EFRAG
European Financial Reporting Advisory Group

INVITATION TO COMMENT ON THE EFRAG'S ASSESSMENTS OF THE AMENDMENT TO IFRS 2 SHARE-BASED PAYMENT: VESTING CONDITIONS AND CANCELLATIONS

Comments should be sent to commentletter@efrag.org or uploaded via our website by 14 April 2008

EFRAG has been asked by the European Commission to provide it with advice and supporting material on the endorsement of the Amendment to IFRS 2 Share-based Payment: *Vesting Conditions and Cancellations* ('the Amendment'). In order to do that, EFRAG has been carrying out a technical assessment of the Amendment against the criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the EU.

A brief summary of the Amendment is set out in Appendix 1.

Before finalising its two assessments, EFRAG would welcome your views on the issues set out below. Please note that all responses received will be placed on the public record unless the respondent requests confidentiality. EFRAG is a transparent organisation and will wish to discuss the responses it receives in a public meeting, so we would prefer to be able to publish all the responses received.

1 Please provide the following details about yourself:

(a) Your name or, if you are responding on behalf of an organisation or company, its name:

German Accounting Standards Board (GASB)

(b) Are you/Is your organisation or company a:

☐ Preparer ☐ User ☒ Other (please specify)

standard-setter

(c) Please provide a short description of your activity/ the general activity of your organisation or company:

(d) Country where you/your organisation or company is located:

Germany

(e) Contact details including e-mail address:

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2 EFRAG's initial assessment of the Amendment is that it meets the technical criteria for endorsement. In other words, it is not contrary to the true and fair principle and it meets the criteria of understandability, relevance, reliability and comparability. EFRAG's reasoning is set out in Appendix 2.

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of the Amendment? If there are, what are those issues and why do you believe they are relevant to the evaluation?

No

3 EFRAG is carrying out a separate assessment of the costs that will arise for preparers and for users to implement the Amendment, both in year one and in subsequent years. Some initial work has been carried out and the need for further targeted work has been identified. The responses to this Invitation to Comment and the results of the additional targeted work will be used to complete the assesment.

The results of the initial assessment are set out in Appendix 3. To summarise, EFRAG's initial assessment is that the Amendment will:

(a) involve many preparers incurring some year one costs—in order to read, understand and implement the new requirements retrospectively. For some of those preparers the year one costs could be significant, but EFRAG's initial assessment is that, across preparers as a whole, the year one costs will not be significant (Appendix 3, paragraphs 4 - 7);

(b) involve preparers incurring only insignificant incremental ongoing costs (Appendix 3, paragraphs 4 and 5); and

(c) involve users incurring no incremental year one or ongoing costs (Appendix 3, paragraph 8).

Do you agree with this assessment?

☐ Yes ☐ No

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be?

We as a national standard-setter are not in a position to answer this question.

4 EFRAG believes (as explained in Appendix 3, paragraph 9) that the Amendment will to improve the quality of the financial information provided and its implementation will involve on an overall level additional costs that will not be significant. Its initial assessment furthermore is thatthe benefits to be derived from applying the Amendment will exceed the costs involved (Appendix 3, paragraph 10).

Do you agree with this assessment?

☐ Yes ☐ No

If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

We as a national standard-setter are not in a position to answer this question.

EFRAG is not aware of any other factors that should be taken into account in reaching a decision as to what endorsement advice it should give the European Commission on the Amendment.

Do you agree that there are no other factors?

☒ Yes ☐ No

If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

APPENDIX 1
A SUMMARY OF THE AMENDMENT TO IFRS 2

1 Entities often grant shares or share options to employees or other parties. Share plans and share option plans are a common feature of employee remuneration, for directors, senior executives and many other employees. Some entities issue shares or share options to pay suppliers, such as suppliers of professional services. Such transactions are known as 'share-based payment transactions'.

2 IFRS 2 *Share-based Payment* sets out how such transactions should be accounted for. Put simply, IFRS 2 requires the value of the transaction to be determined and then recognised as an expense and in equity or as a liability (depending on the nature of the arrangement) over the period during which services are being received or at the point at which the goods are received.

