NSS meeting Rome

September 2010

RESEARCH ON THE IFRS 2 : AN UPDATE

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1. Reminder of the background and objectives of the project

1 IFRS 2 "Share-based Payment" was issued in February 2004 for application to annual periods beginning on or after the 1st January 2005. Since that date IFRS 2 has been subject to a considerable number of requests, which illustrate the complexity of the Standard. Some of these requests have lead to interpretations and amendments[1] whilst others have been rejected by the IFRIC.

2 Considering the number of requests received, some of which questioning the underlying principles of IFRS 2, the IASB decided in 2008 to carry out a review of IFRS 2 in order to clarify the underlying accounting principles. At the National Standard Setters' (NSS) meeting in Melbourne (April 2008) the French national standard setter, the ANC, agreed to take on this review project.

3 The IASB and the ANC agreed on the objectives and scope of the review at a meeting on 14 January 2009. It was agreed that the aim of the project was to:

- Clarify rather than change the core principles;
- Ensure the consistency of these principles both within IFRS 2 and in relation to other IFRSs;
- Make the standard easier to understand and to apply.

4 It was in particular agreed that the following core principles of IFRS 2 would not be challenged within the scope of the review project:

- An asset or an expense is recognised by the entity when it receives an asset or a service in exchange for a share-based payment;
- In an equity-settled share-based payment transaction, the reference date for measuring the asset or the expense by reference to the fair value of the equity instruments granted when the entity cannot estimate reliably the fair value of the goods or service received is the grant date for the related equity instruments when the counterparties of the transaction are employees[2];
- The asset or expense is measured based on a fair value model.

5 Following this meeting, the ANC working group drew up a draft list of accounting principles for presentation to the EFRAG, the IASB and at the NSS meeting in Johannesburg on the 8th and 9th of April 2009[3]. At the NSS meeting in Johannesburg, the following objectives were confirmed:

- To redraft IFRS 2 in a principles-based approach without developing application guidance;

- [1] The interpretation IFRIC 8 clarified the scope of IFRS 2 in January 2006;
- The interpretation IFRIC 11 clarified the accounting treatment of Group and Treasury Share Transactions in November 2006;
- A first amendment to IFRS 2 on Vesting Conditions and Cancellations was issued in January 2008;
- A second amendment to IFRS 2 on Group Cash-settled Share-based Payment Transactions was issued in June 2009; this amendment also incorporated in IFRS 2 the guidance contained in IFRIC 8 and IFRIC 11;
- the IFRS Interpretation Committee is currently analysing how to clarify the distinction between vesting and non-vesting conditions, especially when performance conditions are concerned.

[2] It will be the receipt date when the counterparties of the transaction are others than employees.

[3] These principles are set out in Appendix 1 of Paper 13A

- To maintain the above-mentioned core principles: to recognise an asset or expense as counterpart to a share-based payments, to measure the transaction by reference to the grant date, and to use a fair value (renamed "market-based value" in the ED on Fair Value Measurement issued in May 2009) model;
- To eliminate any inconsistencies within the standard and with other standards.

6 At the NSS meeting in Frankfurt on the 8th and 9th of September 2009 the ANC presented:

- Two alternative accounting objectives that could be considered for IFRS 2 with different possible recognition and measurement approaches, including the effect of different possible interpretations of the notion of service received;
- A first analysis of the interpretation and the related accounting treatment applicable to modifications and cancellations of share-based payment plans for employees.

7 The ANC met members of the IASB Board and staff on 23 November 2009 to discuss issues raised in the September 2009 Report Paper and possible directions for the project. No final conclusions were achieved at this stage on these issues. However, there were no negative reactions to the content of the Report Paper. The ANC also invited EFRAG to express opinion on the issues raised in the September 2009 Report Paper to NSS. The Paper and related issues were presented to the EFRAG TEG on 13 November 2009.

8 At the NSS meeting in Seoul on the 13th and 14th of April 2010 the ANC presented two alternative proposals to amend IFRS 2 depending on the global objective assigned to the standard to portray either services received or services effectively paid:

- The "Unit of Service" approach considered as the most appropriate method if the objective of IFRS 2 is to represent services received in a share-based payment transaction;
- The "Payment" approach considered as the most appropriate method if the objective of IFRS 2 is to represent services effectively paid in a share-based payment transaction.

9 These alternative proposals were designed in order to be consistent with:

- The 7 accounting principles previously identified (see Appendix 1 in Paper 13A);
- The core principles of recognising an asset or expenses when an asset or service is received in exchange of a share-based payment transaction and referring to the grant date fair value for measuring the asset or expenses in a equity-settled share-based payment transaction when the fair value of the goods or services cannot be estimated reliably;
- A principles-based approach that should avoid as far as possible rules based provisions, including anti-abuse clauses.

10 At the NSS meeting, some participants suggested to go deeper into the analysis of the "Payment" approach and to benchmark the basis for choosing between the two approaches to the elements set out in the IASB's Framework. Some questioned the reference to the grant date fair value. The ANC invited all NSS to send their comments by the end of June 2010 (two comments received).

11 The ANC also met members of the IASB Board and staff on 14 May 2010 to discuss the two alternative proposals. Participants to the meeting agreed on the general analysis and the principle-

based approach with no anti-abuse clauses on forfeitures, modifications and cancellations. They considered that potential "negative" amounts could be (partly) seen as renegotiation results an discussed if they should be recognized in equity or as revenues. The ANC was encouraged to continue reviewing the two alternatives and to provide a report that could be used by the IASB as a research paper (i.e. not a post-implementation or application review) by end 2011.

12 On 8 June 2010, the alternative proposals were presented at the meeting of Consultative Forum of Standard Setters (CFSS) organized by EFRAG. Participants to the meeting had mixed views on which approach was the most appropriate, especially in order to predict future cash flows. They agreed that "negative" amounts could be seen as renegotiation results.

13 Conclusions of consultations were that there were a global agreement on the general analysis, but no clear preference for one of the two proposals. Both should be further benchmarked to elements of the Conceptual Framework. Anti-abuse rules should be removed and potential "negative" amounts accepted as renegotiation results to be recognised either in equity or as revenues. Since April 2010, the ANC working group has therefore continued to work on the project in particular in the following directions:

- Analysing the two approaches (unit of service and payment) with reference to the Conceptual Frameworks' (current and new proposed one) objectives and qualitative characteristics;
- Detailing the approach representing services effectively paid, the "Payment" approach, and more globally analyse the coherence of the two proposed approaches with possible accounting treatments, in particular when renegotiation results are concerned;
- Analysing how to better representing service received (or paid) in relation with a performance required rather than a presence.

2. Compatibility of the two approaches with the Conceptual Framework

2.1 - Reminder of the two principles based approaches identified

14 The working group considered which recognition and measurement approaches would enable an appropriate representation of share-based payment transactions considering the possible accounting objectives (see Appendix 2 of Paper 13A) and the definition of services received (see Appendix 3 of Paper 13A) previously noted:

1. **To represent assets acquired by or services received** by the reporting entity as part of a share-based payment transaction irrespective of whether there is an identifiable payment made by the entity (or by a entity's shareholder or another entity of the group).
2. **To represent share-based payments** made by the reporting entity (or by an entity's shareholder or another entity of the group) irrespective of whether there is an identifiable service received by the entity.

15 It therefore appeared that a clarification of the accounting objectives of IFRS 2 was necessary. This question was raised through a consultation of interested constituents, including the NSS, EFRAG and the IASB. No final conclusion has been achieved yet.

16 The ANC tentatively considers that:

- ***The objective to represent services received implies that these services are supposed to be received regularly and to be proportional to the employees' presence (or performance);***
- ***The objective to represent share-based payment effectively vested implies that related services are supposed to be received only if all conditions (presence and performance) are fully completed.***

17 Whilst many of the working group members support the objective of representing services received, which seems also to be the objective highlighted in the IFRS 2 BCs, it was noted after consulting informally European constituents that a certain number of the latter supported the objective of representing payment. Official consultation with NSS and constituents, as well as discussion with the IASB, did not enable a preferred approach to be identified. As a result, the working group decided that both of the above-mentioned objectives required further consideration and that appropriate recognition and measurement approaches should be analysed with a view to representing both "services received" and "services paid".

