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

Topic **Accounting for share-based payment awards upon an entity's termination of an employee**

Objective and introduction

1. The objective of this paper is to examine the accounting treatment of share-based payment awards when the entity terminates the employment of an employee.

2. This Agenda Paper includes:

   (a) background;

   (b) staff analysis;

   (c) agenda criteria assessment for the Committee;

   (d) staff recommendation; and

   (e) questions for the Committee.

3. The following appendices to this paper are provided for reference:

   (a) Appendix A – draft wording for the *IFRIC Updat*e prepared on a consistent basis with the staff recommendations.

   (b) Appendix B – the original request received by the IFRS Interpretations Committee (Committee).

   (c) Appendix C – selected excerpts from IFRS 2 *Share-based Payment*.

   (d) Appendix D – Large international accounting firm guidance.

Background

4. In January 2010, the Committee received a request to add to its agenda a project to clarify the accounting treatment of share-based payment awards in the event of the employer's termination of the employee (ie an involuntary termination).

5. Paragraph 19 of IFRS 2 requires that on a cumulative basis no amount should be recognised for service received if equity instruments granted do not vest because of failure to satisfy a service condition, ie because the employee fails to complete a specified service period.

6. Conversely, paragraph 28 of IFRS 2 requires that the entity should recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period if a grant of equity instruments is cancelled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied).

7. There is no specific guidance on the effect to the share-based payment award resulting from the entity's termination of the employee.

8. Against this background, the request asks the Committee to clarify whether the effect resulting from the entity's termination of employment should be accounted for as a forfeiture event by the employee of the award or a cancellation by the employer of the award.

9. In the staff's opinion, this issue is related to and should be considered in light of the Committee's agenda project *Vesting and Non-vesting Conditions*. The September 2010 Committee Papers 2A-2C address that project. As part of that project, the staff are recommending the concept that the employee providing service to 'pay' for a share-based payment (as noted in paragraph BC171 of IFRS 2) must be an active act by the employee to provide service directly to the entity (or at the entity's direction in order to be considered 'providing service' in the context of IFRS 2. Similarly, if an employee does not provide service directly to the entity it should not be considered 'providing service' in the context of IFRS 2.

Staff analysis

Diverse views

10. The staff are aware of three views that exist in practice regarding the accounting treatment of a share-based payment award in the event of the entity's termination of employment:

    (a) **View A – Forfeiture –** Focus is on the fact that the employee fails to satisfy the service condition. It does not matter why the employee failed to complete the specified period of service.

    (b) **View B – Cancellation –** Focus is on the entity, at its will, terminating the employment of the counterparty. The actions of the entity terminating the counterparty's employment indirectly result in the counterparty being precluded from satisfying the service condition.

    (c) **View C – Forfeiture or Cancellation –** Focus is on <u>why</u> the employee failing to complete the specified period of service:

        (i) **Forfeiture –** Employer's termination of employment for some cause of the counterparty such as gross misconduct should be accounted for as a forfeiture, ie failure to satisfy the service condition because refraining from gross misconduct is an implicit part of the service condition.

        (ii) **Cancellation –** Employer's termination of employment in circumstances other than 'for cause' should be accounted for as a cancellation because the entity unilaterally precludes the counterparty from satisfying the service requirement.

Staff analysis

11. Current IFRS describes a service condition within the definition of vesting conditions in IFRS 2 as follows:

    > Service conditions require the counterparty to complete a specified period of service.

12. The staff notes that IFRS 2 (see Appendix C for relevant excerpts of IFRS 2):

    (a) regards the employee's failure to complete a specified service period as failure to satisfy a service condition in paragraph 19 of IFRS 2;

    (b) does not make any difference as to why the employee has failed to complete a specified service period; and

    (c) isolates cancellation events from the instances where vesting conditions are not satisfied in paragraph 28.

