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

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

Objective

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

2. The objective of this agenda paper is to:

   (a) provide a **summary of staff recommendations** made in agenda papers 3B and 3C;

   (b) outline the **expected impact and improvement** from the recommendations;

   (c) reiterate the **proposed classification (of vesting and non-vesting conditions)**;

   (d) test the proposed staff conditions through **application to specific examples**;

   (e) provide **related information on IFRS 2** for consideration by the Committee; and

   (f) includes **questions for the Committee**.

Summary of staff recommendations

3. The staff has performed analyses on the following items and provides the following staff recommendations for consideration by the Committee:

	Item	Staff recommendation
(a)	Vesting condition	The definition of vesting condition should be clarified to address/ incorporate the following: (1) the counterparty perspective, (2) a required explicit or implicit service requirement, and (3) the elimination of descriptions of specific conditions.
(b)	Non-vesting condition	A stand-alone definition of non-vesting condition should be incorporated into IFRSs and encompass all conditions that do not determine entitlement.
(c)	Service condition	A stand-alone definition of service condition should be incorporated into IFRSs and should be restricted to only a service requirement over a determined period of time.
(d)	Performance condition	A stand-alone definition of performance condition should be incorporated into IFRSs and should be restricted targets that relate to solely to an entity's operations or activities. Additionally, examples similar to those provided in the US GAAP definition should be incorporated.
(e)	Market condition	The definition of market condition should be removed from IFRS 2. Additionally, the concept of a market condition should continue to be captured as a vesting condition within the stand-alone definition of other vesting conditions.
(f)	Other vesting condition	A stand-alone definition of other vesting condition should be incorporated into IFRSs that should encompass all conditions that determine the counterparty's entitlement provided the condition is not categorised as a service or performance condition.
(g)	Contingent feature	Guidance on a contingent feature (inclusive of reload and non-compete provisions) as well as guidance on whether grant date measurement and subsequent measurements should be incorporated into IFRSs.
(h)	Vesting period	The definition of vesting period should be revised to capture the concept of the explicit or implicit service period required for an individual vesting condition.
(i)	Attribution period	A stand-alone definition of attribution period should be incorporated into IFRSs and capture the period of time over which the share-based payment award is recognised. This is the result of the interaction of multiple vesting conditions.
(j)	Multiple vesting conditions	Application guidance should be incorporated into IFRSs addressing the interaction of multiple conditions by either 'or' or 'and' conditions.

Expected impact and improvement

Convergence with US GAAP

4. The staff recommendations for this project propose that the perspective from which services embedded in vesting conditions are viewed switches from the current employer perspective (value received by employer) to the original IFRS 2 employee perspective (value paid by employee). This proposed change would make IFRS 2 consistent with the employee perspective used in US GAAP.

5. In the staff's opinion, there are limited (if any) changes in the underlying principles within IFRS 2, but the changes proposed in this project result in more consistent alignment between IFRSs and US GAAP in application. This is accomplished through clearer definitions. In the staff's opinion, clarity is provided specifically with respect to:

   (a) service condition;

   (b) performance condition;

   (c) vesting period (similar to the US GAAP definitions of explicit service period, implicit service period and derived service period);

   (d) attribution period (similar to the US GAAP definition of requisite service period); and

   (e) the guidance on the interaction of multiple vesting conditions.

Consistency with general understanding of common terminology

6. The definition of vesting condition proposed by the staff will capture all conditions that require either explicitly or implicitly the employee to provide service to the employer as a condition of entitlement of the equity instruments granted in a share-based payment transaction. The proposed definition will not be limited to a service condition and a performance condition. For example, a target based on a commodity index (classified as a non-vesting condition in current IFRS 2) may be a vesting condition (using the proposed definition) provided there is an explicit or implicit service requirement. In that case, the

proposed classification would result in this example being an other vesting condition.

