STAFF PAPER

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IASB Meeting

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Project	**Annual Improvements to IFRSs 2010–2012 Cycle (ED/2012/1) (sweep issues)**
Paper topic	IFRS 2 *Share-based Payment*—length of the performance target with respect to the period of service

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Purpose of this paper

1. The objective of this paper is to address and resolve a sweep issue identified by the staff regarding the duration of the period of assessment of a performance target with respect to the period of service within the proposed definition of 'performance condition'.

2. This issue was addressed as part of the proposed amendment to the definition of *vesting conditions* in Appendix A of IFRS 2 *Share-based Payment* that we presented to the IASB in February 2013 (refer to Agenda Paper 8A).

3. The IASB plans to finalise the amendment to IFRS 2 as part of *Annual Improvements to IFRSs 2010–2012 Cycle*, which will be published in the fourth quarter of 2013.

Background information

4. The Exposure Draft (ED) on *Annual Improvements to IFRSs 2010 –2012 cycle* (ED/2012/1) published in May 2012 includes the IASB's proposal to clarify the definition of *vesting conditions* in Appendix A of IFRS 2 *Share-based Payment* by separately defining a 'performance condition' and a 'service condition'. In doing this the IASB addressed some of the concerns that had been raised by respondents about that definition.

5. Among the concerns expressed on the IASB's proposal to separately define a 'performance condition', respondents to the ED noted that it was unclear whether it was the IASB's intention to exclude from this definition, performance targets for which the period for achieving the performance target exceeded the service period. More specifically, they were unsure whether the period of assessment of a performance target could be or could not be longer than the required service period (ie whether it could start before the service period or end after the service period).

6. During its deliberations at the February 2013 meeting, the IASB confirmed that the duration of the performance condition needed to be wholly within the period of the related service requirement. This meant that the period of assessment of the performance target could not start before the start of the service period and could not end after the service period.

7. Consequently the IASB decided to clarify within the proposed definition of performance condition that the duration of the performance target should be wholly within the period of the related service requirement (ie an employee must be rendering a service for the entire period that the performance target is being measured).

8. The proposed amendment is shown below (emphasis added):

performance condition	A **vesting condition** that requires: (a) the counterparty to complete a specified period of service (ie a 'service condition'); and (b) specified performance targets to be met while the counterparty is rendering the service required in (a). <u>The duration of a performance target should be wholly within the period of the related service requirement for it to constitute a performance condition (ie an employee must be rendering service for the duration of the period that the performance target is being measured). The related service requirement can be implicit or explicit.</u> A performance target is defined by reference to: (a) the entity's own operations (or activities) or the operations or activities of another entity in the same group or

(b) the price (or value) of the entity's **equity instruments** or the equity instruments of another entity in the same group (including shares and **share options**).

A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee.

A performance condition can be a **market condition** or a non-market performance condition. In a market condition that is a performance condition, the performance target relates to the market price of the equity instruments of an entity. In a non-market performance condition, the performance target is not related to the market price of the equity instruments of an entity.

Analysis of concerns raised after the IASB February 2013 meeting

9. In the course of finalising the proposed amendment to IFRS 2 we received some informal communications from some commentators noting some unintended consequences that might be derived from the proposed amendment to the definition of performance condition with respect to the length of the period of assessment of the performance target in relation to the required service period. These commentators claim that:

   (a) it is common for the period of assessment of a performance target to start before the service period, so the starting assessment period of the performance target should not be restricted; and

   (b) requiring the assessment period of a performance target to start at the same time as the service period might produce inconsistent accounting for the same transaction.

10. We analysed the two concerns raised in paragraphs below.

A performance target could precede the start of a service period

11. We observe that the period of assessment of a performance target could precede a specified service period because this type of target is commonly expressed in

terms of an entity's performance over different periods of time. For instance, common examples of performance targets that are assessed over a period preceding the start of the service period could be:

(a) a measure of the growth in earnings per share (EPS target) between the most recently published accounts on the grant date and the most recently accounts published before the vesting date. For example:

> A calendar year reporting entity grants employees share options in **June 20X3** on condition that the employees remain employed for three years during the vesting period. The shares will vest if the entity reaches an EPS growth target of 10 per cent that would measure performance based on EPS growth between the **20X2 financial statements** and the 20X5 financial statements

(b) an increase in the level of earnings or revenue across different periods of time. For example:

> The Compensation Committee of a reporting entity approves an award scheme for employees in **1 March 20X3** on condition that the employees remain employed for five years during the vesting period. The shares will vest if the entity's earnings increase by 15 per cent over a 3-year period starting from **1 January 20X3** through to 31 December 2015.