Vesting period is one unit of account

13. In the staff's opinion, the vesting period ('attribution period' using the definitions recommended by the staff in the September 2010 Committee Paper 2C), should be seen as one unit of account. The employee either does or does not provide service for the entire required vesting period of the applicable share-based payment award.

14. In a cancellation event, the entity has effectively refused to 'pay' the employee in accordance with a share-based payment arrangement. A cancellation event is wholly in the entity's control and may occur independently from the employment status of the employee. A cancellation event may also occur at a any point in time independently of the point in time within the vesting period.

15. In a forfeiture event, the entity has not received the entire one unit of account (ie vesting period) of services agreed upon at inception of the share-based payment arrangement. Therefore, the entity is not obligated to 'pay' for any portion of the service received.

Purpose of entity's decisions

16. In the staff's opinion, the purpose of the entity's decisions provides insight into the primary driver that has an end consequence of the employee not being 'paid' in accordance with the share-based payment arrangement. If an employee terminates employment, the employee is no longer able to provide direct services to the entity and therefore, paragraph 19 of IFRS 2 specifies that the

share-based payment award is forfeited and on a cumulative basis no compensation cost is recognised.

17. Conversely, if an employer terminates the employment of the employee, (in the staff's opinion) the primary driver is the termination of that employee with the employee's subsequent inability to provide the remaining direct service required to satisfy the vesting period. In the staff's opinion this fact pattern is addressed in the first sentence of paragraph 28 of IFRS 2 that states [emphasis added], 'If a grant of equity instruments is cancelled or settled during the vesting period (<u>other than a grant cancelled by forfeiture when the vesting conditions are not satisfied</u>):…'.

Large firm guidance

18. The notes that the large international accounting firms have all published guidance on this issue. The relevant excerpts are included in Appendix D to this paper. Guidance on this issue from the four largest accounting firms can be summarised as:

    (a) Two of the firms specify treatment as a forfeiture with no mention of the ability to treat as a cancellation.

    (b) One of the firms notes treatment as a forfeiture as the appropriate/ preferred treatment, but acknowledges treatment as a cancellation may be acceptable.

    (c) One of the firms does not provide a preferred view and states that this is an accounting policy election of the entity (between treatment as a forfeiture and treatment as a cancellation).

Agenda criteria assessment for the Committee

19. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) The issue is widespread and has practical relevance.

Yes. The staff believes that the issue may occur in any entity that has share-based payment transactions.

(b) *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

Yes. In the staff's opinion, despite a predominant view that this issue should be treated as a forfeiture event, the staff is aware of multiple views exist in practice as noted in Appendix D.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

Yes. The staff believes that financial reporting would be improved through elimination of the divergent interpretations for the same facts and circumstances.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

Yes. The staff believes that the issue may be addressed as a part of the Committee's active agenda project *Vesting and Non-vesting Conditions*.

(e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

Yes. The staff believes that the issue may be effectively addressed in light of the existing preferences in practice and within the context of the Committee's current *Vesting and Non-vesting Conditions* project.

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

There is no active Board project that will address this issue. The issue is related to the Committee's current *Vesting and Non-vesting Conditions* project.

Staff recommendation

Staff views

20. In the staff's opinion, the entity's termination of an employee should be treated a forfeiture event since the employee is unable to satisfy the service condition. Additionally, in the staff's opinion, there is no need to determine the reasons that the entity terminated the employee and if this route were selected it may be extremely subjective and difficult to ascertain the ultimate underlying purpose of the termination.

21. In the staff's opinion, the Committee's agenda criteria are satisfied; however, the staff recommends that this issue not be taken onto the Committee's agenda as a separate issue, but rather included within and addressed as part of the Committee's current *Vesting and Non-vesting Conditions* project. As part of that project, the staff recommend updating the definition of a service condition to take into consideration this issue.