3 Generally speaking, conditions are attached to share-based payment transactions. For example, in the case of a typical employee share option scheme, it is necessary for the employee to complete a specified period of service before the employee is in a position to exercise the options. Often the conditions are in some way performance-related or related to external factors.

4 Under IFRS 2, conditions are dealt with differently depending on their nature. The main differences relate to how the prospect of the condition not being met is taken into account in the value of the share-based payment and how a failure to meet the condition is accounted for.

5 The categories of condition for this purpose are 'vesting conditions' and 'non-vesting conditions'.

(a) Both terms are defined in the standard, but there has been some uncertainty as to whether particular types of condition are vesting conditions or non-vesting conditions. The Amendment seeks to address this uncertainty by clarifying aspects of the definitions.

(b) Similarly, there has been some uncertainty as to how certain types of non-vesting condition should be accounted for under the standard. For example, although the standard is clear as to the accounting treatment that should be followed if a share-based payment arrangement is cancelled or withdrawn by the company that offered it, there are different views as to the required accounting when it is the employee or other supplier of goods or services that cancels their participation or withdraws from the arrangement. Again, the Amendment seeks to clarify the requirements.

Definitions

6 Currently IFRS 2 defines a vesting condition as a condition that must be satisfied for the employee or other counterparty to be entitled to receive cash, other assets or equity instruments of the entity under a share-based payment arrangement. It goes on to explain that vesting conditions "*include* service conditions, which require the other party to complete a specified period of service, and performance conditions, which require specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time)." (Emphasis added) By implication, all other conditions were non-vesting conditions.

7 It has become clear however that this definition and explanation is not clear enough, and as a result there was uncertainty as to whether certain types of

condition were vesting conditions or non-vesting conditions. In particular, the principle underlying the definition was not sufficiently clear, and the inclusion of the word 'include' in the explanation gave the impression that the IFRS 2 required some conditions that were neither service conditions nor performance conditions to be treated as vesting conditions. The IASB had been asked, as a result, to clarify whether restrictive conditions such as non-compete provisions are intended to be treated as vesting conditions.

(a) The Amendment makes clear the principle underlying the definition of a vesting condition, which is that vesting conditions are the conditions that determine whether the entity receives the services that entitle the counterparty to the share-based payment. The definition of 'vest' has also been clarified to reflect this.

(b) The Amendment also clarifies that vesting conditions are restricted to service conditions and certain performance conditions.

(c) Finally, the Amendment clarifies what IFRS 2 means by a 'performance condition' and explains which of them are vesting and which are non-vesting conditions.

8 Thus, for the purposes of IFRS 2 a share-based payment vests when the counterparty's entitlement to it is no longer conditional on future service or performance conditions. Conditions such as non-compete provisions and transfer restrictions are non-vesting conditions.

Accounting for non-vesting conditions

9 As explained in paragraph 2 above, IFRS 2 first requires the reporting entity to determine the value of the share-based payment transaction. The standard makes clear that in some cases this will be done by measuring the fair value of the goods and services received and in other cases by measuring the grant date fair value of the share-based payment made. For example, in the case of employee share options and similar employee-related arrangements, the standard requires the grant date fair value of the share-based payment made to be used.

10 The standard explains how the various conditions that might be attached to the arrangement should be dealt with in that valuation. In particular, the standard requires that, although vesting conditions should not be taken into account in estimating the grant date fair value of the share-based payment made, non-vesting conditions should.

11 This means that the reporting entity needs to take into account, in arriving at its estimate of the grant date fair value of the share-based payment made, the probability that a non-vesting condition will not be met, whereas vesting conditions are taken into account subsequently at each reporting date by adjusting the number of equity instruments that eventually vest.

12 The Amendment does not change these requirements. However, by clarifying which conditions are vesting conditions and which are non-vesting conditions its effect will be that certain conditions not previously taken into account in estimating the grant date fair value of the share-based payment made will henceforth need to be taken into account (and vice versa).