12. Under the current proposal to amend the definition of performance condition, both performance targets in the examples above (EPS and earnings target) would be treated as non-vesting conditions, because the employees will not be providing services throughout the full extent of the performance assessment period (ie the assessment of the performance target starts before the required period service).

13. We will analyse the accounting for vesting and non-vesting conditions in more detail in paragraphs below.

Requiring a performance target to start at the same time as the service period might produce inconsistent accounting

14. Consider the following fact pattern:

    Fact pattern # 1

    A calendar year reporting entity grants shares to its **existing** employees conditional upon the employees remaining in the entity's employment for five years. The shares will vest at the end of the vesting period if the earnings target increases by 10 per cent over a one-year period from **1 January 20X3** to 31 December 20X3.

    In **February 2013** a **new employee** joins the existing award scheme entity of the entity on the same terms as existing employees.

15. On the basis of the fact pattern above, how would the awards be accounted for, from the perspective of:

    (a) existing employees and

    (b) the new employee who joined the scheme?

Guidance in IFRS 2

16. Paragraphs 19 – 21A of IFRS 2 contain guidance in regards to the accounting treatment for vesting (non-market performance) conditions and non-vesting conditions. We will address this guidance in our analysis of the fact pattern below.

Analysis of fact pattern # 1

17. For existing employees, the earnings target would be considered a performance (non-market) vesting condition because employees would be providing their services throughout the full extent of the performance period (ie existing employees remain employed from 1 January–31 December 20X3).

18. Paragraph 19 of IFRS 2, provides guidance on accounting for vesting conditions, and is reproduced below (emphasis added):

Treatment of vesting conditions

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.

19. Consequently, on the basis of paragraph 19 of IFRS 2 a performance (non-market vesting) condition, would be accounted for as follows:

(a) the earnings target would not be taken into account when estimating the fair value of the award at the measurement date; and

(b) the earnings target would be taken into account by adjusting the number of awards that would eventually vest.

20. For the new employee joining the scheme, the earnings target would be treated as a non-vesting condition, because the new employee would not be providing services throughout the full extent of the performance period (ie the new

employee started providing services in February 2013, after the assessment period for the performance target started).

21. Paragraph 21A provides guidance on the accounting for non-vesting conditions and is reproduced below (emphasis added):

> **Treatment of non-vesting conditions**
>
> **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.

22. Consequently, on the basis of paragraph 21A of IFRS 2, a performance (non-market vesting) condition, would be accounted for as follows:

    (a) the earnings target would be taken into account when estimating the grant date fair value of the award at the measurement date; and

    (b) no adjustment would be made to the number of awards that would eventually vest.

Conclusion

23. Under the proposed definition of performance condition which requires the duration of a performance target to be wholly within the period of the related service requirement, the earnings target in the fact pattern analysed would be treated differently for existing and new employees and this would lead to different accounting outcomes on the basis of the guidance in IFRS 2.

24. More specifically:

    (a) the performance target *would have* an effect on the grant-date fair value of the awards if the target is considered to be a non-vesting condition and there would not be a ‘true-up’ for changes in the estimate of the awards that will eventually vest; and

(b) the performance target *would not* have an effect on the grant-date fair value of the awards if the target is considered to be a non-market performance (vesting) condition and there would be a ‘true-up’ for changes in the estimate of the awards that will eventually vest.

25. Consider another fact pattern:

<u>Fact pattern # 2</u>

A calendar year reporting entity grants two different awards to a new employee who joins in February 20X3 conditional upon the employee remaining in the entity’s employment for five years and subject to achieving a performance target for each award, as follows:

Award 1: The shares will vest at the end of the vesting period if the entity’s sales reach £10million, for the whole year of 20X3 (ie January to December 20X3).

Award 2: The shares will vest at the end of the vesting period if the entity’s sales reach £9 million, for the period February to December 20X3. In January 20X3 the entity has already earned sales of £1million.

26. On the basis of the fact pattern above, how would these two awards, for the new employee, be accounted for?

Analysis of fact pattern # 2

27. We observe that if the assessment of the performance target for award 1 begins before the new employee starts providing its services, then the sales condition would be treated as a non-vesting condition; whereas for award 2 if the employee provides services throughout the full period where the performance target is assessed, then the sales condition would be treated as a performance condition.

28. We observe that the accounting for non-vesting and vesting conditions in accordance with IFRS 2 results in different accounting outcomes (refer to our conclusion in paragraph 24 of this paper). However, we do not think that the two awards granted should be accounted for differently. This is because we observe

that both awards are similar and give an employee the same outcome (ie both awards are subject to a sales condition and both awards confer the employee a right to receive shares). The only difference that we observe between the two awards is that the sales condition is assessed throughout a different period of time.