Proposed introduction of concepts underlying different accounting treatment

7. The staff proposes the introduction of concepts that explain the split between the two different types of accounting treatments. Modified grant date accounting does not incorporate a service or performance condition into the grant date fair value as compared to grant date accounting that does incorporate a market condition into the grant date fair value. The staff believes a boundary between the two different types of accounting treatments currently exists based on whether the condition is able to be influenced by the employee. The following list lines up the various vesting conditions along the spectrum of the employee's ability to influence.

   (a) Conditions that are broadly within the employee's influence are those conditions that 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' for revisions to forfeiture estimates at each reporting period. They are either:

      (i) a service condition, which is within the control or direct influence of the employee; or

      (ii) a performance condition, which is within the direct influence of the employee.

   (b) Conditions that are broadly outside the employee's influence are those conditions that should be 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. They are either:

      (i) a market condition, which is not within the direct influence of the employee; or

      (ii) other vesting conditions, which are completely outside the influence of the employee.

Accounting treatment

8. The staff recommendations do not result in a change from current accounting treatment for vesting conditions and non-vesting conditions, except that:

    (a) Conditions (currently classified as non-vesting conditions, noted in the staff analysis as Type B conditions) that the employee can choose whether to meet and therefore conditions over which the employee has a direct influence (eg. paying contributions towards the exercise price of a share-based payment) would either be regarded as:

        (i) a performance condition provided the other requirements of the definition of a performance condition is satisfied (namely that an implicit service requirement exists and the target is based solely to the entity's operations or activities), or

        (ii) a non-vesting condition if the other requirements of the definition of a performance condition are not satisfied.

    (b) Conditions (currently classified as non-vesting conditions, noted in the staff analysis as Type C conditions) that the entity can choose whether to meet and therefore conditions over which the employee does not have a direct influence (eg. continuation of the plan by the entity) should be classified as neither vesting conditions nor non-vesting conditions. That is, these conditions should not be taken into account for accounting purposes when determining the grant date fair value of the share-based payment arrangement and should not be incorporated into the re-estimation of estimated forfeitures. Rather, these conditions should be accounted for at the time a modification, settlement or cancellation of the share-based payment arrangement occurs.

Proposed classification (of vesting and non-vesting conditions)

9. Appendix A to this agenda paper includes a chart that captures the proposed classification of vesting and non-vesting conditions based on the staff recommendations. The chart in Appendix A is a summary only and should not be used to address specific fact patterns.

Application to specific examples

10. This section of the agenda paper shows how the proposed classification applies to specific examples. All of the examples are examined on:

    (a) whether the conditions have an explicit, implicit or derived service condition; and

    (b) whether the conditions are broadly within the direct influence of the employee.

Non-compete provision

11. Some share-based arrangements that do not contain an explicit service condition may contain a non-compete provision that requires an employee to return to the entity the equity instruments granted by the share-based payment arrangement (or return an equivalent amount of cash or other assets) under certain conditions. Generally, a non-compete provision is relevant when the employee has already terminated employment with the entity and therefore, no future service will be provided by the employee. However, such a non-compete provision is often found within a share-based payment arrangement entered into when the employee is providing services to the entity (and there is no current intent by the employee to stop providing those services). In that situation, the staff believes, the non-compete provision is initially considered a contingent feature (ie the employee taking the specific action of working for a competitor). Additionally, the staff believes, the entire facts and circumstances of the non-compete provision should be reviewed to determine if there is an implicit service condition. The determination of whether a non-compete provision includes an implicit service condition is a matter judgment based on the facts and circumstances of the award.

Case A[1]

12. Entity A grants 100,000 restricted shares to an employee. The restricted shares are fully vested as of the date of grant, and retention of the restricted shares is not contingent on future service to Entity A. However, the restricted shares are transferred to the employee based on a 4-year delayed-transfer schedule (25,000 restricted shares to be transferred at the end of each of the 4 years) if and only if a specified non-compete provision is satisfied. The restricted shares are convertible into unrestricted shares any time after transfer.

13. There are some noteworthy fact patterns:

    (a) The fair value of the restricted shares represents approximately four times the expected future annual total compensation of the employee.

    (b) The non-compete provision requires that no work in any capacity may be performed for a competitor.

