Project	**Interpretations Committee: IFRS 2 *Share-based Payment***
Topic	***Vesting and Non-vesting conditions***

Purpose of this paper

1. The purpose of this paper is to:

   (a) inform the Board of the status of IFRS 2 *Share-based Payment* issues deliberated by the IFRS Interpretations Committee (Committee), and

   (b) request the Board provide the Committee with recommendations on how to proceed with the Committee's active agenda project *Vesting and Non-vesting Conditions*.

2. This Agenda Paper includes:

   (a) a **background** of the issues included in this project**;**

   (b) the **Committee status** to date**;**

   (c) the **staff recommendations; and**

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

Background

Background

3. In January 2008, the Board issued *Vesting Conditions and Cancellations* (Amendment to IFRS 2). The objective of that Amendment to IFRS 2 was to clarify the distinction between vesting and non-vesting conditions. Despite that

Amendment to IFRS 2, the Committee has received successive requests to resolve various issues in regard of the distinction between conditions as vesting and non-vesting conditions (or neither).

4. The Committee has deliberated the issues received over the past several Committee meetings and has tentatively reached conclusions on these and how IFRS 2 could be amended to eliminate the current diversity in practice for these issues.

Issues

Issue 1 – Correlation between an employee's responsibility and the performance target

5. What, if any, level of linkage (correlation) is required between a performance target and an individual employee's actions in order for that condition to be a performance condition?

6. For example, there is a clear correlation between the actions of a salesperson and a revenue target, so a revenue target for such an employee is generally accepted as a performance condition when accompanied by an implicit or explicit service requirement. However, would it be acceptable for a revenue target to be classified as a performance condition for a share-based payment award granted to a purchasing manager?

Issue 2 – Share market index target

7. When a share market index target determines how long the employees must provide service for the entity, should the target be considered (i) a performance condition or (ii) a non-vesting condition?

8. An example is the grant is conditional on the FTSE 100 reaching a specified target (say 6,500) at any point in time in the next three years and the employee remaining in service up to the date that the FTSE 100 target is met.

Issue 3 – Performance period longer than the required service period

9. When the achievement of a performance target continues to be assessed over a period of time longer than that in which the employee is required, explicitly or implicitly, to provide direct service for the benefit of the entity. Should such a performance target be considered (i) a performance condition or (ii) a non-vesting condition?

10. An example is a share-based payment award that is conditional on the employee providing service for the entity over the next two years and for which the ultimate 'value' is determined at the end of the third year based on whether the entity achieves a cumulative profit target.

Issue 4 – Non-compete provision

11. Should a non-compete provision be considered (i) a service condition, (ii) a non-vesting condition or (iii) an other type of condition not defined in IFRS 2 (which the staff have recommended the term 'contingent feature', for discussion purposes)?

12. An example is a share (or share option) that has been awarded as compensation in a share-based payment arrangement. The share is vested and the counterparty is therefore entitled to the share; however, the share includes a clawback provision that requires the counterparty to refrain from competing against the entity (typically by refraining from employment with a competitor of the entity) for a specified period of time. If in the future specified period of time, the counterparty breaches the non-compete provision, the counterparty is required to return share (or the gain from the sale of the share).

Issue 5 – Interaction of multiple vesting conditions

13. Over which period should compensation cost be recognised for a share-based payment transaction when it includes more than one vesting condition?

14. An example is the grant that is conditional on the counterparty providing service for the entity for the next 5 years or the cumulative profit of the entity has

increased CU 10 million at any point in time in the next 8 years (provided the counterparty remains an employee until the performance condition is satisfied).

Issue 6 – Termination of employment

15. When the employment of an employee is terminated by the entity, with respect to the share-based payment transaction, should the termination be considered as a (i) forfeiture (ie the employee failing to meet a service condition and a reversal of past expense) or (ii) cancellation (ie the entity directly cancelling the grant, and an acceleration of any expense not yet recognised)?

Committee status

Root cause for the issues

16. The Committee notes that there is:

    (a) a lack of clarity in the current definition of vesting conditions which incorporates the concepts of service conditions, performance conditions and market conditions (and vesting period);

    (b) an absence of the definition of non-vesting conditions; and

    (c) no guidance on the interaction of multiple vesting conditions.

Technical aspect

17. The Committee analysed each of the issues and sought solutions consistent with the underlying principles in IFRS 2. Based on the deliberations of several meetings, the Committee has reached conclusions on those issues.

Procedural aspect

18. The Committee also considered several paths forward to incorporate its conclusions into IFRS 2. The Committee considered finalisation of this project as:

(a) an Interpretation;

(b) an Annual Improvement;

(c) a separate amendment project to IFRS 2; or

(d) as part of the potential post-implementation review of IFRS 2.

19. However, the Committee had a diversity of views with respect to the appropriate path to take given the magnitude, effectiveness and timeliness of the issues and the proposed changes required to address the issues. Therefore, the Committee requests the views of the Board on how to proceed with this project.

20. Draft wording of the amendments the staff thinks would achieve the clarifications needed to address the issues considered was provided to the Interpretations Committee at the September 2010 meeting. An extract of this wording is included in Appendix B to this paper for illustrative purposes only. The Board should note that this wording is a work in progress and is provided in this paper to illustrate the nature and extent of the amendments that the staff is proposing. The staff is not asking for comments from the Board on these draft amendments at this stage.