18 The working group therefore decided to present proposals for:

(a) The "Units of Service" approach considered as the most appropriate for representing "services received".

(b) The "Payment" approach which is the name given to a proposed approach for representing "services paid".

19 The detailed presentations of each approach are stated in Appendixes 4 and 5 of Paper 13A.

20 Following a comment received at the May 2010 NSS meeting in Seoul, the ANC decided to analyse if the Conceptual Framework could help in making a decision on the most appropriate approach (Unit of Service or Payment) for representing share-based payments. The ANC analysed the four following items in the Conceptual Framework (and revised Conceptual Framework[4]) that could help in deciding which approach was the most appropriate:

1. The objectives of financial statements
2. Relevance and faithful presentation (defined as "fundamental qualitative characteristics" in the revised Conceptual Framework)
3. Comparability (defined as one of the "enhancing qualitative characteristics" in the revised Conceptual Framework)
4. Cost (defined as one of the "constraints" in the revised Conceptual Framework)

[4] At the time of this analysis, the IASB published a ballot draft of the revised Conceptual Framework regarding "The Objective of General Purpose Financial Reporting" and "Qualitative characteristics of, and constraints on, useful financial information"

2.2 - The objectives of financial statements

Extracts of the Conceptual Framework and Revised Conceptual Framework (ballot draft)

Conceptual Framework – The objective of financial statements – Extracts § 12, 15, 17

The objective of financial statements is to provide information about financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

The economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation.

Information about the performance of an entity, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future.

Revised Conceptual Framework – Ballot Draft – The Objective of General Purpose Financial Reporting – Extracts OB6 & OB14

The objective of investors, lenders, and other creditors is to receive returns of and returns on their existing or potential interests in the reporting entity. Therefore, they are directly interested in the amount, timing and uncertainty of a reporting entity's future cash flows because those factors directly affect the prices and recoverability of their interests in the reporting entity.

Information about a reporting entity's financial performance helps users understand the return that entity has produced on its economic resources.

Providing information about (financial) performance

21 We could argue that the Unit of Service approach would represent more faithfully the (operational) performance of an entity, assuming that the services are received proportionally to the presence of the employees during the vesting period. Recognition of services received on an accrual basis in the income statement would help representing - and comparing - inputs (services rendered by an assembled workforce) effectively used to generate revenues, whatever the mean of payment of these services is (see IFRS 2 BCs 40 to 44, especially BC 43).

22 Nevertheless we could also consider that measuring performance consists in representing the effective cost of inputs used and the efficient negotiation of the managers in minimizing this cost. In such a perspective, services are recognised only if they are paid (otherwise they have been received for free), or could be considered as rendered only if the targets are met (presence/ performance). Then, the Payment approach could be seen as more appropriate to represent (financial) performance.

23 ➫ The notion of "performance" to be portrayed is not clearly defined in the Conceptual Framework. It depends on how the related "inputs" contributing to the performance are defined. This brings us back to the definition of a service received, which is different in the two alternative approaches. Therefore, it is difficult on this basis to determine which approach better reflects performance.

Information and evaluation of the ability of an entity to generate (future) cash flows

24 The Payment approach represents the "services to be paid" in the form of instruments that effectively vest and then, under this approach services are received – and recognised in the accounts - only to the extent that a "payment" (i.e. vesting) is made. Therefore, this approach would be more consistent with the objective of providing information on the ability of the entity to generate future cash flows.

25 However, this argument could be controversial when payments are equity-settled as there is no cash release but equity issuance. That is partly the reason of the existence of a specific standard for representing this particular form of employee compensation.

26 We could argue that, even there is no “payment” as the entity vest equity instead of cash, there is an indirect cash outflow (1) for the entity that could have received cash from investors in exchange of the equity instrument or (2) for the shareholders who are diluted and then decrease their individual rights to receive cash flows from the entity. In the second case, we may consider that the loss of potential cash inflows is not suffered by the entity. However, the dilution effect may reduce the ability of the entity to issue new shares at a high price, resulting indirectly in a loss of potential cash flows to the entity.

27 ✍ The Unit of Service approach has clearly not the objective to portray the ability of an entity to generate cash flows, as expense will be recognised even if no payment is made. However, the payment approach does not guarantee a clear representation of this ability, especially when the payment is equity-settled. Yet, we may consider that this latter approach globally provides more useful information in such a respect.

Accrual basis of accounting as a mean to meet the objectives of financial statements

28 One of our respondent (see Paper 13B) noted that the Payment approach would not provide an accounting representation in line with the accrual basis method mentioned in paragraph 22 of the current IASB Framework (as well as with paragraph OB15. of the revised one). This paragraph notes in particular that “In order to meet their objectives, financial statements are prepared on the accrual basis of accounting.” Recognising service received using the Unit of Service approach in line with the accrual basis of accounting would therefore better achieve these objectives.

29 In this paragraph 22 it is also noted that the objective and justification of the accrual basis method is that “the effects of transactions and other events are recognised when they occur”. The occurrence notion is closely linked to the definition of the related event, i.e. to the definition of service received when IFRS 2 is concerned. In the Payment approach, the service would be considered as received only if all vesting conditions are completed. Moreover, as the Payment approach would imply recognizing a “provision” for payment on an accrual basis, it may be argued that the accrual basis method is also applied in this approach. However, this provision could be derecognised if it is not probable that the payment will occur, which may appear inconsistent with the accrual basis method that usually recognize events which are (almost) certain.

30 ✍ The Unit of Service approach appears in line with the accrual basis of accounting. It is less intuitive to consider that the Payment approach may also be consistent with it.

31 ✍ Regarding the above arguments, the analysis of the objectives of financial statements (representation of performance and ability to generate cash flows) as defined in the Conceptual Framework does not enable to make a clear choice between the two approaches. The Payment approach may appear as more in line with the second objective whereas the Unit of Service approach may be more in line with the accrual basis method, which is supposed to help achieving the objectives of financial statements .

ISSUE 1

Do you agree that the analysis of the objectives of the financial statements does not enable to make a clear choice between the two methods? If not, explain your answer.

2.3 - Relevance and faithful presentation

Extracts of the Conceptual Framework and Revised Conceptual Framework (ballot draft)

Conceptual Framework - Qualitative characteristics - Extracts § 26 & 33

> To be useful, information must be relevant to the decision-making need of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events, confirming, or correcting, their past evaluation.
>
> To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent.

<u>Revised Conceptual Framework – Ballot Draft – Fundamental qualitative characteristics – Extracts QC 5-11</u>

> *The fundamental qualitative characteristics are relevance and faithful representation.*
>
> *Relevant financial information is capable of making a difference in the decisions made by users […]. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both.*
>
> *To be useful, financial information […] must also faithfully represent the phenomena it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral and free from error.*

32 Relevance and faithful presentation are defined as the two fundamental characteristics in the revised Conceptual Framework. There are also noted within the qualitative characteristics of the current Framework. However, the characteristics of relevance and faithful presentation as defined in the Conceptual Framework and the project of revised Conceptual Framework do not provide us enough information to choose which accounting treatment (Unit of Service or Payment) would be the most useful for the users of financial information.

33 As a matter of fact, assessment of relevance and faithful presentation can be made only in relation to objectives assigned to the representation of transactions and situations in the financial statements. This means that we should first determine which of the two proposed global approaches in the IFRS 2 review project is the more appropriate in terms of representation's objective before assessing the relevance and faithful presentation of the related information. Therefore, reference to these qualitative characteristics cannot help us to make a choice between both approaches, as this choice is a preliminary step to their analysis.

34 ✍ Both approaches have their own logic in terms of representing a certain aspect of the same kind of transactions. As the Framework does not precisely deal with what the financial statements are supposed to represent in this particular respect, it does not assist in choosing the most appropriate approach to represent a transaction within the scope of IFRS 2.

ISSUE 2

> Do you agree that the characteristics of relevance and faithful representation do not assist in choosing the most appropriate approach? If not, explain your answer.

35 In order to know which accounting treatment would be the more useful for users, we would suggest to the IASB, as part of its IFRS 2 post implementation review, to ask users which approach seems to provide the more useful and understandable information.