    (c) The non-compete provision lapses with respect to the restricted shares as they are transferred.

    (d) If the non-compete provision is not satisfied, the employee loses all rights to any restricted shares not yet transferred.

    (e) Additionally, the non-compete provision stipulates that Entity A may seek other available legal remedies, including damages from the employee, in the event the non-compete provision is broken. Entity A has determined that the non-compete provision is legally enforceable and has legally enforced similar arrangements in the past.

Case B[2]

14. Entity B grants an employee an award of 100,000 shares that vest upon the completion of 5 years of service. The shares become freely transferable upon vesting; however, the award provisions specify that, in the event of the employee's termination and subsequent employment by a direct competitor within three years after vesting, the shares or their cash equivalent on the date of

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[1] This example is extracted from ASC 718-20-55-87 through 718-20-55-92 in US GAAP.
[2] This example is extracted from ASC 718-20-55-84 through 718-20-55-86 in US GAAP.

employment by the direct competitor must be returned to Entity B for no consideration. The employee completes five years of service and vests in the award. Approximately two years after vesting in the share award, the employee terminates employment and is hired as an employee of a direct competitor.

Application of the new framework

15. In Case A, the substance of the arrangement may be assessed that the non-compete provision is designed to compensate the employee for future service despite the employee’s ability to terminate the employment relationship during the service period and retain the award. In other words, the non-compete provision may be considered an implicit service condition prompting continued employment (and continued rendering of service by the employee to the employer). This is because the restriction imposed on the employee’s ability to leave the entity and work for the entity’s competitor is severe, in the light of:

    (a) the magnitude of the award’s fair value in relation to the employee’s expected future annual total compensation (which in this case effectively doubles the total compensation given to the employee in each of the 4 years covered by this share-based payment arrangement).

    (b) the severity of the provision limiting the employee’s ability to work in the industry in any capacity.

    (c) the delayed-transfer schedule mirroring the lapse of the non-compete provision.

    (d) the provision’s legal enforceability.

    (e) the employer’s intent to enforce and past practice of enforcement.

16. Consequently, while judgement will be involved in reviewing the substance of the share-based payment arrangement, the non-compete provision in Case A is considered a vesting condition. More specifically, it is classified as a service condition, because the determination of whether the employee satisfies the non-compete provision is within the direct influence of the employee and there is no other condition such as a target attached.

17. In Case B, it may not be presumed that the non-compete provision is designed to compensate the employee for future service, because the employee must provide

5 years of service prior to the non-compete provision activating and the employee receives the shares upon vesting (prior to lapse of the non-compete provision) and may sell them immediately without restriction. Instead, the provisions in Case B should be treated as a contingent feature. This contingent feature that might cause the employee to return to the entity either equity instruments earned or realised gains from the sale of the equity instruments shall not be reflected in estimating the grant date fair value of the equity instrument. Instead, the effect of such a contingent feature shall be accounted for when the contingent event occurs.

Save-As-You-Earn (SAYE) plan

18. A typical SAYE plan has terms requiring employees to contribute periodically (eg monthly) a specified amount to an employee share trust. For example, employees are required to contribute to the SAYE plan for five years, after which they have the choice to either receive their cash back plus accrued interest or use the cash to acquire shares (often at a discount to the market price on the grant date). An employee that ceases paying contributions into the trust receives a reimbursement of all amounts saved to date, plus interest, but forfeits the employee’s right to acquire shares through the plan.

19. The condition to pay contributions into a SAYE plan generally requires the contributions to be withheld from current period compensation, therefore there is an implicit service condition. The staff requests the Committee to consider the impact on the accounting treatment of SAYE plans based on the Committee’s decisions taken in this project. The staff provide the following three views:

    (a) Using the new classifications and supporting rationale proposed by the staff, the condition to pay contributions into a SAYE plan should be considered a <u>performance condition</u> since it requires a service requirement (ie implicit service condition) and there is a specified target that must be met. The specified target is continued periodic payments into the SAYE plan and that on-going action is within the control or direct influence of the employee. In the event an employee decides to stop making periodic contributions into a SAYE plan, the result would be a forfeiture of the award by the employee. Therefore, the entity would reverse previously recognised compensation costs.

