
Project	IFRS 2 <i>Share-based Payment</i>
Topic	Additional analysis of specific fact patterns

Purpose of this paper

1. The objective of this agenda paper is to provide the IFRS Interpretations Committee with a follow-up analysis on accounting for two specific fact patterns: (1) a non-compete provision and (2) a performance target exceeding the required service period.
2. This Agenda Paper includes:
 - (a) **background;**
 - (b) **staff analysis;**
 - (c) **staff recommendation; and**
 - (d) **questions for the Committee.**

Background

3. At the July 2010 Committee meeting, the staff analysed a set of examples to illustrate the current accounting treatment(s) applied in practice and how the staff proposal would apply to each example. At that meeting, the staff proposed, in part, that:

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRS Interpretations Committee.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRS Interpretations Committee or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

Decisions made by the IFRS Interpretations Committee are reported in *IFRIC Update*.

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- (a) a non-compete provision should be presumed to be a ‘contingent feature’. (Refer to Appendices B and C to the [July 2010 Committee Agenda Paper 3C](#)); and
 - (b) a performance target should be fully combined with an explicit or implicit service requirement for the entire period between grant date and the performance target date in order to constitute a performance condition. (Refer to Appendix G to the [July 2010 Agenda Paper 3C](#))
4. At the July 2010 Committee meeting, some Committee members raised the following views as arguments against the staff proposals:
- (a) The employee refraining from working for the entity’s competitor in compliance with a non-compete provision should be considered to be the employee providing ‘service’ towards the entity; and
 - (b) A performance target should be taken to constitute a performance condition even if its achievement is determined over the period exceeding the period that the employee is required to provide service.
5. Some Committee members indicated that the staff should perform additional analysis on the issues of a non-compete provision and a performance target exceeding a required service period. Therefore, the staff conducted a follow-up analysis on those two issues and is included in this paper.

Staff analysis

Non-compete provision

Rationale for a non-compete provision as a service condition

6. Some believe that the employee is providing service for the entity as long as he or she refrains from working for the entity’s competitor, whether in employment with the entity or not. They make the case by referring to paragraph 8 of SIC 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*, which states [emphasis added]:

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The criteria in paragraph 20 of IAS 18 shall be applied to the facts and circumstances of each arrangement in determining when to recognise a fee as income that an Entity might receive. Factors such as **whether there is continuing involvement in the form of significant future performance obligations necessary to earn the fee**, whether there are retained risks, the terms of any guarantee arrangements, and the risk of repayment of the fee, shall be considered. Indicators that individually demonstrate that recognition of the entire fee as income when received, if received at the beginning of the arrangement, is inappropriate include:

- (a) **obligations either to perform or to refrain from certain significant activities are conditions of earning the fee received**, and therefore execution of a legally binding arrangement is not the most significant act required by the arrangement;
- (b) limitations are put on the use of the underlying asset that have the practical effect of restricting and significantly changing the Entity's ability to use (eg deplete, sell or pledge as collateral) the asset;
- (c) the possibility of reimbursing any amount of the fee and possibly paying some additional amount is not remote. This occurs when, for example,
 - (i) the underlying asset is not a specialised asset that is required by the Entity to conduct its business, and therefore there is a possibility that the Entity may pay an amount to terminate the arrangement early; or
 - (ii) the Entity is required by the terms of the arrangement, or has some or total discretion, to invest a prepaid amount in assets carrying more than an insignificant amount of risk (eg currency, interest rate or credit risk). In this circumstance, the risk of the investment's value being insufficient to satisfy the lease payment obligations is not remote, and therefore there is a possibility that the Entity may be required to pay some amount.

7. Also, paragraph 4 of IAS 18 *Revenue* provides an explanation about the meaning of service as follows [emphasis added]:

The rendering of services typically involves the performance by the entity of a contractually agreed task over an agreed period of time. The services may be rendered within a single period or over more than one period. Some contracts for the rendering of services are directly related to construction contracts, for example, those for the services of project managers and architects. Revenue arising from these contracts is not dealt with in this Standard but is dealt with in accordance with the requirements for construction contracts as specified in IAS 11 Construction Contracts.

8. Although these paragraphs address the situation where the entity 'provides' service rather than 'receives' service, some believe that these paragraphs support

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the argument that a non-compete provision should be considered a service condition in the context of IFRS 2. In their opinion, the significant performance (ie rendering of service) by the (former) ‘employee’ in return for a share-based payment award includes not only providing direct service (ie doing a positive act for the entity) but also providing indirect service (ie refraining from doing a negative act against the entity).