Staff recommendation

21. The staff thinks that the issues satisfy agenda criteria for *Annual Improvements* and thus recommends that they should be added to the next cycle of *Annual Improvements* (with the next exposure draft anticipated to be published in Q4 2010) The staff's assessment against the criteria is shown in Appendix A.

Questions for the Board

22. The staff requests the Board answer the following question:

Question 1

1. Does the Board agree with the staff recommendation that the issues should be addressed through *Annual Improvements*?

Question 2

2. If not, what other option does the Board want to take or recommend that the Committee take?

Appendix A — The staff's assessment against the proposed agenda criteria for *Annual Improvements*

A1. The staff provides the proposed criteria for Annual Improvements included in *The annual improvements process: Proposals to amend the Due Process Handbook for the IASB* published in August 2010.

> In planning whether an issue should be addressed by amending IFRSs within the annual improvements project, the IASB assesses the issue against the following criteria. All criteria (a)–(d) must be met to qualify for inclusion in annual improvements.
>
> (a) The proposed amendment has one or both of the following characteristics:
>
> (i) clarifying–the proposed amendment would improve IFRSs by:
>
> - clarifying unclear wording in existing IFRSs, or
> - providing guidance where an absence of guidance is causing concern.
>
> A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.
>
> (ii) correcting–the proposed amendment would improve IFRSs by:
>
> - resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirement should be applied, or.
> - addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs.
>
> A correcting amendment does not propose a new principle or a change to an existing principle, but may create an exception to an existing principle, for example an omitted consequential amendment from a recent change to an IFRS.
>
> *[Staff analysis – This criterion is satisfied. There is a need for clarification of the definitions relating to vesting conditions.]*
>
> (b) The proposed amendment has a narrow and well-defined purpose, i.e., the consequences of the proposed change have been considered sufficiently and identified.
>
> *[Staff analysis – This criterion is satisfied. The issue is sufficiently narrow, has a well-defined purpose, and significant outreach has been performed to ensure the proposed changes have been considered sufficiently and identified.]*

(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach a conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.

[Staff analysis – This criterion is satisfied. The staff note that the Committee has been able to address these issues on a timely basis and thinks that the Board should be in a position to also reach conclusion on a timely basis. The issues can be sufficiently tackled by clarification of current wording in IFRS 2 that will provide increased clarity for the issues where diversity currently exists while not significantly impacting one of or the primary accounting treatment that exists in practice for each of the issues.]

(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a pressing need to make the amendment sooner than the project would.

[Staff analysis – This criterion is satisfied. There is no current IASB project on IFRS 2.]

Appendix B – Proposed drafting

A1. This appendix is an extract from Agenda Paper 2C from the IFRS Interpretations Committee meeting in September 2010. As such it is a work in progress, and is provided for illustrative purposes only. Comments on the draft amendments are not requested from the Board at this stage.

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.

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 estimate of the length of the expected vesting period based on a market or other vesting condition shall be consistent with the assumptions used in estimating the fair value of the options granted, and shall not be subsequently revised.</u>

[The above paragraph is amended to set out separate guidance on market or other vesting conditions.]

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*. Paragraphs B41D and B41E contain further guidance on the determination of the attribution period.

[The above paragraph is added to set out separate guidance on 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,~~ Service conditions and performance conditions shall not be taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, ~~vesting conditions~~ service conditions and performance 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~~.

[The above paragraph is amended to directly refer to service conditions and performance conditions.]

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~~.

[The above paragraph is amended because a market condition is no longer an example of performance conditions.]

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.

[The above paragraph is amended to combine market conditions and other vesting condition because they are accounted for in the same way.]

Treatment of non-vesting conditions

21A ~~Similarly, a~~ An entity shall take into account all non-vesting conditions, such as a restriction on post-vesting transfer or a performance target that does not include required service, 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.

[The above paragraph is amended to give an example of non-vesting conditions.]

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 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.

[The above paragraph is amended to extend the guidance on a reload feature to all other contingent features.]

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(c) 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.

[The above paragraph is amended to cover the case in which an attribution period should be determined because there are multiple vesting conditions.]

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.

[The above paragraph is amended to cover the case in which an attribution period should be determined because there are multiple vesting conditions.]

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)~~ a service condition and/or a performance condition 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.

[The above paragraph is amended to directly refer to service conditions and performance conditions.]

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.

[The above paragraph is amended to directly refer to service conditions and performance conditions.]

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 or other vesting condition or non-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.

[The above paragraph is amended to specify the types of condition that should be incorporated into the measurement of fair value.]

Appendix A Defined terms

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

attribution period (and required service)
The period:

(a) during which an employee is required to provide service in exchange for an award; and

(b) over which the required combination of vesting conditions is to be met

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*.

contingent feature
A feature that is dependent on the occurrence of the counterparty's action after an award has vested.

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

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

(b) the achievement of a specified target while the counterparty is rendering the service required in (a) other than such a performance target as is described in the definition of performance condition.

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

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

(b) achieving a specified performance target while the counterparty is rendering the service required in (a) and where that specified performance target 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 in a consolidated group.

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. If the counterparty, regardless of the reason, ceases to provide service during the vesting period, the counterparty has failed to satisfy the condition.

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**.~~

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