EXPOSURE DRAFT

AMENDMENT TO FRS

AMENDMENT TO FRS 20 (IFRS 2)

'SHARE-BASED PAYMENT'

VESTING CONDITIONS AND CANCELLATIONS

ACCOUNTING
STANDARDS
BOARD

This draft is issued by the Accounting Standards Board for comment. It should be noted that the draft may be modified in the light of comments received before being issued in final form.

For ease of handling, we prefer comments to be sent by e-mail (in Word format) to:

amendfrs20@frc-asb.org.uk

Comments may also be sent in hard copy form to:

Simon Peerless
ACCOUNTING STANDARDS BOARD
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

Comments should reach us by 2 June 2006.
All replies will be regarded as on the public record unless the writer asks for confidentiality. If you are sending a confidential response by e-mail, please include the word 'confidential' in the subject line of your e-mail.

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ISBN 1-84140-793-3

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PREFACE

Background

1 In April 2004 the Accounting Standards Board (the ASB) issued FRS 20 (IFRS 2) 'Share-based Payment'. FRS 20 implemented the requirements of IFRS 2 for those applying UK standards.

2 In February 2006, the IASB issued 'Proposed Amendments to IFRS 2 Share-based Payment' proposing limited amendments to IFRS 2.

3 The ASB is proposing to make equivalent amendments to FRS 20, as set out in this exposure draft.

4 The proposals would amend IFRS 2 and FRS 20 to define vesting conditions and clarify the accounting treatment of cancellations by parties other than the entity. These proposals are being made because of uncertainties as to how the standards apply to employee share purchase plans.

5 Under IFRS 2 and FRS 20, where share options are granted to employees, the value of the options (at grant date) is treated as an expense over the period in which services are received from the employees in exchange for the options – normally the period until the options can be exercised.

6 Share options granted to an employee can fail to be exercised for two main reasons:

(a) the 'vesting conditions' that must be satisfied before the options can be exercised are not met – vesting conditions are requirements for the employee to remain in the employment for a specified period, or requirements for specified performance targets by the entity to be met;

(b) the share options may be cancelled.

7 Under IFRS 2 and FRS 20 a failure to meet the vesting condition results in the cost being recognised in profit and loss account in respect of the options being reversed, so that the options are treated as never having been granted in the first place. However, a very different treatment is required for share options cancelled by the employer. The standards treat employer cancellations as an acceleration of vesting, and all unamortised costs relating to the options are recognised immediately. However, it is currently unclear how a cancellation by the employee should be treated – either as a failure to meet vesting conditions, or in the same way as a cancellation by the employer.

8 This is particularly relevant to savings-based share option schemes (such as Save As You Earn (SAYE) schemes in the UK), where the employee must make monthly savings contributions to remain in the scheme – if the monthly contributions are not made, the options are cancelled.

IASB's proposed amendment

9 The proposed amendment would require cancellations by the employee to be treated in the same way as cancellations by the employer, resulting in an accelerated charge to profit and loss account of the unamortised balance of the value of the options granted.

10 The issue was addressed by IFRIC in 2004, and a draft Interpretation D11 on employee share purchase plans (ESPPs) issued which set out a similar conclusion. This draft was also issued by the UITF in Information Sheet 73 (February 2005) for comment, although the UITF was not in agreement with the proposal.

11 After considering respondents' comments on D11, IFRIC was unable to reach a consensus, and the issue

was referred to the IASB. The IASB has now considered the issue and proposed amendments to IFRS 2.

Concerns with the proposals

12 Several concerns were raised at the time of the IFRIC and UITF discussions, in relation to the effect on SAYE schemes, and arguing that treating employee withdrawals from SAYE schemes in the same way as cancellations by the employer is not a fair representation. An SAYE scheme has two elements. One is an agreement to save (with a third party). The other is an option over the company's shares that can only be exercised using the proceeds of the savings account (which includes tax free interest and a bonus). However, for the option to vest, the employee must remain in employment and continue to save for a specified period. If he fails to satisfy either condition, he forfeits the option.