2.4 - Comparability

Extracts of the Conceptual Framework and Revised Conceptual Framework (ballot draft)

Conceptual Framework - Qualitative characteristics – Comparability – Extracts § 39

> Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out
> - in a consistent way throughout an entity and over time for that entity and
> - in a consistent way for different entities

Revised Conceptual Framework – Ballot Draft – Qualitative characteristics – Enhancing qualitative characteristics – Extract QC 19

> *Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.*

Cash-settled versus equity-settled transactions (within IFRS 2)

36 We could argue that the means of settlement for share-based payment transactions (cash or equity) should not have an impact on the accounting treatment as the substance of the transaction appears to be similar. For example, this is particularly true when the employee realises the gain on the exercise of share options by selling the shares immediately after exercise, as commonly occurs. As a consequence, according to the Framework the accounting treatment should be the same. This argument was developed in IFRS 2 BC 113 and IFRS 2 BC 252.

37 The two main differences in the accounting treatment between cash-settled transactions and proposed treatments for equity-settled transactions could arise from:

1. The “quantity” of services recognised in the accounts (Unit of Service approach only)

38 The “quantity” of services recognised in the accounts is comparable for cash-settled and equity-settled transactions under the Payment approach. It is also comparable with non-share-based payment transactions. This is not the case under the Unit of Service approach.

39 Hence, for example, when vesting conditions are not met under the Unit of Service approach, an expense is recognised for equity-settled transaction considering that part of the service has been rendered before the forfeiture whereas in cash-settled transactions no expense is recognised. On the contrary, under the Payment approach, no expense is recognised if vesting conditions are not met, regardless of the means of settlement (cash or equity).

40 ✎ As a consequence, the Payment approach may improve comparability of the “quantity” of services recognised in the accounts between similar transactions whatever the kind of payment is, as services received but not paid will not be recognised in the accounts in all these cases (employees are working for free).

41 The above argument was questioned within ANC’s working group as equity settled transactions and cash settled transactions are by nature not comparable: employees are considered as future shareholders of the entity (equity settled transactions) or employees have a right to receive cash (cash settled transactions) if certain conditions are met. Therefore, it may not worth trying to compare them. Moreover, the working group already proposed to adapt the accounting treatment of cash-settled transactions to make them be more comparable to equity settled transactions under the Unit of Service approach, by distinguishing services received in operating expenses from changes in the fair value of the liability to be vested in OCI or financial expenses/income.

42 ✎ Then, operating expenses would be comparable under the Unit of Service approach between equity-settled and cash-settled transactions.

43 This way to improve comparability was analysed by the Board in ED 2 who considered differentiating two components in a cash- settled transactions: (1) an amount based on the fair value of the cash-settled transaction at grant date, recognised over the vesting period and (2) changes in estimate between grant date and settlement date. The latter component would then be recognised either in the notes or in the face of the income statement. The Board concluded that applying this distinction under the Modified Grant Date approach (MGD) was too complex (see IFRS 2 BC 255).With the Payment approach this argument could be reconsidered, as the Payment method is simpler than the MGD, which is not the case for the Unit of Service approach.

44 ✎ Distinguishing changes in fair value for cash-settled transactions would be less complex under the Payment approach. Hence, it may ease distinguishing operational expenses from financial results and thus making equity-settled and cash-settled transactions be more comparable.

2. The value of services recognised in the accounts (both approaches)

45 Cash-settled transactions are re-valued between the grant date and the settlement date according to the change in the estimation of the assets which will be paid out whereas for equity-settled transactions the value of the equity instruments to be issued are measured at the grant date without further changes, assuming that the grant date fair value remains the reference in the Payment approach too. This will generate a difference in measurement between cash-settled and equity-settled transactions, whatever the approach is.

Non-market performance conditions versus other « no service » conditions

46 For equity-settled transactions under the Unit of Service approach, the accounting treatment depends on the type of conditions included in the contract. Hence, if service (presence) or / and non-market performance conditions are met, expenses are recognised even if other conditions are not met. If non-market performance conditions are not met, expenses are partly recognised assuming that services are received gradually.

47 For collective performance conditions, we could question this difference in the accounting treatment. For example, the service received in exchange for an equity-settled transaction with a performance condition based on the increase of x % of the share price may or may not be considered as substantially similar to an equity-settled transaction with a collective performance obligation of increasing the revenue by y %. Depending on how the distinction between market and non-market performance conditions is made – which may be subjective -, the grant date fair value as well as the number of Unit of Services recognised may vary significantly. This may reduce comparability between operations of similar nature if interpretation on this kind of distinction diverge. The IFRS Interpretation Committee and IASB staff are currently working on clarifying the criteria to be used for addressing this interpretation issue.

48 Such differences of accounting treatment between market and non-market performance conditions do not exist under the proposed Payment approach, as they will both be excluded from the grant date fair value and analysed as elements that influence the "quantity" recognised in the accounts. This may make the Payment approach ensure to treat operations of similar nature comparably.

49 ✎ The accounting treatment proposed under the Payment approach may provide more comparability between equity settled contracts of similar nature than the Unit of Service approach by avoiding subjective distinctions between market and non-market performance conditions.

Share-based payments transactions versus other employee benefits and other transactions

50 The accounting treatment of other employee benefits as termination benefit or profit-sharing (cf. IAS 19) is closer to the Payment approach: when the vesting conditions are not met, no expense is recognised even if the service has been partially rendered. Moreover where services are rendered for free (for example unpaid overtime or performance targets that are exceeded without a corresponding payment), no expense is recognised which is consistent with the Payment method. We may also consider that treatments of some payment commitments (under certain conditions) in IFRS 3 are more comparable to the Payment approach.

51 ✎ The Payment approach is more comparable to the accounting treatment of other employee benefits (except that the "payment" is not re-valued) and more globally to other cash-settled (not share-based) transactions.

52 ✎ **As a conclusion on comparability, it seems that the Payment approach may make recognition of services received be more comparable with the way they are recognised when payments other than equity-settled share-based payment are used. However, one may question the objective of making a share-based payment be comparable to other means of payment.**

ISSUE 3

(a) Do you agree that the Payment approach may make the recognition of equity-settled share-based transactions be more comparable with the way other transactions are recognised (for example: cash settled transactions, employee or termination benefits, services rendered for free) than the Unit of Service approach? If not, explain your answer.

(b) In your view, does it make sense to compare equity-settled share-based payment transactions with other transactions (for example: cash-settled transactions, employee or termination benefit, services rendered for free)? Explain your answer.

(c) Do you have any other comments to the above arguments regarding the comparability characteristic of the two proposed approaches?

2.5 - Cost

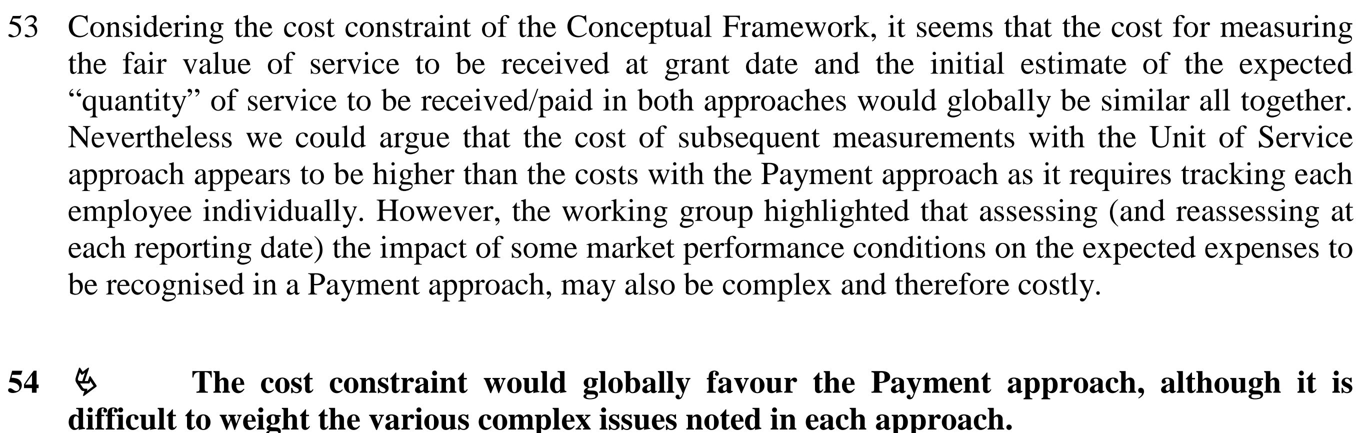
Extracts of the Conceptual Framework and Revised Conceptual Framework (ballot draft)

Conceptual Framework - Constraints on relevant and reliable information – balance between benefit and cost – Extract § 44

The benefits derived from information should exceed the cost of providing it.