22. The proposed new definition of a service condition is laid out in the September 2010 Committee Paper 2C.

Questions for the Committee

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

Questions for the Committee
1. Does the Committee agree with the staff recommendation that an entity's of an employee should be accounted for as a forfeiture of the share-based payment award? 2. Does Committee agree with the staff recommendation that the issue on an entity's termination of an employee should be incorporated into the Committee's active agenda project *Vesting and Non-vesting Conditions*?

Appendix A – Tentative agenda decision draft wording

A1. The below tentative agenda decision is proposed if the Committee supports the staff recommendation in the agenda paper.

IFRS 2 *Share-based Payment* – Share-based payment transaction nullified as a result of involuntary termination of employment

The Committee received a request for guidance on the accounting treatment of a share-based payment transaction in the event of the entity's termination of employment of the employee during the vesting period of the share-based payment award. The request asks whether the effect resulting from the entity's termination of employment of the employee should be accounted for as a forfeiture or cancellation.

The Committee noted that this issue may be addressed in conjunction with the Committee's current project on *Vesting and Non-vesting Conditions*. Consequently, the Committee [decided] not to add this issue to its agenda as a separate project, but incorporate it into the current project on *Vesting and Non-vesting Conditions*.

Appendix B – Agenda item request

B1. All the information has been copied without modification by the staff, except for details that would identify the submitter of the request.

The issue:

When an entity grants an award in a share-based payment transaction to an employee that includes a service condition and the entity makes that employee redundant, and as a result, the options lapse, does the entity account for this lapse as a forfeiture or as a cancellation under IFRS 2?

Current practice:

View A:

The lapse of the award is a forfeiture in all cases. Because of the redundancy, the employee is unable to render the service required in order for the options to vest. The first column of the table included in paragraph IG24 of the implementation guidance in IFRS 2 (see the Appendix) gives, as an example of a forfeiture, an award where a requirement to remain in service 'is not met.' The passive voice in this guidance implies that it does not matter whether the failure to meet the service condition is due to the action of the employee or those of the employer.

View B:

The lapse of the award is a cancellation in all cases. Since the options lapse as a direct result of the employer's action, the effect is equivalent to a cancellation of the award by the employer. The sixth column of the table included in paragraph IG24 of the Implementation Guidance of IFRS 2 gives, as an example of a non-vesting condition, the continuation of the plan by the entity. When an entity chooses to terminate a plan, it breaches a non-vesting condition within its control, requiring cancellation accounting. By analogy if the entity terminates an individual employee, this would similarly be a non-vesting condition that the entity breaches, and the accounting must also be as a cancellation.

View C:

The lapse of an award on termination of employment for cause (such as gross misconduct) is a forfeiture, but a lapse on termination in other circumstances is a cancellation. Refraining from gross misconduct is an implied term of any employment contract. Therefore, an employee dismissed for such conduct did not provide services, and the award is forfeited.

Opponents of this view note that it is often difficult to determine the true reason for a termination of employment. Senior levels of management, whose employment is in reality being terminated, often agree to tender a letter of resignation for a number of reasons, ranging from employment law to media relations. Similarly, producing evidence for the real reason can be difficult to obtain.

Reasons for the Committee to address the issue:

There are diverse views regarding the accounting when an entity makes an employee redundant. The implications of each treatment are extremely different (reversal of expense for a forfeiture, and acceleration of expense for a cancellation), and therefore we feel the IFRIC should address the issue to ensure consistent application. We are aware of preparers and auditors that hold each of the views above.

Appendix C – Extracts from IFRS 2 [emphasis added]

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, shall not be taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, vesting 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.

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.

21 Market conditions, such as a target share price 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 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), irrespective of whether that market condition is satisfied.

Treatment of non-vesting conditions

21A Similarly, an entity shall take into account all non-vesting conditions 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), irrespective of whether those non-vesting conditions are satisfied.

28 If a grant of equity instruments is cancelled or settled during the vesting period (**other than** a grant cancelled by forfeiture **when the vesting conditions are not satisfied**):

(a) the entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

(b) any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the repurchase of an equity interest, ie as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess shall be recognised as an expense. However, if the share-based payment arrangement included liability components, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement. Any payment made to settle the liability component shall be accounted for as an extinguishment of the liability.