13 IFRS 2 requires that the value of the transaction shall be revised in certain circumstances. The Amendment makes it clear that, although failure to meet a vesting condition can result in the value of the transaction being revised (by

adjusting the number of equity instruments included in the measurement), failure to meet a non-vesting condition will not result in such a revision.

14 The general principle in IFRS 2 is that the value of the transaction shall be expensed and recognised as a liability or as an increase in equity (depending on the nature of the arrangements involved) as the goods or services that are the subject of the transaction are received. IFRS 2 also specifies that, when an entity cancels a grant of equity instruments, the part of the value of the transaction that has at that date not been expensed should be immediately recognised as an expense. However, it does not explicitly state how cancellations by a party other than the entity should be accounted for. As a result, there has been some uncertainty as to the accounting required. The Amendment makes clear that:

(a) Cancellations by parties other than the entity shall be accounted for in the same way as cancellations by the entity.

(b) A failure to meet a non-vesting condition when the entity or the counterparty can choose whether that condition is met shall be treated the same as a cancellation.

(c) A failure to meet a non-vesting condition when neither the counterparty nor the entity can choose whether the condition is met is, on the other hand, not a cancellation. When such a failure occurs, the entity shall continue recognising the value of the transaction over the remainder of the vesting period (i.e. no change to the accounting).

APPENDIX 2
EFRAG'S TECHNICAL ASSESSMENT OF THE AMENDMENT TO IFRS 2 AGAINST THE ENDORSEMENT CRITERIA

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

1 When evaluating the merits of the Amendments, EFRAG considered the following key questions:

(a) Is there an issue that needs to be addressed?

(b) Are the requirements of the Amendments consistent with the IASB's *Framework for the Preparation and Presentation of Financial Statements* ('the Framework')?

(c) Would the amended IFRS's implementation result in an improvement in accounting?

(d) Does the accounting that results from the application of the Amendments meet the criteria for EU endorsement?

Is there an issue that needs to be addressed?

2 Under existing IFRS 2, the way in which a share-based payment is measured and recognised in the financial statements depends on whether the conditions attached to the share-based payment arrangement are considered to be vesting conditions or other ('non-vesting') conditions. It is therefore important that the standard distinguishes clearly between vesting conditions and non-vesting conditions, and that the required accounting treatment for each type of condition is also clear.

3 Existing IFRS 2 provides guidance on how vesting conditions should be accounted for. However, it does not provide specific guidance on how to account for non-vesting conditions. Furthermore, IFRS 2 is silent on how to account for a cancellation by a party other than the entity.

4 It is clear from the discussions that EFRAG has had during its meetings, [and from the comment letters received,] that the issues addressed in the Amendments are causing uncertainties and other problems in practice and are leading to divergence in accounting for similar transactions. For those reasons, EFRAG agrees that the issues addressed by the Amendments need to be addressed.

Are the requirements of the amendments consistent with the IASB's Framework?

5 EFRAG considered whether the requirements in the Amendments are consistent with the IASB's Framework. The Amendments focus primarily on providing

clarification and additional guidance on some accounting aspects of IFRS 2 for which the standard lacks guidance, and do not introduce fundamental changes to existing IFRS 2 literature.

6 When EFRAG considered whether existing IFRS 2 should be endorsed, it considered whether the accounting treatment for share-based payment arrangements was consistent with the Framework. As the Amendments focus on providing clarification of and guidance on existing IFRS 2, EFRAG concluded that the Amendments are consistent with the provisions in the Framework.

Would the amended IFRS's implementation result in an improvement in accounting?

7 When EFRAG assessed the Amendments, it asked itself whether the Amendments will make the resulting financial information worse or better or have no significant impact on the financial information.

Issue 1- What are vesting conditions?

8 The objective of existing IFRS 2 is to recognise services as they are received by the entity, generally over the vesting period. It specifies that vesting conditions are those conditions which ensure that the counterparty provide the services required to 'pay' for the share options that the entity granted to them.