Revised Conceptual Framework – Ballot Draft – Constraint on financial reporting – Cost – Extract QC 35

Reporting financial information imposes costs and it is important that those costs are exceeded by the benefits of reporting that information.



53 Considering the cost constraint of the Conceptual Framework, it seems that the cost for measuring the fair value of service to be received at grant date and the initial estimate of the expected “quantity” of service to be received/paid in both approaches would globally be similar all together. Nevertheless we could argue that the cost of subsequent measurements with the Unit of Service approach appears to be higher than the costs with the Payment approach as it requires tracking each employee individually. However, the working group highlighted that assessing (and reassessing at each reporting date) the impact of some market performance conditions on the expected expenses to be recognised in a Payment approach, may also be complex and therefore costly.

54 The cost constraint would globally favour the Payment approach, although it is difficult to weight the various complex issues noted in each approach.

ISSUE 4

Do you agree that the characteristic of cost would globally favour the Payment approach? If not, explain your answer.

2.6 - Conclusion on the compatibility of the two approaches with the Conceptual Framework

55 The Payment approach seems slightly more consistent with the (enhancing) qualitative characteristic of Compatibility and the constraint of Cost included in the Conceptual Frameworks (the current as well as the revised one) than the Unit of Service approach. But, there is no evidence that one of these approaches is more in line with the global objectives of financial statements or with the (fundamental) qualitative characteristics of relevance and faithful representation. Therefore, we may conclude that there is no decisive argument derived from the analysis of the Conceptual Framework that can help in determining which is the most appropriate approach, compared to the importance of deciding in favour of one of them, i.e. of deciding what financial statements should portray as performance, and of the significant resulting accounting consequences.

56 It may be noted that some correspondents, including members of the IASB Board, suggested to test the possibility to combine both approaches (the Unit of Service approach on the debit side and the Payment approach on the credit side). We have not yet analysed this avenue that may be quite complex to build up.

ISSUE 5

(a) Do you agree that there is no decisive argument from the analysis of the Conceptual Framework that can help in concluding the most appropriate approach?

(b) Do you have any other argument that could help choosing one of the proposed methods or to combine them? Please explain our answers to these two questions.

3. Coherence of the proposed approaches with envisaged accounting treatments

57 The second direction taken by the working group since the NSS meeting in April 2010 has been to analyse the coherence of the Unit of Services and Payment approaches with accounting treatments that could be applied to certain events or situations. Hence, developing a principle-based approach for accounting share-based payment suppose analysing this coherence, especially when the accounting treatment of renegotiations and cancellations is concerned.

3.1 - Discussion on the coherence of the Unit of Service approach

1. The Unit of Service approach is compatible with the use of the "grant date fair value" for measuring share-based payment expenses related to service received.

58 The Unit of Service approach is supposed to represent services regularly received from employees in exchange of share-based payments granted according to a contractual agreement between the employer and the employees whose conditions have been determined at the grant date (see appendix 4 in Paper 13A for further details). It would be difficult and burdensome to reliably estimate the fair value of each unit of service received at the time the services are received, not to mention that it is also difficult to precisely determine when they are received. Moreover, as mentioned in the BC95 of IFRS 2 and reminded when Accounting Principle 6, it is unlikely that there will be a high correlation between changes in the fair value of service received and changes in the fair value of related promised instruments. Therefore, service date fair value is not the appropriate measurement reference. Instead, it is reasonable to presume that the fair value determined at grant date of each unit of service to be received in exchange of equity instruments is representative of the global balanced agreement between both parties on the value of the related expected services and therefore of the value of each unit of service gradually received.

ISSUE 6

Do you agree with the above coherence between the Unit of Service approach and the "Grant date" fair value (as an estimate of the exchange value at the time the services are received)? If not, explain your answer.

2. The fair value of units of service takes into account all elements of the contract that may have an effect on the expected value of the considerations exchanged.

59 The objective of the Unit of Service approach is to recognize service received measured at the fair value of these services as estimated by both parties at the grant date. This implies that all elements and conditions included in the accord that may have an effect on the fair value of the considerations exchanged as estimated by the parties have to be taken into account when measuring the grant date fair value. Then, in order to determine the fair value of each unit of service, the number of units of service expected to be received should be estimated including the expected realization by the parties of all conditions that may have an effect on the reception of units of services (in fact expected realization of service and performance conditions). Finally, the grant date fair value should be

divided by the number of unit of service expected to be received and the resulting unit of service's fair value should be multiplied by the units of services effectively received.

60 One respondent suggested (see Paper 13B) that a possibility to simplify the measurement issue in the Unit of Service approach could be to eliminate in the calculation of the grant date fair value the expected effect of all vesting conditions and forfeiture expectations, and to divide it by the maximum number of unit of services that could be received. We have not tested this proposal. A preliminary thought could be that it would provide a good estimate of the expected fair value of considerations exchanged between the parties if the respective effects of the simplification on the numerator and denominator of the calculation are similar. The less there are market and vesting conditions that do not relate to conditions that have a potential effect of reception of services (service or non-market performance conditions), the better the estimate would be.

ISSUE 7

(a) Do you agree with the coherence between the Unit of Service approach and above description of measuring the fair value of units of service? If not, explain your answer.

(b) Do you think the proposed simplified calculation is a good idea? Explain your answer.

3. No adjustment to expenses recognized before a forfeiture, a cancellation or a modification.

61 The rationale of the Unit of Services approach (see appendix 4 for further details) is that the quantity and value of services received before a forfeiture, a cancellation or a modification are definitively received by the employer and they cannot be modified because of renegotiations. Moreover, according to accounting principle 7, the right to receive equity instruments in exchange of services rendered (IFRS 2 BCs) should not be re-valued.

62 Then two accounting treatments of the result of the renegotiation could be considered:

a. Use a prospective "cancel and replace" approach for services to be received

63 This accounting treatment is compliant with the principle of no revaluation of services previously received as well as accumulated rights to equity instruments, as the proposed "cancel and replace" approach would be used to estimate the value of future services to be received only. The proposed treatment supposes to evaluate the services to be received according to the fair value of equity instruments granted at the renegotiation date proportionally to the residual vesting conditions.

64 Illustrative example:

Assumptions: Vesting period = 3 years Value of UoS (10000/3) =3333	*Initial agreement* Beginning period 1(CU)	*Modification* End period 2 (CU)
FV of instruments initially granted at the date of modification/cancellation (m/c)	10 000	100 000
FV of instruments/compensation granted through m/c	n/a	120 000
Recognized services expenses		
Recognized expenses at end period 2	6 667	6 667
Recognized expenses in period 3	3 333	40 000
Total recognized expenses (3 periods)	**10 000**	**46 667**

Residual vesting condition: 1 year among 3 years

b. Recognizing a result according to the "difference" at the renegotiation date between the fair value of the instruments granted before and after the renegotiation

65 This accounting treatment is compliant with the principle of no revaluation of services previously received as well as accumulated rights to equity instruments. The treatment supposes to evaluate the difference of the fair value of the equity instruments granted before and after the renegotiation date. This "result" is attributable to services already received and also to services to be received. Only the latter will be recognized as expenses in the forthcoming periods.

