending on the terms of the share-based payment award.

11. US GAAP provides guidance on the period over which compensation costs should be recognised for share-based payment transactions. FASB ASC 718-10-30-25 states:

> An entity shall make its initial best estimate of the requisite service period at the grant date (or at the service inception date, if that date precedes the grant date) and shall base accruals of compensation cost on that period.

*Possible remedy*

12. The staff thinks that:

    (a) The definition of the vesting period in IFRS 2 could be clarified to deal with a single vesting condition. This notion would remain consistent with the guidance and examples illustrated by paragraph 15 of IFRS 2. Therefore, each vesting condition will have its own explicit or implicit vesting period.

    (b) The period of time over which a share-based payment transaction vests (and costs are recognised by the entity) could be captured by the addition of a new definition within IFRSs, the attribution period. This new definition would capture the end result of the interaction of each vesting period for a share-based payment transaction that has multiple vesting conditions. For a share-based payment transaction with only one vesting condition, the attribution period would be the same as the vesting period for that one vesting condition.

    (c) The IFRS 2 cost of the share-based payment transaction would be recognised by the entity over the attribution period.

13. The staff believes that the new concept capturing the period of time over which a share-based payment transaction vests (ie attribution period) can utilise the concepts included in the US GAAP definition of 'requisite service period'.

*Staff recommendation*

14. The staff recommends that:

    (a) the definition of the vesting period should be the explicit or implicit period over which an individual vesting condition will be satisfied; and

    (b) the new definition of attribution period should be incorporated into IFRS 2 as the end result of the interaction between the multiple vesting conditions. More specifically it will be the composite of the vesting periods of each individual vesting condition. This new definition will capture the concept of the period an employee is expected to provide services and a share-based payment award is expected to vest and the period over which compensation cost should be recognised.

### *Multiple vesting conditions*

*Current guidance of IFRS 2*

15. The guidance on how to determine the vesting period of a share-based payment transaction with a single vesting condition is set out in paragraph 15 of IFRS 2. In the staff's opinion, current IFRS 2 does not provide guidance on how to assess the interaction of multiple vesting conditions in order to determine the attribution period for a share-based payment transaction with multiple vesting conditions.

*Potential diversity or confusion and its cause*

16. In the staff's opinion, the lack of guidance on how to determine the attribution period for a share-based payment transaction with multiple vesting conditions has caused diversity in practice. In the staff's opinion, this diversity is linked to several other items within this project including the definition of vesting conditions and vesting period.

*US GAAP*

17. US GAAP provides specific guidance on how to determine or estimate the requisite service period for a share-based payment transaction that includes multiple conditions. This guidance addresses both 'and' interactions and 'or' interactions. FASB ASC 718-10-55-72 and 718-10-55-73 states [emphasis added]:

> 55-72 An award with a combination of market, performance, or service conditions may contain multiple explicit, implicit, or derived service periods. For such an award, the estimate of the requisite service period shall be based 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.**

18. Appendix A to this agenda paper provides FASB ASC 718-10-55-74 through 718-10-55-79. This guidance includes specific examples and also provides additional information and clarity on the subsequent accounting treatment for a share-based payment transaction with multiple conditions if there is a change in the assumptions used to determine the requisite service period (attribution period for IFRS 2).

*Possible remedy*

19. The staff believes the guidance on the interaction of multiple vesting conditions and their impact on the requisite service period (attribution period for IFRS 2) included in US GAAP is consistent with IFRS 2 and could be incorporated into IFRSs to provide clarity.

20. In addition to the guidance included in US GAAP, in the staff's opinion, a flowchart illustrating the steps used when determining the attribution period may provide clarity. The staff believe the flowchart would comprise the following three steps:

(a) Step 1 – Identify all specified vesting conditions within the share-based payment arrangement.

(b) Step 2 – Determine the explicit or implicit vesting period for each vesting condition.

(c) Step 3 – Compare the interaction of the individual vesting periods depending on the interaction of each vesting condition. That is are they ‘and’ conditions or ‘or’ conditions. The end result is the attribution period for the share-based payment arrangement.

21. Appendix B and Appendix C to this agenda paper include examples of the interaction of multiple vesting conditions. Appendix B illustrates the interaction between a service condition and a performance condition. Appendix C illustrates the interaction between a service condition and a market condition.

*Staff recommendation*

22. The staff recommends that the attribution period should be determined after considering the interaction between individual vesting periods. The staff also recommends that specific guidance be incorporated into IFRSs to provide clarity on the interaction of multiple vesting conditions. The staff recommends this guidance be consistent with the guidance presently existing in US GAAP.