(c) if new equity instruments are granted to the employee and, on the date when those new equity instruments are granted, the entity identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for the granting of replacement equity instruments in the same way as a modification of the original grant of equity instruments, in accordance with paragraph 27 and the guidance in Appendix B. The incremental fair value granted is the difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments, at the date the replacement equity instruments are granted. The net fair value of the cancelled equity instruments is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the equity instruments that is accounted for as a deduction from equity in accordance with (b) above. If the entity does not identify new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for those new equity instruments as a new grant of equity instruments.

28A If an entity or counterparty can choose whether to meet a non-vesting condition, the entity shall treat the entity's or counterparty's failure to meet that non-vesting condition during the vesting period as a cancellation.

Basis for Conclusions to IFRS 2

BC171 **Vesting conditions ensure that the employees provide the services required to 'pay' for their share options**. For example, the usual reason for imposing service conditions is to retain staff; the usual reason for imposing other performance conditions is to provide an incentive for the employees to work towards specified performance targets.

Appendix D – Large International Accounting Firm Guidance [emphasis added]

D1. Deloitte iGAAP 2010

Chapter 27 ***Share-based payment***

Section 3.2.1 Equity-settled share-based payment transactions

The question arises of whether failure to complete the specified period of service because of redundancy should be treated in the same way as a voluntary termination of employment by the employee. The Standard does not specify whether redundancy should be treated as forfeiture or cancellation. This is key because forfeiture would enable the employer to 'true up' and therefore reverse the IFRS 2 expense previously recognised, whereas cancellation would trigger accelerated recognition of the remaining charges. IFRS 2 specifies that failure to meet a service condition by an employee, for example due to voluntary departure, should be treated as forfeiture. The January 2008 amendments to IFRS 2 introduced a relevant principle. This principle is that a cancellation, whether by an employee or the employer, should be accounted for in the same way. Building on this principle, <u>the employer's decision to make an employee redundant should be treated in the same manner as a voluntary departure and consequently this should be accounted for as a forfeiture</u>.

However, attention should be paid to cases where the severance of an employee's contract is accompanied by a compensation package at the time of termination of employment. In such instances, facts and circumstances should be considered to assess whether the severance package (or part thereof) should be treated as a modification and settlement of the original awards.

D2. Ernst&Young International GAAP 2010 – Generally Accepted Accounting Practice under IFRS

Chapter 27 ***Share-based payment***

7.4.1 Distinction between cancellation and forfeiture

The above provisions of IFRS 2 (2009) apply when an award of equity instruments is cancelled or settled 'other than a grant cancelled by forfeiture when the vesting conditions are not satisfied'. The significance of this is that the terms of many share-based awards provide that they are, or can be, 'cancelled' on forfeiture. IFRS 2 (2009) is clarifying that, where an award is forfeited (within the meaning of that term in IFRS 2 (2009)), the entity should apply the accounting treatment for a forfeiture (i.e. reversal of expense previously recognised), even if the award is cancelled as a consequence of the forfeiture.

A Termination of employment by entity

In some cases, however, it is not clear whether cancellation or forfeiture has occurred, particularly where options lapse as the result of a termination of employment by the entity. For example, an entity might grant options to an employee on 1 January 2010 on condition of his remaining in employment until at least 31 December 2012. During 2011, however, economic conditions require the entity to make a number of its personnel, including that employee, redundant, as a result of which his options lapse. Is this lapse a forfeiture or a cancellation for the purposes of IFRS 2 (2009)?

Some argue that, as a result of the redundancy, the employee will be unable to render the service required in order for the options to vest. On this analysis, the lapse of the award should be treated as a forfeiture. This view is supported by column 1 of the table included in paragraph IG24 of the implementation guidance in IFRS 2 (2009) which gives, as an example of a forfeiture, an award where a requirement to remain in service 'is not met' – implying that it does not matter whether the failure to meet the condition is due to the actions of the employee or those of the employer.