66 Illustrative example:

Assumptions: Vesting period = 3 years Value of UoS (10000/3) =3333	*Initial agreement* Beginning period 1 (CU)	*Modification* End period 2 (CU)
FV of instruments initially granted at the date of modification/cancellation (m/c)	10 000	100 000
FV of instruments/compensation granted through m/c	n/a	120 000
Difference in FV due to m/c	0	+20 000
Recognized services expenses		
Recognized expenses at end period 2	6 667	6 667
Recognized expenses in period 3		
1 period x initial value of UoS	3 333	3 333
Difference of renegotiation in expense (difference in FV x 1 period / 3 periods) (1)	0	+6 667
Recognized expenses in period 3	3 333	10 000
Total recognized expenses (3 periods)	**10 000**	**16 667**

Part of the « difference » related to services to be received

(1) The repartition between services received and services to be received can be differently estimated (see the general discussion on modifications and cancellations below)

67 Both proposed accounting treatments may result in 1) significant change in the fair value of units of service received after the renegotiation, and in 2) measuring parts of accumulated rights to equity instruments (recognized partly before and partly after the renegotiation date) at significant different values. This phenomenon may be more important when a prospective "cancel and replace" method is applied (accounting treatment "a"). It may be considered as inconsistent or confusing to use different fair value to measure parts of services received and parts of related accumulated rights to equity instruments which are of similar nature. We also may question if such valuation changes are consistent with reference to the grant date fair value that has been considered as appropriate under the Unit of Service approach. However, we may note that reference to the fair value at the initial grant date is justified by its representation of the balanced agreement at that time between both parties on the fair value of the exchange of considerations. If the contract is renegotiated, the fair

value at the renegotiation date could be considered as representative of an updated balanced agreement between both parties on the fair value of the exchange of considerations, at least for the future (a "new" grant date fair value). Therefore, proposed accounting treatments would be consistent with reference to the (new) grant date fair value and it may be appropriate to measure future service received and related future rights to equity instruments at this value.

68 Accounting treatment "a" may be considered as not consistent with accounting principle 7 that prohibits re-measurement of equity instruments, as the new fair value referred to includes the revaluation effect of already accumulated rights to equity instruments. On the contrary, accounting treatment "b" includes fair value changes due solely to renegotiation effects excluding revaluation of accumulated rights to equity instruments. Therefore, accounting treatment "b" may appear as more consistent with accounting principle 7. However, the new fair value in accounting treatment "a" is used only prospectively.

ISSUE 8

(a) Do you agree that both proposed treatments for renegotiations' effects are coherent with the Unit of Service approach, the reference to the grant date fair value and the absence of re-valuation of accumulated rights to equity instruments (according to principle 7)? If not (or if only one seems coherent to you), explain your answer.

(b) In your view, does one of the proposed treatment is a more faithfully represent services received?

4. Under accounting treatment "b" the result of renegotiation attributable to services already received is recognized directly in equity.

69 As a matter of fact, the Unit of Service approach supposes that the employees regularly acquire – as the services are received – rights to the equity instruments of the entity. These rights can be renegotiated during the agreement's period whereas the units of service received cannot because they are definitively received on an accrual basis. If the accounting treatment of modifications and cancellations supposes to identify a difference on fair value related to past services, this "result" is necessarily related to equity instruments' rights, as services already received cannot be renegotiated. As a consequence, the renegotiation result concerns the rights of (future) shareholders – the employees -. Therefore, it has to be recognized directly in equity.

70 Recognition in equity should only reflect the effects of the renegotiation and should exclude the effect of the revaluation of accumulated rights to equity instruments. Accounting treatment "b" identify and measure separately this renegotiation effect whereas accounting treatment "a" doesn't. Therefore, it is easier under accounting treatment "b" to recognize these renegotiation effects in equity. This may be another argument for considering accounting treatment "b" as more consistent with accounting principle 7.

ISSUE 9

Do you agree with the above rationale? If no, explain your answer.

3.2 - Discussion on the coherence of the Payment approach

1. Expenses recognized are adjusted in all cases that prevent or modify payment to vest, including forfeiture, cancellation or modification

71 The Payment approach is supposed to represent “services paid” (see appendix 5 of Paper 13A for further details) and services are supposed to be received only if all vesting conditions are fully completed. Then, share-based payment expenses represent the accrual of the expected payment related to the period. This recognition expenses has the “accounting status” of a provision. It can be reversed if the related payment is no more expected to occur, for example in case of forfeiture, as services are not considered to be definitively received as long as vesting conditions are not fully completed. Every “result” of renegotiation should also be recognized in financial statements as it represents a change in the estimate of the expected payment (and value) of services that still have to be completed.

ISSUE 10

Do you agree with the above rationale? If no, explain your answer.

2. Initial (Grant date) fair value should exclude effects of any elements of the contract that may prevent payment to vest

72 The objective of the Payment approach is to recognize share-based payment that effectively vest. Therefore, it would be logic to first focus on the value of the equity instruments which are the basis for payment and then to estimate (and regularly adjust the estimate of) the number of the related share-based payment expected to vest. As a consequence, the initial fair value to be used as a reference should be the fair value of the equity instruments granted at the grant date without taking into account the potential effects of any vesting conditions. The effects of those conditions should rather be included in the calculation of the number of share-based payments expected to vest.

ISSUE 11

Do you agree with the above rationale? If no, explain your answer.

73 When discussing the coherence of the Payment approach, some members of the working group argued that this approach was not compatible with the reference to the Grant date. In fact, if a share-based payment does not vest, the service expense is reversed. This seems more coherent with a reference to a vesting date. Therefore, although the working group acknowledged that the Grant date reference was a core principle agreed with the IASB, it decided that it could be interesting to analyse the coherence of the Payment approach using the Grant date but also the Vesting Date for measuring equity instruments that vest, particularly as regard of modifications and cancellations.

74 However one respondent (see Paper 13B) argued that a Payment approach is not necessarily incoherent with a reference to a Grant date fair value. As the Grant date fair value represents the value on which both parties agreed to exchange considerations (including the expected payment on the employer's side) and taking into consideration accounting principle 7 prohibiting revaluation of equity instruments granted, a Payment approach could be coherent with this reference. Adjustment would be made only on the quantity of share-based payment that finally vest. Discussion with IASB Board members and staff, as well as with various constituents did not reveal strong support for reference to the Vesting date, except if one considers that the share-based payment that is not yet vested is a liability by nature.

a. Payment approach and Grant Date fair value for measuring equity instruments to vest

75 In a Payment approach with reference to the Grant date fair value, we may envisage to use either the "fair value difference" or the "cancel and replace" accounting treatments for modifications and cancellations. As a matter of fact, recognizing a result according to the " fair value difference" of the equity instruments before and after the renegotiation seems coherent with both the reference to the Grant date fair value as representative of the agreed value of considerations exchanged before the renegotiation and with accounting principle 7 prohibiting re-measurement of equity elements. In this case, only the change of value due to renegotiation (excluding change of value of the equity instruments between the initial agreement and the renegotiation date) would impact the income statement. The change of value of equity instruments before the renegotiation date would have no impact. However, it could also be argued that the Payment approach would require portraying the amount that will finally be paid and not what was initially agreed. This may justify using a "cancel and replace" accounting treatment, although it does not seem coherent with the abovementioned reference and principle (see example below).

76 <u>Illustrative example:</u>

		« Différence »	*« Cancel and replace »*
Assumptions: Vesting period = 3 years	*Initial agreement* Beginning period 1(CU)	*Modification* End period 2 (CU)	*Modification* End period 2 (CU)
FV of instruments initially granted at the date of modification/cancellation (m/c)	10 000	100 000	100 000
FV of instruments/compensation granted through m/c	n/a	120 000	120 000
Difference in FV due to m/c	0	+20 000	+20 000
Recognized services expenses			
Recognized expenses at end period 2	6 667	6 667	6 667
Recognized expenses in period 3			
1 period x initial value of UoS	3 333	3 333	3 333
Renegotiation adjustment period 1 + 2		13 333	73 333
Renegotiation adjustment period 3	0	+6 667	36 667
Total recognized expenses (3 periods)	**10 000**	**30 000**	**120 000**

77 It has to be noticed that with a "cancel and replace" accounting treatment for modifications and cancellations, entities could renegotiate some agreements without any substantial modification in order to re-value the expense at the renegotiation date (otherwise the expenses would have been calculated according to the fair value of equity instruments at the date of the initial agreement – i.e. Grant date). This argument is advocating for "anti-abuse" rule that is not compatible with a principle-based approach. However, we have to have in mind this kind of possible side-effects.

ISSUE 12

(a) Which of the above accounting treatments for modifications and cancellations under the Payment approach with reference to the Grant date would you consider as more appropriate? Explain your answer.