13 To treat such an employee withdrawal as an accelerated vesting gives rise to the following concerns:

(a) Common reasons for employees withdrawing from SAYE schemes are:

- they change their minds, often early on, about committing to monthly saving; alternatively, they simply need the cash
- they leave the company
- they join a better scheme.

The accounting result seems harsh, if not penal for SAYE schemes. For example, if an employee decides not to continue to save after six months and forfeits his option, why should that give rise to an immediate expense for the company?

(b) A common reason for an employee to withdraw from an ESPP scheme is that he or she is preparing to resign. There seems little difference in substance between an employee who withdraws and then resigns, and an employee who resigns and thereby withdraws – yet under the proposed amendment to IFRS 2 the accounting will be fundamentally different. (Note, however, that paragraph BC19 of the IASB's Basis for Conclusions indicates that withdrawal should be treated as a forfeiture when it is as a consequence of their expected termination of employment).

(c) Employee withdrawals are dissimilar from employer cancellations. Employers are not free to cancel share option arrangements – agreement of the employees will likely have to be bought. Employees, on the other hand, are free to withdraw from SAYE schemes – this seems less like an accelerated vesting. The difference may justify a different accounting treatment.

(d) Where an employee cancels participation in one SAYE scheme in order to take up options under a new scheme offered by the employer, this can be seen as similar to a modification of the first scheme. Under IFRS 2 and FRS 20 a modification would be accounted for by continuing the expensing of the value attached to the original grant and in addition expensing the value attributed to the modification over the period to the new vesting date; this is different from the proposed treatment as a cancellation of the first scheme.

IASB's arguments

14 IASB, in their Basis for Conclusions, set out four possible treatments for employee cancellations of options (paragraph BC8):

- reverse the expenditure to date (the same as a forfeiture such as failure to meet vesting conditions)
- cease recognising future expense from the date of cancellation
- continue recognising expense as if the cancellation had not occurred
- accelerate recognition of the remaining expense (the same as a cancellation by the entity).

15 IFRS 2 and FRS 20 are based on the principle that the services received in exchange for the issue of shares or options over shares should be reflected in the profit and loss account at their full cost as those services are received, and that this cost is best measured by using the fair value of the shares or options issued as a proxy. IASB argue (in paragraph BC11) that it would be inconsistent with this principle for the expenditure to date to be reversed on a cancellation, or for the recognition of the cost to cease on cancellation of the option (since the services will continue to be received).

16 However, the argument against continuing to recognise the cost (paragraphs BC12-15) is not based on this principle, but on the difficulty of distinguishing between cancellations by the employer and cancellations by the employee, and the ‘structuring’ opportunities that would arise. Whilst this may be the case for ‘executive’ schemes, it is difficult to see how such ambiguity and structuring can arise in normal SAYE schemes.

17 The IASB’s conclusion that the cost must be recognised in full at the time of cancellation therefore appears driven more by concerns over abuse than consistency with the principles.

18 Indeed, the IASB’s reasons in the Basis for Conclusions for IFRS 2 itself (paragraph BC233) for requiring an

immediate recognition of costs in the case of cancellations by the entity are also partly in response to concerns that abuse will arise. This paragraph reads, in part:

> "In the Board's view, it is very unlikely that a share option or share grant would be cancelled without some compensation to the counterparty, either in the form of cash or replacement share options. Moreover, the Board saw no difference between a repricing of share options and a cancellation of share options followed by the granting of replacement share options at a lower exercise price, and therefore concluded that the accounting treatment should be the same."

19 The IASB also state, in paragraph BC 10, that whereas forfeitures are not taken into account in the determination of the fair value of the options given, the probability that counterparties will cancel their participation is taken into account. It is not clear whether this is in fact taken into account, or indeed whether it is practicable to estimate the likely level of cancellations (which might depend on many factors affecting employees' ability and willingness to save, including future movements in the share price). The ASB has included a question on this issue in the Invitation to comment set out below.

