EFRAG

European Financial Reporting Advisory Group

The costs and benefits of implementing the Amendment to IFRS 2 *Share-based Payment: Vesting Conditions and Cancellations* in the EU

Introduction

1 Following discussions between the various parties involved in the EU endorsement process, the European Commission decided in 2007 that more extensive information than hitherto needs to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of the Amendment to IFRS 2 *Share-based Payment: Vesting Conditions and Cancellations* (the Amendment). This report sets out that information.

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendment, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this.) Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the Amendment in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments received.

EFRAG's endorsement advice

3 EFRAG already carries out a *technical* assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

Description of the Amendment

4 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'.

5 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.

6 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.

7 Under IFRS 2, such 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.

8 The categories of condition for these purposes 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

9 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)

10 It has become apparent however that this definition and explanation was 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 was therefore asked to clarify whether restrictive conditions such as non-compete provisions were 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 conditions and which are non-vesting conditions.

11 Thus, for the purposes of IFRS 2 as amended, 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

12 As explained in paragraph 5 above, IFRS 2 first requires the reporting entity to determine the value of the share-based payment transaction. The standard requires this in some cases to 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.

13 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.

14 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. Vesting conditions are taken into account subsequently at each reporting date by adjusting the number of equity instruments included in the overall calculation to reflect the number that eventually vest.

15 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).

16 IFRS 2 requires that the value of the transaction shall be revised in certain circumstances. The Amendment makes it clear that, although a 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.

17 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 in such circumstances. 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 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).

EFRAG's initial analysis of the costs and benefits of the Amendment and Stakeholders' views on it

18 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users, both in year one and in subsequent years, from implementing the Amendment.

19 On the basis of that initial assessment, EFRAG tentatively concluded that the Amendment would improve the quality of the financial information provided and, as such, that its implementation in the EU will benefit users.

20 EFRAG further tentatively concluded that the Amendment would:

(a) involve preparers incurring some year one costs—in order to read, understand and implement the new requirements. For some of those preparers the year one costs could be significant but, across preparers as a whole, the year one costs would not be significant;

(b) involve preparers incurring only insignificant incremental ongoing costs; and

(c) involve users incurring no incremental year one or ongoing costs.

21 Finally, EFRAG also tentatively concluded that the benefits it expected to arise from applying the Amendment were likely to exceed the costs involved in its implementation.

22 EFRAG published the above results of its initial assessment on 13 March 2008, together with a detailed supporting analysis. It invited comment on the material by 14 April 2008. EFRAG received 9 comment letters in response, and all of those commenting on the costs and benefits likely to arise from implementing the Amendment in the EU supported EFRAG's assessment.

23 In addition, EFRAG consulted its User Panel on the impact that the Amendment to IFRS 2 would have on users. Most Panel members were generally supportive of EFRAG's assessment of the costs and benefits to users that will arise from implementing the revised standard.

EFRAG's final analysis of the costs and benefits of the Amendment to IFRS 2

24 Based on its initial analysis and the stakeholders' views on that analysis, EFRAG's detailed final analysis and supporting reasoning are presented in the paragraphs below.

Costs for preparers

25 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.

26 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 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.

27 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 to meet a condition, 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) possible restatements of the financial statements to apply the Amendment retrospectively.

28 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 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 place. 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.

29 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 other types of conditions. This will involve an incremental cost. However, although such estimates can be subject to significant uncertainties, EFRAG's assessment is that such uncertainties will not make the estimates significantly more expensive to make than 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 the model 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 assessment is that overall this additional year one cost will not be significant.

30 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.

31 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.

Costs for users

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

Benefits for preparers and users

33 EFRAG has concluded, for the reasons explained above, 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

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

EFRAG
12 May 2008