## Questions for the Committee

23. The staff requests the Committee to provide the staff with guidance on the following questions:

| Question 1 – Vesting period |
| --- |
| 1. Does the Committee agree with the staff recommendation that the definition of the vesting period should be revised to be the vesting period for each individual vesting condition? |

| Question 2 – Attribution period |
| --- |
| 2. Does the Committee agree with the staff recommendation that a definition of the attribution period should be incorporated into IFRSs? |

| Question 3 – Multiple vesting conditions |
| --- |
| 3. Does the Committee agree with the staff recommendation that the attribution period should be determined based on the interaction between individual vesting periods and that specific guidance on the interaction of multiple vesting conditions should be incorporated into IFRSs? |

# Appendix A – US GAAP examples of the interaction of multiple vesting conditions

A1. These examples are included in FASB ASC 718-10-55-74 through 718-10-55-79.

**55-74** For example, a share option might specify that vesting occurs after three years of continuous employee service or when the employee completes a specified project. The employer estimates that it is probable that the project will be completed within 18 months. The employer also believes it is probable that the service condition will be satisfied. Thus, that award contains an explicit service period of 3 years related to the service condition and an implicit service period of 18 months related to the performance condition. Because it is considered probable that both the performance condition and the service condition will be achieved, the requisite service period over which compensation cost is recognized is 18 months, which is the shorter of the explicit and implicit service periods.

**55-75** As illustrated in the preceding paragraph , if an award vests upon the earlier of the satisfaction of a service condition (for example, four years of service) or the satisfaction of one or more performance conditions, it will be necessary to estimate when, if at all, the performance conditions are probable of achievement. For example, if initially the four-year service condition is probable of achievement and no performance condition is probable of achievement, the requisite service period is four years. If one year into the four-year requisite service period a performance condition becomes probable of achievement by the end of the second year, the requisite service period would be revised to two years for attribution of compensation cost (at that point in time, there would be only one year of the two-year requisite service period remaining).

**55-76** If an award vests upon the satisfaction of both a service condition and the satisfaction of one or more performance conditions, the entity also must initially determine which outcomes are probable of achievement. For example, an award contains a four-year service condition and two performance conditions, all of which need to be satisfied. If initially the four-year service condition is probable of achievement and no performance condition is probable of achievement, then no compensation cost would be recognized unless the two performance conditions and the service condition subsequently become probable of achievement. If both performance conditions become probable of achievement one year after the grant date and the entity estimates that both performance conditions will be achieved by the end of the second year, the requisite service period would be four years as that is the longest period of both the explicit service period and the implicit service periods. Because the requisite service is now expected to be rendered, compensation cost will be recognized in the period of the change in estimate (see paragraph 718-10-35-3) as the cumulative effect on current and prior periods of the change in the estimated number of awards for which the requisite service is expected to be rendered. Therefore, compensation cost for the first year will be recognized immediately at the time of the change in estimate for the awards for which the requisite service is expected to be rendered. The remaining unrecognized compensation cost for those awards would be recognized prospectively over the remaining requisite service period.

**55-77** As indicated in paragraph 718-10-55-75, the initial estimate of the requisite service period based on an explicit or implicit service period shall be adjusted for changes in the expected and actual outcomes of the related service or performance conditions that affect vesting of the award. Such adjustments will occur as the entity revises its estimates of whether or when different conditions or combinations of conditions are probable of being satisfied. Compensation cost ultimately recognized is equal to the grant-date fair value of the award based on the actual outcome of the performance or service conditions (see paragraph 718-10-30-15). If an award contains a market condition and a performance or a service condition and the initial estimate of the requisite service period is based on the market condition's derived service period, then the requisite service period shall not be revised unless either of the following criteria is met:

a. The market condition is satisfied before the end of the derived service period

b. Satisfying the market condition is no longer the basis for determining the requisite service period.

**55-78** How a change to the initial estimate of the requisite service period is accounted for depends on whether that change would affect the grant-date fair value of the award (including the quantity of instruments) that is to be recognized as compensation. For example, if the quantity of instruments for which the requisite service is expected to be rendered changes because a vesting condition becomes probable of satisfaction or if the grant-date fair value of an instrument changes because another performance or service condition becomes probable of satisfaction (for example, a performance or service condition that affects exercise price becomes probable of satisfaction), the cumulative effect on current and prior periods of those changes in estimates shall be recognized in the period of the change. In contrast, if compensation cost is already being attributed over an initially estimated requisite service period and that initially estimated period changes solely because another market, performance, or service condition becomes the basis for the requisite service period, any unrecognized compensation cost at that date of change shall be recognized prospectively over the revised requisite service period, if any (that is, no cumulative-effect adjustment is recognized).