Conclusion

20 In summary, the ASB has concerns over the proposed amendment and its impact on entities with SAYE schemes. However, as most entities with SAYE schemes and applying UK standards are likely to be subsidiaries of listed groups that apply IFRS, there seems little merit in allowing FRS 20 to diverge from IFRS 2 on this issue. The ASB therefore proposes to amend FRS 20 to maintain consistency with IFRS 2 if the amendment to IFRS 2 is confirmed by the IASB.

Invitation to comment

21 The ASB is issuing this exposure draft to request comments on the IASB's proposals and on the ASB's proposals for implementing them in the UK. The IASB's Invitation to comment is set out on pages 14 to 15 of this exposure draft. In addition, the ASB would welcome comments on the following issues:

ASB Q1: What are the implications of implementing these proposals in the UK, in relation to SAYE schemes or other employee share schemes?

ASB Q2: In paragraph BC 10 of the Basis of Conclusions, the IASB state that the expected level of employee cancellations should be taken into account in determining the fair value of the options at their grant date. Are you aware of practical difficulties this would involve?

PROPOSED AMENDMENT TO FINANCIAL REPORTING STANDARD 20 (IFRS 2) 'SHARE-BASED PAYMENT'

CONTENTS

INTRODUCTION*

1 This Exposure Draft contains proposals by the International Accounting Standards Board to amend IFRS 2 *Share-based Payment* to define vesting conditions and clarify the accounting treatment of cancellations by parties other than the entity.

2 IFRS 2 describes vesting conditions as including service conditions and performance conditions. It is silent on whether other features of a share-based payment transaction are vesting conditions.

3 IFRS 2 specifies the accounting treatment when an entity cancels a grant of equity instruments. It does not state how cancellations by a party other than the entity should be accounted for.

4 These issues were considered by the International Financial Reporting Interpretations Committee (IFRIC) in its draft Interpretation D11 *Changes in Contributions to Employee Share Purchase Plans*, which was published for comment in December 2004†. However, the IFRIC was subsequently unable to reach a consensus and the issues were referred to the Board. The Board agreed with the IFRIC that these issues should be clarified. Accordingly, this document sets out the Board's proposed definition of vesting conditions and guidance on the accounting treatment of cancellations by parties other than the entity.

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* *ASB footnote: This introduction has been prepared by the IASB and is included unamended. References here to the 'Board' are to the IASB.*

† *ASB footnote: Similar proposals were issued in the UK by the UITF in Information Sheet No. 73, issued in February 2005.*

Features of this Exposure Draft

5 The Exposure Draft proposes amendments that:

(a) restrict vesting conditions to service conditions and performance conditions;

(b) require cancellations by parties other than the entity, whether by employees, shareholders or any other parties, to be accounted for in the same way as cancellations by the entity (paragraph 28 of IFRS 2);

(c) require these changes to be applied in annual periods beginning on or after 1 January 2007. The amendments are to be applied retrospectively.

INVITATION TO COMMENT

The International Accounting Standards Board invites comments on the amendments proposed in this Exposure Draft, particularly on the questions set out below. Comments are most helpful if they:

(a) comment on the questions as stated;

(b) contain a clear rationale; and

(c) include any alternative the Board should consider, if applicable.

Respondents should submit comments in writing so as to be received no later than **2 June 2006**.

Question 1 – Vesting conditions

The Exposure Draft proposes that vesting conditions should be restricted to performance conditions and service conditions.

Do you agree? If not, what changes do you propose, and why?

Question 2 – Cancellations

The Exposure Draft proposes that cancellations by parties other than the entity should be accounted for in the same way as cancellations by the entity.

Do you agree that all cancellations should be treated in the same way? If not, please specify the nature of any differences between types of cancellations and explain how they influence the selection of appropriate accounting requirements.

Question 3 – Effective date and transition

The proposed changes would apply to periods beginning on or after 1 January 2007, and would be required to be applied retrospectively. Earlier application would be encouraged.

Are the proposed effective date and transition appropriate? If not, what do you propose, and why?