(b) Would you consider the abovementioned "anti-abuse" argument and could you propose avenues to address this issue?

b. Payment approach and Vesting Date fair value for measuring equity instruments to vest

78 Payment approach with a reference to the Vesting date (i.e. measuring the value of equity instrument to vest at the Vesting date) suppose considering that the date of exchange is when the service is fully completed (i.e. at the Vesting date). This is consistent with the notion of service received under the Payment approach. However, reference to the Vesting date instead of the Grant date for considering the exchange may also mean that the rights to equity instruments are granted only at the vesting date. This may imply that the nature of the expected payment is rather a liability than an equity instrument for the employer[5] before the vesting date. As a consequence, the "cancel and replace" treatment for accounting modifications and cancellations seems more appropriate as this method implies the accounting of accruals of services that will only be completely received at the Vesting date and the possibility to revalue the rights to equity instruments until the Vesting date.

ISSUE 13

(a) Do you agree with the above rationale?

(b) Do you have any other arguments regarding the coherence of the Payment approach with the Vesting date?

3.3 - General discussion on modifications and cancellations

79 The most complex identified issue to address in IFRS 2 is the accounting treatment to apply to renegotiations of share-based payment plans between employers and employees. There is a general agreement in the working group as well as all from correspondents (IASB Board and staff members, EFRAG, NSS, other constituents) that the current accounting treatment on modifications and cancellations of share-based payment plans is complex, difficult to understand, anti-abuse oriented and incoherent with a principles-based approach. Our correspondents generally agreed that there should be a coherent (symmetrical?) treatment between "positive" and "negative" renegotiations, as well as accounting provisions in conformity with accounting principles as those identified by the working group. This part of the report presents thoughts developed in this respect.

[5] This thought has been developed by andrew Lennard in his Paper: "Liabilities and how to account for them: an Exploratory Essay", ASB, October 2002

1. Reminder on current requirements of IFRS 2 related to modifications and cancellations

80 According to the IASB, it would be difficult for an employer to reduce or cancel employee benefits without granting equivalent compensation or implementing a replacement plan (BC 233). Based on this argument IFRS 2 requires, when a plan is cancelled, the immediate recognition of remuneration expense that would otherwise have been recognized over the remainder of the vesting period. However, and particularly in times of financial and economic crisis as recently experienced, it appeared that employee benefits under a plan could be decreased or eliminated without equivalent compensation. Moreover, it is difficult to establish a principles-based basis for continuing to recognize expense for services received as if the agreement between employer and employee continued when that agreement has been replaced or cancelled without at least checking if equivalent compensation is granted. This is all the more difficult that recognition of expense for services received was initially justified by the existence of an agreement including a share-based payment. It would therefore be preferable and more principles-based to analyse if a compensation or replacement has been granted when a cancellation occurs rather than presuming it. Then, an appropriate accounting treatment should be applied to the identified compensation.

81 The ANC working group considers that the current accounting treatment in IFRS 2 that relates to modifications resulting in increasing the fair value of the considerations given to employees at the date of the modification appears appropriate and consistent with the accounting principles underlying IFRS 2. IFRS 2 does not however require a symmetrical treatment for modifications that give rise to a decrease in the fair value of the instrument granted. The working group found no principles-based justification for this position. It is stated in BCs that an entity should not be able to avoid recognizing at least the agreed grant date fair value of remuneration. As for cancellation, this accounting treatment of disadvantageous modification does not seem consistent with the reasoning underlying Accounting Principles n°1 (see Appendix 1 of Paper 13A) that considers there should be a balanced exchange of consideration that justify the recognition of the expenses. Therefore, changes in the terms of the agreement that determine the balanced exchange should be taken into account where recognition of the expenses is concerned.

2. Proposals of symmetrical accounting treatments of positive and negative renegotiations

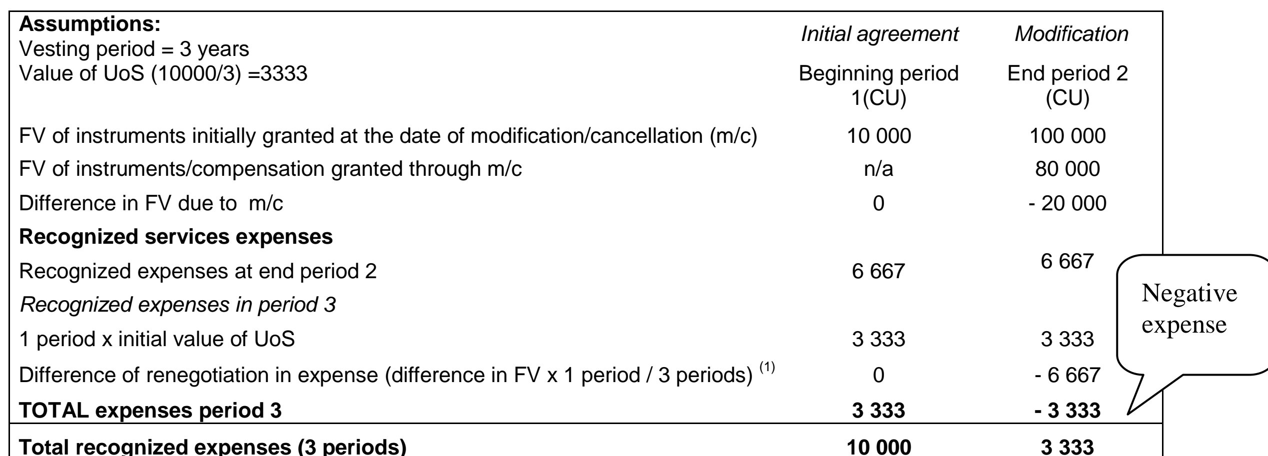
82 Modifications and cancellations are similar in substance and should therefore be treated in a consistent manner. Modifications which maintain or increase employee benefits and cancellations replaced by a new plan of equal or increased value for the employee are in substance equivalent. A modification resulting in decreased employee benefits and a cancellation replaced by a new plan with decreased benefits are also similar in substance. A straightforward cancellation without compensation could be considered as a particularly disadvantageous modification.

83 Therefore, the working group first concluded that the accounting treatment of modifications and cancellations should be symmetrical with one another, whatever the circumstances are (advantageous or disadvantageous modifications, cancellations with or without compensations. The following developments analyse different possibilities for accounting symmetrically positive and negative modification. The main issue is to allocate the renegotiation “result” between service received and services to be received. Each of the methods explored has effects that are not coherent with the situation it purports to represent.

a. Recognizing a result according to the “difference” at the renegotiation date of the fair value of the instruments granted

84 The treatment supposes to evaluate the difference of the fair value of the equity instruments granted before and after the renegotiation date. It is in conformity with reference to the Grant date fair value and with no re-measurement of equity elements (accounting principle 7). The “result” should be allocated to services already received and services to be received. This allocation was first envisaged to be proportional to the vesting period. It could be noted that this method could entail services received during one period to be negative that sounded counter-intuitive.

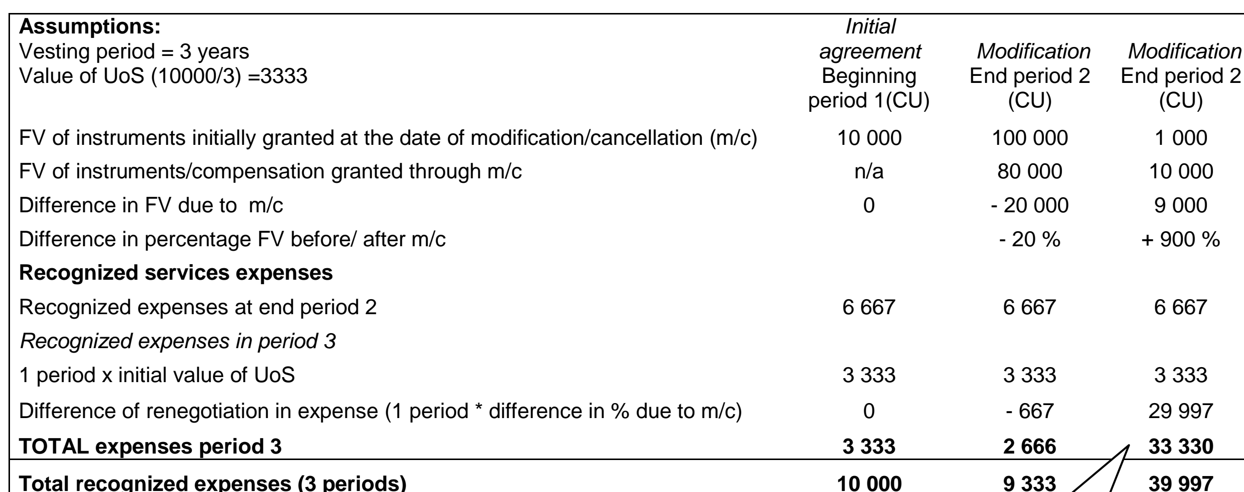
85 <u>Illustrative example (Unit of Service method)</u>