**55-79** To summarize, changes in actual or estimated outcomes that affect either the grant-date fair value of the instrument awarded or the quantity of instruments for which the requisite service is expected to be rendered (or both) are accounted for using a cumulative effect adjustment, and changes in estimated requisite service periods for awards for which compensation cost is already being attributed are accounted for prospectively only over the revised requisite service period, if any

## Appendix B – Interaction of multiple vesting conditions (service condition and performance condition)

B1. The three steps to determine the attribution period of an award with multiple vesting conditions are illustrated with the following 4 examples:

| **Step 1**<br>**Identify vesting conditions** | | | **Step 2**<br>**Determine each vesting period** | | **Step 3**<br>**Compare their interaction** | **Attribution period** |
|---|---|---|---|---|---|---|
| **Service condition** | **Interaction** | **Performance condition** | **Explicit service period** | **Implicit service period embedded in performance condition (Note *1)** | | |
| 3 years of service | **or** | Meet the profit target (and remain in employment until then) | **3 years** | Initial : **2 years**<br>Revised : **4 years** | **Or**<br>**(Shortest period)** | Initial : **2 years**<br>Revised : **3 years** |
| 3 years of service | **or** | Meet the profit target (and remain in employment until then) | **3 years** | Initial : **4 years**<br>Revised : **2 years** | **Or**<br>**(Shortest period)** | Initial : **3 years**<br>Revised : **2 years** |
| 3 years of service | **and** | Meet the profit target (and remain in employment until then) | **3 years** | Initial : **2 years**<br>Revised : **4 years** | **And**<br>**(Longest period)** | Initial : **3 years**<br>Revised : **4 years** |
| 3 years of service | **and** | Meet the profit target (and remain in employment until then) | **3 years** | Initial : **4 years**<br>Revised : **2 years** | **And**<br>**(Longest period)** | Initial : **4 years**<br>Revised : **3 years** |

***Note *1*** The initial and revised implicit service period embedded in the performance condition are the result of the initial and subsequent period assessment of the length of time required to meet the performance condition.

## Appendix C – Interaction of multiple vesting conditions (service condition and market condition)

C1. The three steps to determine the attribution period of an award with multiple vesting conditions are illustrated with the following 4 examples:

| **Step 1 Identify vesting conditions** | | | **Step 2 Determine each vesting period** | | **Step 3 Compare their interaction** | **Attribution period** |
|---|---|---|---|---|---|---|
| **Service condition** | **Interaction** | **Market condition** | **Explicit service period** | **Implied service period embedded in market condition (Note *4)** | | |
| 3 years of service | **or** | Meet the share price target (and remain in employment until then) | **3 years** | Initial : **2 years**<br>Revised : **4 years** | **Or**<br>**(Shortest period)** | Initial : **2 years**<br>Revision is prohibited |
| 3 years of service | **or** | Meet the share price target (and remain in employment until then) | **3 years** | Initial : **4 years**<br>Revised : **2 years** | **Or**<br>**(Shortest period)** | Initial : **3 years**<br>***Note *2*** |
| 3 years of service | **and** | Meet the share price target (and remain in employment until then) | **3 years** | Initial : **2 years**<br>Revised : **4 years** | **And**<br>**(Longest period)** | Initial : **3 years**<br>Revision is prohibited |
| 3 years of service | **and** | Meet the share price target (and remain in employment until then) | **3 years** | Initial : **4 years**<br>Revised : **2 years** | **And**<br>**(Longest period)** | Initial : **4 years**<br>***Note *3*** |

***Note *2*** Paragraph 15 of IFRS 2 states that the estimate of the length of the expected vesting period of a market performance condition shall not be subsequently revised. However, this contradicts the general understanding of vesting period and entitlement. The former suggests that revision of the attribution period is prohibited and the latter suggests that if an award vests at an earlier date that the recognition of compensation cost is accelerated. If the attribution period is revised it would be **2 years** in this case.

***Note *3*** The same argument as (*1) can be made for this case. If the attribution period is revised it would be **3 years** in this case.

***Note *4*** The initial and revised implicit service period embedded in the market condition are the result of the initial and subsequent period assessment of the length of time required to meet the market condition.