Summary of views

29. We note that, as illustrated in the fact patterns discussed above, a relatively minor difference on the way awards are structured, could lead to a significant difference on the way awards are accounted for, being that the awards could be substantially the same. This could provide an opportunity for management to structure award schemes according to a desired outcome (ie structure a performance target in a certain way to treat the performance condition as either a vesting or as a non-vesting condition).

30. We think that to achieve consistent accounting for what is essentially the same award, and to avoid unintended consequences from the proposed wording of the performance condition definition, the beginning of the period of assessment for the performance target should not be restricted.

31. Consequently, even if the assessment period for a performance target begins before the required service period, the performance condition should still be considered a non-market vesting condition provided that the period of measurement of the performance target does not extend beyond the end of the required service period. If the assessment period for a performance target extends beyond the end of the required service period then the performance condition should be considered a non-vesting condition.

Staff recommendation

32. On the basis of the analysis in the previous section, we suggest to the IASB that it should revise the proposed definition of 'performance condition'.

33. In our view, the definition of performance condition should clearly state that the performance target cannot end after the service period. We also think that the start of the assessment period for the performance target should not be restricted.

Consequently, the period of assessment of the performance target could start before the start of the service period but could not end after the service period.

34. The revision to the proposed amendment is shown in Appendix A with the related Basis for Conclusions.

Question to the IASB
Does the IASB agree with the staff recommendation to amend the proposed definition of performance condition as described in Appendix A of this paper?

Appendix A—Changes for finalising the amendment

A1. The proposed amendment to the definition of performance conditions (from what was proposed at the IASB February 2013 meeting) is presented below (new text is underlined and deleted text is struck through).

Appendix A

Defined terms

performance condition

A **vesting condition** that requires:

(c) the counterparty to complete a specified period of service (ie a 'service condition'); and

(d) specified performance targets to be met while the counterparty is rendering the service required in (a).

The duration of the performance target should not extend beyond the end of the service period (ie the measurement period for the performance target can start before the service period but cannot end after the service period). ~~be wholly within the period of the related service requirement for it to constitute a performance condition (ie an employee must be rendering service for the duration of the period that the performance target is being measured)~~.

A performance target is defined by reference to:

(c) the entity's own operations (or activities) or the operations or activities of another entity in the same group or

(d) the price (or value) of the entity's **equity instruments** or the equity instruments of another entity in the same group (including shares and **share options**).

A performance target might relate either to the performance of the entity as a whole or to some part of the entity (or part of the group), such as a division or an individual employee.

A performance condition can be a **market condition** or a non-market performance condition. In a market condition that is a performance condition, the performance target relates to the market price of the equity instruments of an entity. In a non-market performance condition, the performance target is not related to the market price of the equity instruments of an entity.

Basis for Conclusions on amendments to IFRS 2 *Share-based Payment*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Definition of vesting condition[1] (2012 amendments)

BC334 (....)

BC336 In response to the comments received on the Exposure Draft *Annual Improvements to IFRSs 2010–2012 Cycle* (Proposed amendments to International Financial Reporting Standards) the IASB addresses the following concerns that have been raised about the definitions of 'performance condition', 'service condition' and 'market condition':

(a) (...)

(b) whether a performance target that refers to a longer period than the required service period may constitute a performance condition;

(c) (...)

(a) Whether a performance target that refers to a longer period than the required service period may constitute a performance condition

BC339 The IASB observed that IFRS 2 was not clear about~~ require a performance target to coincide with a service requirement for it to constitute a performance condition. Consequently, it does not explicitly~~ the duration of a performance target relative to the related service condition. Some interpreted it to be–wholly within the period of the related service requirement;~~ for it to constitute a performance condition. For example, ~~some others believe that a performance target ~~should be taken to constitute a performance condition even if the achievement of the performance target is~~ could be assessed over a period that exceeds the period for which the employee is required to provide service.

BC340 The IASB decided to clarify that the duration of the performance ~~condition~~ target should not extend beyond the end of the service period ~~need~~ not ~~s to be 'wholly within the period' of the related service requirement. The duration of the performance target~~ This means that the measurement period of the performance target can~~not~~ start before the start of the service period ~~and~~ but cannot end after the service period. ~~Consequently, the duration of the performance target needs to be within the period of the related service requirement.~~ The IASB observed that otherwise, the generic definition of '~~vesting ~~performance condition~~s~~' may be compromised ~~where a service is not received during a portion of the~~

[1]The IASB confirmed at the February 2013 meeting to add paragraphs BC333 –BC369 as part of Annual *Improvements to IFRSs 2010–2012 Cycle*.

~~performance target period~~ because to qualify as a performance condition a performance target needs to be closely related to the service condition.