9 The Amendments amend the definition of vesting conditions and vest so that:

(a) Vesting conditions are restricted to service and performance conditions only. Performance conditions are those conditions that require the counterparty to complete a specified period of service and specified performance target to be met. As a result, only those conditions that determine whether the entity receives the services that entitle the counterparty to the share-based payment are vesting conditions.

(b) A share-based payment arrangement vests when the counterparty's entitlement is no longer conditional on a vesting condition being met.

10 EFRAG noted that the Amendments restrict performance conditions to only those conditions that impute an element of service, and therefore all they do is they clarify something that is already implicit in IFRS 2. This clarification will lead to increased consistency in accounting and thus will enhance comparability of financial information.

Issue 2 – How to account for non-vesting conditions

11 As a general principle, existing IFRS 2 is based on a "grant date approach" and requires the probability of failure to meet the terms and conditions of a share-based payment arrangement to be reflected in the measurement of fair value at measurement date (i.e. for transactions with employees this is the grant date). The IASB granted an exemption to this measurement principle; but only for vesting conditions other than market conditions – this approach is referred to as the "modified grant date approach". Under this approach, service conditions and non-market performance conditions are excluded from the grant date valuation and are instead taken into account based on the number of equity instruments that eventually vest.

12 In Issue 2, the Amendment clarifies that non-vesting conditions are those conditions that do not determine whether the entity receives the required services. The Amendments go on to make clear that :

(a) non-vesting conditions should be taken into account in the initial estimate of fair value at grant date, and an entity shall recognise the goods and services from a counterparty that satisfies all vesting conditions, other than market conditions, irrespective of whether that non-vesting condition is satisfied;

(b) if an entity can choose whether to meet a non-vesting condition, the entity's failure to meet that non-vesting condition during the vesting period shall be treated as a cancellation by the entity. Similarly, if a counterparty can choose whether to meet a non-vesting condition, the counterparty's failure to meet that non-vesting condition during the vesting period shall be treated as a cancellation by the counterparty; and

(c) if a non-vesting condition is not met (for a reason(s) other than a cancellation), the entity does not change its accounting and will recognise the expense over the remaining vesting period, unless, as explained in issue 1 above, the employee fails to meet a vesting condition. In other words, a share-based payment may vest even if a non-vesting condition has not been met.

13 The accounting treatment of cancellations (and therefore of failures by the entity (or by the counterparty) to meet non-vesting conditions that the entity (or the counterparty) can choose whether to meet) is dealt with in the next section. EFRAG believes that the clarifications in (a) and (c) do not raise any new issues about how to account for non-vesting conditions because, as previously mentioned, existing IFRS 2 already requires all conditions (except for service conditions and non-market performance conditions) to be reflected in the grant date fair value. On the other hand, EFRAG believes they represent useful clarification. Having specific guidance on how to address the accounting for non-vesting conditions will reduce the current uncertainty in practice and would result in all entities adopting the same accounting treatment in respect to non-vesting conditions, therefore enhance comparability of financial information in the financial statements. For that reason, EFRAG believes that the Amendments will improve the financial information provided.

Issue 3 - How to account for cancellations

14 Existing IFRS 2 requires cancellations by an entity to be treated as an acceleration of vesting. This means that if an entity cancels a share-based payment arrangement it will recognise immediately the amount of the "unrecognised" expense.

15 In Issue 3 the Amendment requires that cancellations by a counterparty should be treated in the same way as cancellations by the entity.

16 EFRAG considered whether there is difference in substance between a cancellation by the entity and a cancellation by the counterparty. EFRAG believes that if such differences could be identified, then the most appropriate accounting treatment for a cancellation by a counterparty would probably be not to change the accounting (in other words, to continue to recognise the 'unrecognised' expense over the remaining vesting period).