Assumptions: Vesting period = 3 years Value of UoS (10000/3) =3333	*Initial agreement* Beginning period 1(CU)	*Modification* End period 2 (CU)
FV of instruments initially granted at the date of modification/cancellation (m/c)	10 000	100 000
FV of instruments/compensation granted through m/c	n/a	80 000
Difference in FV due to m/c	0	- 20 000
Recognized services expenses		
Recognized expenses at end period 2	6 667	6 667
Recognized expenses in period 3		
1 period x initial value of UoS	3 333	3 333
Difference of renegotiation in expense (difference in FV x 1 period / 3 periods) (1)	0	- 6 667
TOTAL expenses period 3	**3 333**	**- 3 333**
Total recognized expenses (3 periods)	**10 000**	**3 333**

86 Then, It has been considered to calculate a result of renegotiation in percentage (change in percentage of the fair value of equity instruments before and after renegotiation) and apply this percentage of renegotiation to services rendered/ services to be rendered. This allocation method would prevent negative amount, but could entail very high leverage effects.

87 <u>Illustrative example (Unit of Service method)</u>



Assumptions: Vesting period = 3 years Value of UoS (10000/3) =3333	*Initial agreement* Beginning period 1(CU)	*Modification* End period 2 (CU)	*Modification* End period 2 (CU)
FV of instruments initially granted at the date of modification/cancellation (m/c)	10 000	100 000	1 000
FV of instruments/compensation granted through m/c	n/a	80 000	10 000
Difference in FV due to m/c	0	- 20 000	9 000
Difference in percentage FV before/ after m/c		- 20 %	+ 900 %
Recognized services expenses			
Recognized expenses at end period 2	6 667	6 667	6 667
Recognized expenses in period 3			
1 period x initial value of UoS	3 333	3 333	3 333
Difference of renegotiation in expense (1 period * difference in % due to m/c)	0	- 667	29 997
TOTAL expenses period 3	**3 333**	**2 666**	**33 330**
Total recognized expenses (3 periods)	**10 000**	**9 333**	**39 997**

88 A third envisaged accounting treatment was on the basis of the renegotiation difference in value compared to the initial fair value of equity instruments granted. This allocation method could entail very high leverage effects and also negative services for a period.

89 <u>Illustrative example (Unit of Service method)</u>

Assumptions: Vesting period = 3 years Value of UoS (10000/3) =3333	*Initial agreement* Beginning period 1(CU)	*Modification* End period 2 (CU)	*Modification* End period 2 (CU)
FV of instruments initially granted at the date of modification/cancellation (m/c)	10 000	1 000	100 000
FV of instruments/compensation granted through m/c	n/a	10 100	80 000
Difference in FV due to m/c	0	9 100	- 20 000
Difference in percentage FV after m/c and initial FV		+ 91 %	-200 %
Recognized services expenses			
Recognized expenses at end period 2	6 667	6 667	6 667
Recognized expenses in period 3			
1 period x initial value of UoS	3 333	3 333	3 333
Difference of renegotiation in expense (1 period * difference in % due to m/c)	0	3 033	-6 667
TOTAL expenses period 3	**3 333**	**6 366**	**-3 334**
Total recognized expenses (3 periods)	**10 000**	**13 033**	**3 333**

Negative expense

ISSUE 14

(a) Do you have any comments regarding the above methods for allocating the renegotiation difference between services received and services to be received?

(b) Do you have any suggestion on another allocation method?

b. Use a “cancel and replace” approach

90 Regarding the “cancel and replace” approach for accounting modifications and cancellations, it implies considering the renegotiated agreement as a new agreement. This method prevents negative amounts to be recognized, but includes effects of the re-measurement of equity elements, contrary to accounting principle 7. It can entail very high value differences between the cost of services before and after the renegotiation, that may not correspond to the change of services received before and after the renegotiation.

91 Illustrative example (Unit of Service or Payment method)

Assumptions: Vesting period = 3 years Value of UoS (10000/3) =3333	*Initial agreement* Beginning period 1(CU)	*Modification* End period 2 (CU)
FV of instruments initially granted at the date of modification/cancellation (m/c)	10 000	100 000
FV of instruments/compensation granted through m/c	n/a	120 000
Recognized services expenses		
Recognized expenses at end period 2	6 667	6 667
Recognized expenses in period 3	3 333	40 000
Renegotiation on period 1 & 2 (expense or equity depending UoS or P method)	73 333	73 333

High change of the value of services rendered between and after renegotiation

ISSUE 15

(a) Do you have any other comment on the above treatment for representing the effect of the renegotiation?

3. Proposals of a different accounting treatment for positive and negative renegotiations

92 There could also be envisaged to have a differentiated accounting treatment for positive and negative renegotiation reasoning on what the different kind of renegotiations purport to represent. One of the arguments is that some renegotiations aim at restoring the previous situation. This is the case for a negative renegotiation when the fair value of equity instruments has increased since the initial grant date or for positive renegotiation when the fair value of equity instruments has decreased. In such renegotiations, we could argue, at least for Unit of Service method, that cost of services received should not be modified after renegotiation. This treatment appears difficult to apply, with no differentiation between more or less large renegotiations.

93 Illustrative example (UoS method)

Assumptions: Vesting period = 3 years Value of UoS (10000/3) =3333	*Initial agreement* Beginning period 1(CU)	*Modification* End period 2 (CU)	*Modification* End period 2 (CU)
FV of instruments initially granted at the date of modification/cancellation (m/c)	10 000	100 000	1 000
FV of instruments/compensation granted through m/c	n/a	80 000	10 000
Recognized services expenses			
Recognized expenses at end period 2	6 667	6 667	6 667
Recognized expenses in period 3			
1 period x initial value of UoS	3 333	3 333	3 333
TOTAL expenses period 3	**3 333**	**3 333**	**3 333**
Total recognized expenses (3 periods)	**10 000**	**10 000**	**10 000**

ISSUE 16

(a) Do you agree with the above arguments that may justify this treatment?

94 Finally, one could consider that a negative renegotiation could be interpreted as a decrease of the benefit granted to employees and then represents a reduction of the initial agreement that should therefore be accounted in proportionally diminishing the initial cost of services still to be received. The reasoning is that employees have no particular reason to agree on a “negative” new contract. They could only accept reduction of previously granted advantages through an existing contract due to particular circumstances. This treatment also prevents negative amounts to be recognized and avoids taking into account revaluation of the equity elements between the grant date and the renegotiation.

95 On the other side, a positive renegotiation could be considered substantially as an additional contract to the initial one. The reasoning is that the employer has no particular reasons to enhance an existing contract (unless the objective would be to restore a previously devaluated contract). As a consequence, the additional benefit granted at the renegotiation date should be accounted in full.

96 This dissimilar treatment of negative and positive renegotiation could be combined with the previous proposal to distinguish renegotiations that restore the balance of previously revaluated or devaluated contracts. Then, the present dissimilar proposal would apply to contracts those balance do not need to be restored.