Staff view

9. The staff acknowledges that there is a merit in reviewing other guidance in IFRSs (including on revenue recognition), because that guidance may give a hint at the general meaning of ‘service’ across IFRSs. Nonetheless, the staff does not agree with the rationale that a non-compete provision is a service condition within the context of IFRS 2 for the following reasons:
 - (a) Even for the purpose of revenue recognition, it is not clear-cut in general terms whether the rendering of services includes not only doing a positive act but also refraining from doing a negative act since SIC 27 requires a ‘significant’ activity.
 - (b) In US GAAP, refraining from working for the entity’s competitor in compliance with the non-compete provision is presumed to be a contingent feature that has no current consequence on the share-based payment transaction.
 - (c) If refraining from working for the entity’s competitor in compliance with the non-compete provision is considered to be ‘providing service towards the entity’, an additional issue needs to be considered because the service is provided by the counterparty not in his or her capacity as an employee but in his or her capacity as a non-employee (ie former employee).
10. First, IAS 18 does not spell out the nature of the performance by the entity which is said to be the typical part of the rendering of services. SIC 27 includes a reference to IAS 18 and paragraph 8 of SIC 27 states that the obligation to

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refrain from certain significant activities is an example of an obligation necessary to recognise the fee as income. However, the staff thinks that it is not appropriate to analogise to paragraph 8 of SIC 27 because it addresses only a specific transaction (lease).

11. The staff checked whether the nature of the performance by the entity might be explored in the light of the proposed definition of performance obligation in the Exposure Draft *Revenue from Contracts with Customers* (Revenue ED) published in June 2010 [emphasis added]:

An enforceable promise (whether explicit or implicit) in a contract with a customer to **transfer** a good or **service to the customer**.

12. However, the staff notes that the Revenue ED does not provide any guidance or examples of an entity satisfying its performance obligations by specifically not performing a specific task or function. The staff notes paragraph 28 of the Revenue ED discusses protective rights and states:

If an entity retains some rights to an asset solely as protection against the customer's failure to comply with the terms of the contract (for example, when an entity retains legal title as protection against the customer's failure to pay), those rights are protective rights and do not preclude a customer from obtaining control of an asset.

13. In the staff's opinion, it may be appropriate to think of non-compete provisions and the consequential clawback features if a non-compete provision is broken as a protective right included within a share-based payment award provided to an employee (or soon to be former employee) as a means to protect the entity's value that was previously created as a result of the employees prior employment activities.
14. Second, US GAAP guidance and its implementation in practice views a non-compete provision as a remedy option for the entity without requiring a substantive service requirement in case that the former employee competes against the entity. This remedy is the 'clawback feature' (a contingent feature).
15. US GAAP also provides guidance on assessing whether a non-compete provision is intended to prevent the former employee from competing against the entity or whether the non-compete provision may help the entity retain the

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employee in employment. Consistent practice has evolved in the application of US GAAP such that substantially all non-compete provisions are deemed to be provisions to prevent future competition.

16. Against this background, the staff notes that if a non-compete provision is considered to be a service condition in the context of IFRS 2, the accounting for a non-compete provision will diverge with US GAAP.
17. Third, if refraining from working for the entity's competitor in compliance with the non-compete provision is considered to be 'providing service towards the entity', an additional issue needs to be considered because the service is provided by the counterparty not in his or her capacity as an employee but in his or her capacity as a non-employee (ie former employee).
18. Current IFRS 2 requires different guidance to be applied to the share-based payment transactions with employees and non-employees for the measurement of equity-settled share-based payment transactions. IFRS 2 states [emphasis added]:
 - 11 To apply the requirements of paragraph 10 to **transactions with employees and others providing similar services**, the entity shall measure the fair value of the services received by reference to the fair value of the equity instruments granted, because typically it is not possible to estimate reliably the fair value of the services received, as explained in paragraph 12. **The fair value of those equity instruments shall be measured at grant date.**
 - 13 To apply the requirements of paragraph 10 to **transactions with parties other than employees**, there shall be a rebuttable presumption that the fair value of the goods or services received can be estimated reliably. **That fair value shall be measured at the date the entity obtains the goods or the counterparty renders service.** In rare cases, if the entity rebuts this presumption because it cannot estimate reliably the fair value of the goods or services received, the entity shall measure the goods or services received, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted, **measured at the date the entity obtains the goods or the counterparty renders service.**
19. In turn, Appendix A of IFRS 2 defines 'employees and others providing similar services' as [emphasis added]:

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Individuals who render personal services to the entity and either **(a) the individuals are regarded as employees for legal or tax purposes, (b) the individuals work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes, or (c) the services rendered are similar to those rendered by employees.**

For example, the term encompasses all management personnel, ie those persons having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors.