Others, however, argue that, since the options lapse as a direct result of the employer's actions, the effect is equivalent to a cancellation of the award by the employer. This view is, somewhat ironically, also supported by the table included in paragraph IG24 of the implementation guidance referred to above, column 6 of which gives, as an example of a non-vesting condition, the continuation of the plan by the entity. On this analysis, if the entity chooses to terminate the plan, it breaches a non-vesting condition within its control, requiring cancellation accounting to be applied (see 7.1 above).

<u>In our view, unlikely as it is that the IASB intended such an outcome, both analyses are supportable under IFRS 2 (2009), and an entity may adopt either treatment as a choice of accounting policy</u>.

Another possible analysis might be that the lapse of an award on termination of employment for cause (such as gross misconduct) is a forfeiture, but a lapse on termination in other circumstances is a cancellation. The argument here would essentially be that refraining from gross misconduct is an implied term of any employment contract. An employee dismissed for such conduct has therefore not provided services of an appropriate nature, and the award is accordingly forfeited. We can see some theoretical merit in such an approach, but have the concern – from an auditor's perspective – that it is often difficult to determine the true reason for a termination of employment. There is the added complication that employees, particularly at senior levels of management, whose employment is in reality being terminated, will often agree to tender a letter of resignation for a number of reasons ranging from employment law to media relations.

At first sight, it might seem unlikely that an entity would not wish treat the lapse of an award on a termination of employment as a forfeiture, given that this will give rise to a profit (as any cost previously recognised is reversed), whereas treatment as a cancellation will give rise to a loss (as any part of the grant date fair value not yet recognised as a cost is accelerated). However, where the employee is granted another award in compensation, the interaction between the rules in IFRS 2 (2009) for cancellation and those for replacement awards may make treatment as a cancellation less 'costly' in terms of the overall charge to profit or loss.

D3. KPMG Insights into IFRS 2009/10 – KPMG's practical guide to IFRS

Section 4.5 Share-based payment

4.5.430.70 Under the modified grant-date approach, estimated share-based payment expense is trued up for forfeiture due to an employee failing to provide service. The standard is not explicit regarding whether forfeiture applies only when the employee terminates service or if it also applies when an employer terminates services of the employee and therefore prevents the required service from being provided. In our view, it is appropriate to treat a failure to provide service triggered by termination by the employer as a forfeiture. This is because the entity has not received the agreed services. However, treatment as cancellation by the employer also may be appropriate as it is the employer who is precluding the service from being provided.

D4. PwC Manual of accounting IFRS 2010

Chapter 12 Share-based payment

Forfeitures

12.143 A forfeiture occurs when either a service or a non-market performance condition is not met, as this affects the number of awards that vest. Failures to meet either market conditions or non-vesting conditions are not forfeitures as these are already taken into account when determining the grant date fair value.

12.144 The accounting for forfeitures is different to that of cancellations described from paragraph 12.138 above. Forfeiture of a vested award has no accounting implications, unless it results from a post-vesting restriction, which will have been incorporated into the grant date fair value.

12.145 Where a number of individual awards within a larger portfolio of awards are forfeited, the expense is revised to reflect the best available estimate of the number of equity instruments expected to vest. Hence, on a cumulative basis, no expense is recognised for goods or services received if the equity instruments do not vest (for example, if the employee or counterparty fails to complete a specified service period).

Example – Employee made redundant

Entity A granted share option awards to a number of its employees with a three year service requirement. The individuals were required to remain in service with the entity for three years from the date of grant. 18 months into the plan, one employee is made redundant.

Having been made redundant, the employee is unable to satisfy the three-year service condition and, therefore, this should be treated as a forfeiture rather than a cancellation. The expense recognised to date is reversed.