(b) Using the new classifications and supporting rationale proposed by the staff, the condition to pay contributions into a SAYE plan should be considered an other vesting condition since it requires a service requirement (ie implicit service condition), but the specified target that must be met (of continued periodic payments into the SAYE plan) does not meet the strict definition of a performance condition as it is not a target related solely to the entity's operations or activities. In the event an employee decides to stop making periodic contributions into a SAYE plan, there would be no change (provided the employee continues to remain in service) to the originally determined accounting. The entity would continue to recognise the compensation costs determined as of the grant date of the award.

(c) Retaining the current guidance in paragraph IG24 of IFRS 2, the condition to pay contributions into a SAYE plan is considered a non-vesting condition. The event of an employee deciding to stop making periodic contributions into a SAYE plan is considered a cancellation of the award (whether or not the employee continues to remain in service). Therefore, the entity would accelerate and immediately recognise all remaining previously unrecognized compensation cost that was determined as of the grant date of the award.

Multiple vesting conditions

20. The staff has introduced a three step process when determining the attribution period for a share-based payment arrangement with multiple vesting conditions. That three step process is:

(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.

Related information on IFRS 2

22. An additional item for consideration by the Committee, is that the Board and Committee continue to receive requests to review IFRS 2. Requests recently received by the Committee that have not yet been analysed by the staff include:

(a) The determination of whether share-based payment arrangements that lapse as a result of employee termination should be accounted for as cancellations or forfeitures.

(b) The ability of an entity to net settle share-based payment transactions for the purpose of withholding equity instruments to settle employee income tax obligations.

23. The staff intends to bring an analysis of these items to a future Committee meeting. This will permit the Committee to deliberate (and tentatively conclude on) the items in this project that may assist the Committee in its deliberation on these additional IFRS 2 items. See the Committee work in progress Agenda Paper 19 for additional information including the submissions received without modification, except for changes to provide anonymity to the submitter.

Questions for the Committee

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

Question – Overall project
1. Does the Committee agree with the staff recommendations for this project? 2. What does the Committee recommend as the next steps to be taken by the staff?

Appendix A — Summary chart of proposed classification based on staff recommendations

A1. 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><th>Service condition</th><th>Performance condition</th><th>Other vesting condition</th><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>

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 examples:

Step 1 **Identify vesting conditions**			**Step 2** **Determine each vesting period**		**Step 3** **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** Revised : **4 years**	**Or** **(Shortest period)**	Initial : **2 years** Revised : **3 years**
3 years of service	**or**	Meet the profit target (and remain in employment until then)	**3 years**	Initial : **4 years** Revised : **2 years**	**Or** **(Shortest period)**	Initial : **3 years** Revised : **2 years**
3 years of service	**and**	Meet the profit target (and remain in employment until then)	**3 years**	Initial : **2 years** Revised : **4 years**	**And** **(Longest period)**	Initial : **3 years** Revised : **4 years**
3 years of service	**and**	Meet the profit target (and remain in employment until then)	**3 years**	Initial : **4 years** Revised : **2 years**	**And** **(Longest period)**	Initial : **4 years** 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 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** Revised : **4 years**	**Or** **(Shortest period)**	Initial : **2 years** Revision is prohibited
3 years of service	**or**	Meet the share price target (and remain in employment until then)	**3 years**	Initial : **4 years** Revised : **2 years**	**Or** **(Shortest period)**	Initial : **3 years** ***Note *2***
3 years of service	**and**	Meet the share price target (and remain in employment until then)	**3 years**	Initial : **2 years** Revised : **4 years**	**And** **(Longest period)**	Initial : **3 years** Revision is prohibited
3 years of service	**and**	Meet the share price target (and remain in employment until then)	**3 years**	Initial : **4 years** Revised : **2 years**	**And** **(Longest period)**	Initial : **4 years** ***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.