PROPOSED AMENDMENTS TO FRS 20 (IFRS 2) *SHARE-BASED PAYMENT*

In Appendix A, the definition of **vesting conditions** is amended ~~(new text is underlined and deleted text is struck through) as follows~~ to read:

vesting conditions ...Vesting conditions are either service conditions, which require the other party to complete a specified period of service, or performance conditions, which require specified performance targets to be met (such as a specified increase in the entity's profit over a specified time).

Paragraph 28 is amended ~~(new text is underlined and deleted text is struck through) as follows~~ to read:

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) ...

Paragraph 61 is added, as follows:

61 An entity shall apply the following amendments retrospectively in annual periods beginning on or after 1 January 2007:

(a) the revised definition of vesting conditions in Appendix A;*

* *Vesting conditions are either ~~include~~ service conditions, ... ~~and~~ or performance conditions...*

(b) the amendment in paragraph 28.*

Earlier application is encouraged. If an entity applies the amendments above for a period beginning before 1 January 2007, it shall disclose that fact.

* *If ~~the entity cancels or settles~~ a grant of equity instruments is cancelled or settled.*

BASIS FOR CONCLUSIONS

This Basis for Conclusions accompanies, but is not part of, the proposed Amendments to IFRS 2.

ASB Note: The Basis for Conclusions material that the IASB prepared to accompany its exposure draft is set out below in full. All references in this section to 'the Board' and 'Board members' are references to the IASB Board and IASB Board members.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in the Exposure Draft of Proposed Amendments to IFRS 2—*Vesting Conditions and Cancellations*. Individual Board members gave greater weight to some factors than to others.

Vesting conditions

BC2 IFRS 2 states that vesting conditions include service and performance conditions. Paragraph BC171 of the Basis for Conclusions to IFRS 2 describes vesting conditions as those conditions that ensure that the counterparty provides the services required to 'pay' for the equity instruments issued. For example, service conditions are imposed to ensure that employees provide a minimum period of service in return for the equity instruments. Performance conditions are usually imposed to ensure that a minimum level or quality of service is provided by using performance targets as an incentive.

BC3 In developing these proposals, the Board considered whether other features of a share-based payment transaction should be regarded as vesting conditions. For example, some employee share purchase plans require employees to make regular plan contributions over a specified period. In other plans, employees may be awarded an initial grant of shares in a matching share scheme. If the initial grant of shares has not been sold or transferred during a specified period an additional grant of shares is awarded at a future date.

BC4 The Board acknowledged that additional features, such as a contribution requirement or a requirement to hold an initial grant of shares, may constitute terms that must be satisfied in order for the equity instrument to be issued to the counterparty. These additional features are taken into account in the measurement of the fair value of the equity instrument. However, they are not vesting conditions because they do not ensure that the counterparty provides the services required to 'pay' for the equity instruments.

BC5 More generally, the Board noted that the only conditions that ensure the counterparty provides the services required to 'pay' for the equity instruments granted are either the service conditions themselves, or the conditions that directly affect the services rendered. Therefore, the Board concluded that vesting conditions are either service conditions or performance conditions. No other features should be considered vesting conditions.

Cancellations

BC6 The Board noted that cancellations can be separated into three categories: cancellations by the entity, cancellations by the counterparty (eg an employee or service provider) and cancellations by a third party (eg a shareholder). The Board considered the treatment of each type of cancellation and concluded that all cancellations should receive the same accounting treatment.

Cancellations by the counterparty

BC7 Counterparties may cancel their participation in a plan directly or indirectly by failing to meet a non-vesting condition.* For example, if an employee share purchase plan requires employees to make regular plan contributions over a specified period, the employees may cancel their participation in the plan indirectly by ceasing to make contributions to the plan.

BC8 The Board considered the four ways in which a counterparty cancellation could be accounted for. The entity could:

(a) reverse the expense charged to date (same as a forfeiture);

(b) cease recognising future expense from the date of cancellation;

(c) continue recognising the expense as if the cancellation had not occurred; or

(d) accelerate the recognition of the remaining expense (same as a cancellation by the entity).

