EFRAG
European Financial Reporting Advisory Group

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1049 Brussels

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Dear Mr Holmquist

Adoption of the Amendment to IFRS 2 Share-based Payment: *Vesting Conditions and Cancellations*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of the Amendment to IFRS 2 Share-based Payment: *Vesting Conditions and Cancellations* ('the Amendment'), which was published in January 2008. The Amendment was issued in an exposure draft which EFRAG commented on.

The Amendment provides clarification and additional guidance on some accounting issues for which existing IFRS 2 is either silent or lacks accounting guidance. In particular, it addresses three aspects of IFRS 2, namely:

(a) what are vesting conditions;

(b) how to account for non-vesting conditions; and

(c) how to account for cancellations of a share-based payment arrangement by the entity or the counterparty.

The Amendment will apply for annual periods beginning on or after 1 January 2009, with earlier application being permitted.

EFRAG has carried out an evaluation of the Amendment. As part of that process, EFRAG issued a draft evaluation for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and EFRAG's discussions of technical matters are open to the public.

EFRAG supports the Amendment and has concluded that the Amendment meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

- it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt the Amendment and, accordingly, EFRAG recommends its adoption. (EFRAG's reasoning is explained in the attached 'Appendix—Basis for Conclusions'.)

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix
Basis for Conclusions

Set out below is the basis for the conclusions reached and for the recommendation made by EFRAG on the Amendment to IFRS 2 Share-based Payment: Vesting Conditions and Cancellations *('the Amendment').*

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 Amendment, EFRAG considered the following key questions:

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

(b) Are the requirements of the Amendment 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 Amendment meet the criteria for EU endorsement?

2 Having formed tentative views on the issues and prepared a draft evaluation, EFRAG issued that draft on 13 March 2008 and asked for comments on the draft by 14 April 2008. EFRAG has considered all the comments received in response, and the main comments received that are relevant to its technical assessment are dealt with in this appendix.

Is there an issue that needs to be addressed?

3 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.

4 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.

5 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 Amendment 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 Amendment need to be addressed.

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

6 EFRAG considered whether the requirements in the Amendment are consistent with the IASB's Framework. The Amendment focuses primarily on providing clarification and additional guidance on some accounting aspects of IFRS 2 for which the standard lacks guidance, and does not introduce fundamental changes to existing IFRS 2 literature.

7 When EFRAG recommended that existing IFRS 2 should be endorsed, it took into account whether the accounting treatment set out in that standard was consistent with the Framework. As the Amendment focuses on providing clarification of and guidance on existing IFRS 2, EFRAG concluded that no new issues arise relative to the Framework and that the Amendment is consistent with the Framework.

Would the Amendment's implementation result in an improvement in accounting?

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

Issue 1 – What are vesting conditions?

9 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 that ensure the counterparty provides the services required to 'pay' for the share options the entity granted to them.

10 The Amendment amends 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.

11 EFRAG noted that the Amendment restricts 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

12 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 the measurement date. The IASB granted an exemption to this measurement principle; but only for vesting conditions other than market conditions. (Hence the approach is referred to as a 'modified grant date approach'.) Under this approach, service conditions and non-market performance conditions are excluded from the grant date valuation and instead taken into account based on the number of equity instruments that eventually vest.

13 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 Amendment goes 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 (or reasons) other than a cancellation), the entity will recognise the expense not so far recognised 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.

14 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 of this appendix. EFRAG believes that the clarifications in (a) and (c) above 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. In EFRAG's view, (a) and (c) represent useful clarification. Having specific guidance on how to address the accounting for non-vesting conditions will reduce the existing uncertainty and will result in consistent accounting of non-vesting conditions, thus enhancing the comparability of the financial statements. For that reason, EFRAG believes that the Amendment will improve the financial information provided.

Issue 3 – How to account for cancellations

15 Existing IFRS 2 requires cancellations by an entity to be treated as an accelerated vesting. The result is that, if an entity cancels a share-based payment arrangement, it will recognise immediately the amount of the 'unrecognised' expense.

16 The issue addressed in Issue 3 is how to account for cancellations by the counterparty. The Amendment requires cancellations *by a counterparty* to be treated in the same way as cancellations *by the entity*.

17 In EFRAG's view, if it were possible to distinguish between a cancellation by the counterparty and a cancellation by the entity a difference in substance could be identified, it believes that the most appropriate accounting treatment for a cancellation *by a counterparty* would probably be to continue to recognise the 'unrecognised' expense over the remaining vesting period; in other words, not as an accelerated vesting (which is how cancellations by the entity are accounted for).

18 Therefore, in EFRAG's view 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. EFRAG 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.

19 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

20 EFRAG members generally view both IFRS 2 and the Amendment 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 is. On the other hand, none 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?

21 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.

22 When considering whether the Amendment meets 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 Amendment aligns the accounting treatment required for *all* cancellations of a share-based payment.

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

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