17 EFRAG concluded that the key issue is whether it is possible to distinguish between a decision by the counterparty not to meet a non-vesting condition and a

cancellation by the entity. It noted that the IASB concluded there are no non-arbitrary or unambiguous criteria for differentiating between these two 'types' of cancellations and that, for example, an approach based on a rebuttable presumption should not be adopted because "in most cases, the information about the entity's decision making processes that is publicly available would be insufficient to determine whether the presumption had been rebutted".

(a) Some EFRAG members agree with these conclusions.

(b) Some EFRAG members do not. In their opinion it is possible at least sometimes—perhaps through the adoption of a rebuttable presumption approach—to distinguish between entity cancellations and counterparty decision. In the view of these members, in the circumstances in which the Amendment does not distinguish between the two even when it is possible to do, the Amendment will require inappropriate accounting. However, these EFRAG members believe that, although it is obviously unsatisfactory for a standard to ever require inappropriate accounting, the circumstances involved in this case will be sufficiently infrequent that non-endorsement is not justified.

18 The amendment also makes it clear that, if the share-based payment arrangement includes a liability component, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement. EFRAG believes this is a useful clarification that is consistent with existing IFRS 2.

General view on IFRS 2

19 EFRAG members generally view both IFRS 2 and the Amendments as rather rules-based. Although some members are not concerned that the IASB has in effect issued further rules on accounting for share-based payments—in their view it is usually possible to clarify a rules-based standard only by issuing more rules—some members are concerned that the effect is to make IFRS 2 more rules-based than hitherto. In their view, the more rules-based a standard becomes, the less satisfactory the standard becomes. On the other hand, non of those members believe the problem is sufficient in itself to justify non-endorsement.

Does the accounting that results from the application of the amendment meet the criteria for EU endorsement?

20 As already mentioned, EFRAG has previously concluded that the existing IFRS 2 meets the endorsement criteria. In other words, EFRAG concluded that the application of IFRS 2 and, in particular the accounting implications resulting from the definition of vesting conditions and the accounting requirements in respect to cancellations by the entity (of share-based payment arrangements), would result in financial information that meets the true and fair view principle and the other criteria for EU endorsement.

21 When considering whether the Amendments meet the criteria for EU endorsement and whether adoption of the amendment would be in the European interest:

(a) regarding issues 1 and 2, EFRAG concluded that the amended definition of vesting conditions and the accounting for non-vesting conditions are consistent with the principles that underpin existing IFRS 2; and

(b) regarding issue 3, EFRAG noted that the Amendments align the accounting treatment required for *all* cancellations of a share-based payment.

22 EFRAG also concluded that there was no reason to believe that the information resulting from the application of the Amendments would be contrary to the true and fair view principle.

23 Having considered the various arguments described in this Appendix in respect of all three issues addressed in the Amendments, EFRAG concluded that the Amendments satisfy the criteria for EU endorsement.

APPENDIX 3
EFRAG'S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENT TO IFRS 2

Costs for preparers

1 EFRAG has considered whether, and if so to what extent, applying the accounting treatment required by the Amendment would result in preparers incurring incremental costs.

2 The Amendment does not introduce any new ways of accounting. Some conditions are still dealt with in the value of the share-based payment and some are not, and the failures to meet conditions are still to be accounted for in the same ways (for example, depending on the type of condition involved, by adjusting the grant date fair value of the share-based payment made, through the immediate recognition of the expense not so far recognised, or as if the failure has not occurred). What has changed is that the failure to meet some types of condition might, depending on how the standard was being applied previously, need to be dealt with differently from before.

3 As a result, implementing the Amendment will involve:

(a) identifying and categorising any conditions attached to the arrangement;

(b) in the case of non-vesting conditions (ie the conditions that are required to be taken into account in estimating the grant date fair value of the share-based payment), estimating the probability of the conditions not being met and incorporating those estimates in the valuation;

(c) tracking compliance with and failures to meet the various conditions attached to the share-based payment;

(d) when there has been a failure, identifying which type of condition has not be met and accounting for the failure in accordance with the accounting required by IFRS 2 for that type of failure; and

(e) the restatements of the financial statements necessary to apply the Amendment retrospectively.