BC9 The Board noted that the primary objective of IFRS 2 is to measure the value of goods or services received in return for the equity instruments granted. If a counterparty cancels participation in a plan, this does not imply that the services required to pay for the equity instrument have not been (or will not be) rendered.

BC10 Furthermore, if the event were a forfeiture, a reversal of the expense would be appropriate because no adjustment for forfeitures is included in the grant date fair value of the equity instrument.† However, the fair value of the equity instrument takes into account all the factors that a knowledgeable, willing market participant would take

* *Failure to meet a vesting condition is a forfeiture.*

† *Where the goods or services received are measured by reference to the fair value of the equity instruments granted.*

into account at the grant date, including the probability that counterparties will cancel their participation in a plan.

BC11 Therefore, the Board concluded that, when a cancellation by a counterparty occurs, reversing the expense or ceasing to recognise future expense would be inappropriate, because this would be inconsistent with the primary objective of measuring the value of the goods or services received and with the grant date measurement approach.

BC12 The Board then considered whether the entity should continue to recognise the expense as if the cancellation had not occurred or accelerate the recognition of the remaining expense (as with a cancellation by the entity). In particular, the Board deliberated whether a cancellation by a counterparty should be treated differently from a cancellation by the entity.

BC13 The Board observed that in some cases, legal, taxation or other factors can make it difficult to identify whether the entity or the counterparty cancelled the counterparty's participation in the plan.

BC14 Suitable non-arbitrary and unambiguous criteria would be needed to distinguish these events. The Board observed that such criteria do not exist at present and that to develop them would be difficult and involve a lengthy process. The Board was not convinced that the potential improvement in financial reporting would be commensurate with the resources that would be required.

BC15 The Board also noted that requiring more than one method of accounting for cancellations would create incentives for structuring transactions to achieve a desired accounting result, particularly because the different methods being considered (ie the acceleration of expense method and the continuation of expense method) produce significantly different accounting results.

BC16 Therefore, the Board concluded that a cancellation by the counterparty should be treated in the same way as a cancellation by the entity.

Cancellations and settlements by other parties

BC17 The Board also noted that a cancellation or settlement by an entity is economically equivalent to a cancellation or settlement by a third party on the entity's behalf and should therefore receive the same accounting treatment.

Cancellations and termination of employment

BC18 Some have argued that there is an apparent discrepancy between the treatment of cancellations by employees immediately before they leave service (which are cancellations) and cancellations by employees on leaving service (which are forfeitures).

BC19 The Board observed that this apparent discrepancy could arise only when it is clear that the employees are cancelling their participation in the plan as a consequence of their expected termination of employment. Moreover, the Board noted that, in this case, it would be clear that the grant has been cancelled by forfeiture and, furthermore, that paragraph 28 of the IFRS does not require grants that are cancelled by forfeiture to be treated as cancellations. Therefore, the Board does not propose to issue any additional guidance.

Consistency with US GAAP

BC20 The Board noted that the relevant requirements of the US standard SFAS 123 (revised 2004) *Share-based Payment* are the same as the proposed Amendments. In particular, vesting conditions are restricted to service conditions and performance conditions and all cancellations receive the same accounting treatment.

Transition requirements

BC21 IFRS 2 became effective on 1 January 2005. The Board noted that if an entity's financial statements in previous years contain any material disclosed or undisclosed departures from the requirements of the proposed Amendments, the entity would be required to apply IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in correcting them. However, entities that have applied IFRS 2 should have sufficient information to apply the proposed Amendments retrospectively.

BC22 The Board also noted that the entity is not required to apply IFRS 2 to share-based payments that have been cancelled before the date of transition. Therefore, entities that will adopt the standard for the first time would not need to apply an unacceptable level of hindsight in applying the proposed Amendments.

BC23 Accordingly, the Board concluded that the proposed Amendments should be applied retrospectively and that no specific transition requirements should be proposed.

ISBN 1-84140-793-3

9 781841 407937

UP/ASBD-BI6282

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145 LONDON ROAD

KINGSTON UPON THAMES

SURREY KT2 6SR

TELEPHONE: 020 8247 1264

FAX: 020 8247 1124