20. The staff notes that the service generated from the counterparty complying with the non-compete provision:
- (a) may be rendered even if the counterparty is not an employee for legal or tax purposes;
 - (b) is too indirect to be tantamount to ‘work’; and
 - (c) is not similar to ordinary services rendered by employees, which usually involve doing an action rather than doing an inaction.
21. Therefore, the share-based payment transaction subject to only a non-compete provision is considered to be a transaction with parties other than employees and paragraph 13 of IFRS 2 should be applied to the service condition resulting from refraining from working for the entity’s competitor in compliance with the non-compete provision. In the staff’s opinion, application of the measurement guidance for equity-settled share-based payment awards issued to non-employees would be difficult in the context of a non-compete provision. The entity would be required to determine the value of the lack of competition that results from the former employee not competing for a specified period of time in the future.
22. In summary, the staff thinks that the argument that the employee is providing service for the entity as long as he or she refrains from working for the entity’s competitor, whether in employment with the entity or not, is not appropriate for the purpose of this agenda project.

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Performance target exceeding a required service period

Rationale for a performance target that exceeds a required service period to be considered a performance condition

23. Some believe that a performance target should be taken to constitute a performance condition even if the achievement of the performance target is assessed over the period exceeding the period that the employee is required to provide service. The rationale for this view is supported by the fact that current IFRS 2 does not explicitly require a performance target to be fully combined with a service requirement for it to constitute a performance condition.
24. The definition of vesting conditions in current IFRS 2 describes performance conditions as follows [emphasis added]:

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**).

The arguers think that 'a specified period of service' does not have to be as long as or can be longer than 'a specified period of time (for the performance target)', therefore 'a specified period of service' is allowed to be shorter than 'a specified period of time (for the performance target)'.

Current practice

25. The practice under current IFRS 2 indicates that there is the prevalent view that if a performance target's achievement is only determined after any required service period, then the performance target does not constitute a performance condition. This view is held by each of the four largest international accounting firms:
 - (a) Deloitte iGAAP 2010 – A guide to IFRS reporting, Chapter 27 Share-based payment, 3.2.1 Equity-settled share-based payment transactions;
 - (b) Ernst&Young International GAAP 2010 – Generally Accepted Accounting Practice under IFRS, Chapter 27 Share-based payment, 3.2 Conditions that are neither service conditions nor performance conditions ('non-vesting' conditions);

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- (c) KPMG Insights into IFRS 2009/10 – KPMG’s practical guide to IFRS, Section 4.5 Share-based payment, 4.5.400 Initial public offerings (IPOs); and
- (d) PwC Manual of accounting IFRS 2010, Chapter 12 Share-based payment, Performance conditions, 12.91.

Staff view

- 26. The staff acknowledges that the specific description of performance conditions (included within the definition of vesting conditions) does not provide explicit guidance on the required periods of time associated with a performance target as compared to the explicit or implicit service requirement. However, the staff notes that the definition of vesting conditions makes clear that a vesting condition (including a performance condition) must ‘determine whether the entity receives the services that entitle the counterparty to receive’ the share-based payment.
- 27. In the light of that requirement, the staff thinks that the argument that a performance target should be taken to constitute a performance condition even if the achievement of the performance target is assessed over the period exceeding the period that the employee is required to provide service, is not sustainable because:
 - (a) the employee is free to leave the entity after the required service period has passed; and hence
 - (b) the performance target only may not determine whether the entity receives the ‘services’ that entitle the counterparty to receive the share-based payment after that period.
- 28. The proposed new definition of a performance condition included in Paper 2C for this meeting defines performance conditions as follows:

A condition affecting the vesting, exercise price, or other pertinent factors used in determining the fair value_of an award that relates to both:

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- (a) a counterparty's rendering service for a specified (either explicitly or implicitly) period of time, and
- (b) achieving a specified performance target that is defined by reference to:
 - (i) the employer's own operations (or activities); or
 - (ii) the same performance measure of another entity or group of entities,

while the counterparty is rendering the required service.

29. The staff believes that the new definition of performance conditions proposed in Agenda paper 2C will add to the clarity, will reflect the prevalent view in current practice and will not create divergence with US GAAP (given that the staff recommendation is consistent with one of three views accepted in the application of US GAAP).

Staff recommendation

30. The staff reaffirms its recommendations made at the July 2010 Committee meeting and recommends that:
- (a) a non-compete provision should be presumed to be a 'contingent feature'; and
 - (b) a performance target must be fully combined with an explicit or implicit service requirement in order to constitute a performance condition. A performance target that does not have a fully combined explicit or implicit service requirement shall be considered a non-vesting condition. That is, a performance target that is determined after the required service period shall be considered a non-vesting condition.

Questions for the Committee

31. The staff requests the Committee answer the following questions:

Question 1 – Non-compete provision

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1. Does Committee agree with the staff recommendation that a non-compete provision should be presumed to be a 'contingent feature'?

Questions 2 and 3 – performance target exceeding a required service period

2. Does Committee agree with the staff recommendation that a performance target should be fully combined with an explicit or implicit service requirement in order to constitute a performance condition?
3. Does the Committee agree with the staff recommendation that a performance target that does not have a fully combined explicit or implicit service requirement shall be considered a non-vesting condition?