4 Some entities will already be applying IFRS 2 in a way that is identical or very similar to that required by the Amendment, and for those entities it is likely that there will be little if any incremental cost involved in implementing the Amendment. For other entities, EFRAG's initial assessment is that the work described in (a), (c) and (d) will also result in little if any incremental costs in year one and on an ongoing basis. That is because most entities will already have the necessary procedures and systems. In future, they will need to be able to identify separately non-vesting conditions which one or both of the parties can choose whether to meet, but EFRAG believes this involve only insignificant costs.

5 The work described in (b) will involve estimating the likelihood of non-vesting conditions not being met and using those estimates as input to an appropriate valuation model.

(a) *Assessing the probability of non-vesting conditions not being met:* Prior to the Amendment preparers attaching certain conditions to their arrangements would already have been required to estimate the probability of those conditions not being met. However, as a result of the Amendment some preparers will need to do this for the first time for certain types of conditions. This will involve an incremental cost. However, although such estimates can be subject to significant uncertainties, EFRAG's initial assessment is that such uncertainties will not make the estimates significantly more expensive to make that any of the other probability estimates that have to be made for valuation purposes. As a result, EFRAG's view is that the incremental costs involved in this aspect of the work will be insignificant, both in the year of implementation and on an ongoing basis.

(b) *Changes to the valuation model:* Under IFRS 2, preparers are free to use whichever valuation model they wish as long as its measurement objective is the one described in the standard and it can deal appropriately with all the inputs that the standard requires to be taken into account in the model. EFRAG understands that in practice this has meant that different companies are using different models. Some of those models are better than others at dealing with probability estimates of the type described in the preceding sub-paragraph. Therefore, one possible implication of the Amendment for some preparers is that they will have to change valuation model.. Although the ongoing costs are unlikely to be significantly different, changing model will in most cases involve incremental year one costs. EFRAG's believes that, although this incremental cost will not significant for some of the companies that will have to change valuation model, it could be for some others. However, bearing in mind that many companies will probably not have to change valuation model, EFRAG's initial assessment is that overall this additional year one cost will not be significant.

6 As already mentioned, entities are required to apply the Amendment retrospectively. IFRS 2's effective date was accounting periods beginning on or after 1 January 2005, so in theory retrospective application will involve looking again at how the various conditions attached to share-based payments were treated in those three years and, to the extent that they were treated differently from the accounting required under the Amendment, recalculating the numbers involved.

(a) If the Amendment results in an entity being required to treat as a non-vesting condition something that was not previously treated as a non-vesting condition, retrospective application of the standard will require the entity to re-assess past estimates of fair value. In some cases, new valuation models will need to be used to make new estimates of those past fair values.

(b) The Amendment may also require an entity to consider the way in which it has categorised each failure (since IFRS 2 was implemented) to meet a condition attached to a share-based payment arrangement and perhaps to change the amount of expenses relating to that cancelled arrangement that have been recognised.

7 Although in theory this could be quite an extensive exercise EFRAG believes that the methodologies that will generally be used will mean that, across all preparers as a whole, the year one costs will not be significant. It intends however to carry out further work into the matter.

Costs for users

8 EFRAG has also considered whether the Amendment will in some way increase the burden on users of financial statements. Its tentative view is that it will impose no additional burden on users.

Benefits for preparers and users

9 EFRAG has concluded, for the reasons explained in Appendix 2, that the Amendment will reduce uncertainty about how to account for equity settled share based payments and result in a reduction in divergence in practice, thereby enhancing consistency and comparability of the information provided. This should be a benefit to all stakeholders.

Conclusion

10 To summarise, EFRAG's tentative assessment is that the Amendment will involve no incremental costs for users and only insignificant incremental ongoing costs for preparers. The year one costs could be significant for some preparers although for when the position of preparers overall is considered, those costs are not likely to be significant. On the other hand, he Amendment the will result in enhanced consistency and comparability between entities. EFRAG's initial assessment is that this benefit is likely to outweigh the costs involved.