97 Illustrative example (Unit of Service method)

Assumptions: Vesting period = 3 years Value of UoS (10000/3) =3333	*Initial agreement* Beginning period 1(CU)	*Modification* End period 2 (CU)	*Modification* End period 2 (CU)	*Modification* End period 2 (CU)	*Modification* End period 2 (CU)
FV of instruments initially granted at the date of modification/cancellation (m/c)	10 000	100 000	100 000	1 000	1 000
FV of instruments/compensation granted through m/c	n/a	120 000	80 000	10 000	0
Difference in FV due to m/c	0	20 000	- 20 000	9 000	- 1000
Difference in percentage FV before/ after m/c			- 20 %		- 100 %
Recognized services expenses					
Recognized expenses at end period 2	6 667	6 667	6 667	6 667	6 667
Recognized expenses in period 3					
1 period x initial value of UoS	3 333	3 333	3 333	3 333	3 333
Difference of renegotiation in expense	0	6 667 *(20 000/3)*	- 667 *(3 333 – 20%)*	3 000 *(9 000/3)*	- 3 333
TOTAL expenses period 3	**3 333**	**10 000**	**2 666**	**6 333**	**0**
Total recognized expenses (3 periods)	**10 000**	**16 667**	**9 333**	**13 000**	**6 667**

ISSUE 17

(a) What is your view on the above proposed treatment for modifications and cancellations?

4. Additional discussion on how to reflect performance conditions

98 The working group discussed on how to reflect performance conditions, especially their potential effect on recognition of service received. As a consequence of the financial crisis, there have been calls for developing share-based payment transactions linked to performance conditions. This highlighted the issue of the appropriate representation of performance conditions under IFRS 2.

99 The working group did not analysed what should be considered as performance conditions in regards to IFRS 2 definition of "vesting conditions". We are aware of the work-in-progress within the IFRS Interpretation Committee in order to clarify the identification of these performance conditions. This kind of issue is rather an interpretation or application issue of current IFRS 2. The working group (and the IASB participants to the meeting on 14 May 2010) therefore considered that this issue was not in the scope of the present IFRS 2 review project.

100 Assuming that performance conditions meet the current definition of vesting conditions in IFRS 2, the working group noted that this definition of vesting conditions always requires a service element. It appears that a commonly accepted interpretation of this definition is that service condition is considered as the vesting condition that prevails. As a consequence, services received in relation to a share-based payment transaction are generally recognized on an accrual basis pro-rata temporis on the vesting period. Performance conditions are treated like service conditions, assuming that the probability of realization of the required performance has been assessed and measured.

101 However, there could be avenues to better represent the effect of performance conditions. When performance condition is linked to an implicit service condition (i.e. the vesting period can be considered as closed when the performance is achieved), then the vesting period could be adjusted to the period necessary to achieve the performance. This can be applied under the current IFRS 2.

102 Another possible improvement could be to consider that recognition timing of services received could depart from a pro-rata temporis basis on the vesting period if we could reliably identify and measure the degree of realization of the required performance. In this case, the recognition timing of services received would rather be linked to the degree of realization of the performance.

103 If the defined objective of IFRS 2 is to represent services received, we may envisage to develop a "Unit of Performance" approach similar to the "Unit of Service" approach, assuming that the realization of these "Units of Performance" could be reliably identified and measured. Then, these "Units of Performance" could be proportionally recognized even if the performance is not fully achieved following the same reasoning as for the Unit of Service approach that portions of performance have been nevertheless received by the entity. Many members of the working group wonder about the consistency and practicality of this approach within current IFRS 2.

104 The case of performance conditions whose realization could be recognized even if the employee has left (for example the transactions initiated by this employee against which realization of the performance is measured are still living and producing effects, or the remuneration of the employee is linked to a collective performance still in progress within the entity) has been envisaged. Many members of the working group considered that services could not continue to be received when the employee has left, but other constituents are on an opposite opinion.

ISSUE 18

What do you think about these different avenues aiming at improving representation of the realization of performance conditions?

APPENDIXES TO THE PAPER “RESEARCH ON THE IFRS 2: AN UPDATE”

LIST OF APPENDIXES

APPENDIX 1 : ANALYSIS OF THE KEY ACCOUNTING PRINCIPLES

APPENDIX 2 : ACCOUNTING OBJECTIVES OF IFRS 2

APPENDIX 3 : DEFINITION OF THE NOTION OF SERVICES RECEIVED

APPENDIX 4 : DESCRIPTION OF THE UNIT OF SERVICES APPROACH

APPENDIX 5 : DESCRIPTION OF THE PAYMENT APPROACH

APPENDIX 1 : ANALYSIS OF THE KEY ACCOUNTING PRINCIPLES

(extract from the Report Back Paper presented at the Frankfurt NSS meeting in September 2009)

Accounting principle 1

1.1 An entity shall recognize goods or services received in exchange for share-based payments[6] as an asset or expenditure respectively[7].

General case

1.2 When goods or services are acquired from a third party they can generally be easily identified as a contract is generally required where considerations exchanged are precisely defined. The contract will also usually enables the determination of the fair value of the considerations exchanged, as well as exchange conditions and timing.

Specific case

1.3 However, some services cannot be clearly identified. This is the case in particular of services received from employees in exchange for share-based payments. They are by nature difficult to identify and measure directly independently from the usual work to be provided by employees in exchange for their basic cash salaries.

1.4 It is assumed that when an entity makes a share-based payment it receives corresponding consideration irrespective of whether that consideration can be clearly identified. This assumption applies to services received from employees in exchange for share-based payments.

Accounting principle 2

1.5 An asset or an expense shall be recognized even if the share-based payment is made by a shareholder of the entity or another group entity.

General case

1.6 When a shareholder of the entity or another entity of the same group makes a share-based payment to a supplier or to employees of the entity, it is assumed to be in consideration for an asset or service received by the entity.

1.7 In this case, the entity receiving the goods or services without the obligation to settle the share-based payment transaction to the supplier or its employees recognizes an equity-settled share-based payment transaction. The shareholder or entity of the same group which settles the share-based payment transaction recognizes it as an equity-settled share-based payment transaction if it is settled in their own equity instruments. Otherwise, they recognise it as a cash-settled share-based payment transaction.

[6] These share-based payments are not made with a shareholder acting in his capacity as a shareholder.

[7] This analysis will not challenge the statement that share-based payments should be considered as an expense of the issuing entity. This basic assumption, which has been extensively discussed when IFRS 2 was initially elaborated, forms part of the frame of reference of the project.

Accounting principle 3

1.8 The asset is recognized when received and an expense is recognized when the asset received is consumed or the service received.

<u>General case</u>

1.9 For assets or services that can be readily identified, it is generally easy to identify the date when the asset is received or the period over which the service is received. This date or period will be considered as the date or period of recognition.

<u>Specific case</u>

1.10 When, as for most services received from employees, the asset or service cannot be readily identified the recognition date or period need to be determined indirectly by reference to the terms of the contract:

- Where entitlement to the share-based payment is linked to the completion of a vesting period, the service is assumed to be carried out evenly over that period unless otherwise indicated
- Where entitlement to the share-based payment is not linked to the completion of a vesting period, the service is assumed to be carried out immediately

Accounting principle 4

o **Consideration given for the goods or services received is recognized in equity or in debt according to the type of payment.**

<u>General case</u>

o The ANC working group noted that the current definition of equity and debt in IFRS 2 is very concise and makes reference to the Framework only. This creates differences with the definition of equity and debt in IAS 32 on the grounds that it is a service being measured and not a financial instrument, as well as that in certain cases the number of share options to which the employees are entitled varies (IFRS 2 BC 107).

o Some differences in practice can be noted, such as:

- A settlement of a variable number of shares (issue of a variable number of shares in exchange for a fixed amount) can be considered as an equity-settled share-based payment;
- Constructive obligation to pay in cash resulting in the share-based payment being considered as cash settled;
- Contingent settlement not dealt with;
- Split accounting being slightly different from IAS 32.

o The classification will depend on the nature of the instrument the entity ultimately remits to the beneficiary.

o The ANC working group considers that the distinction between equity and debt should be consistent with the requirements of IAS 32 although this is not the case in the current version of IFRS 2.

Accounting principle 5

- **The asset or service received is measured at the fair value of what is received or of what is given up according to the general principles applicable to exchange transactions.**

  General case

- For cash-settled share-based payment transactions, the entity shall measure the goods or services received at the fair value of the liability incurred.
- For equity-settled share-based payment transactions, the entity shall measure the goods or services received directly at the fair value of the goods or services received (unless that fair value cannot be estimated reliably).

  Specific case

- If the fair value of the goods or services received cannot be estimated reliably, the entity shall measure their value indirectly by reference to the fair value of the equity instruments granted.

- The ANC working group has not seen significant reasons to question this accounting treatment.

Accounting principle 6

- **Initial measurement is made (at the fair value) at the exchange date.**

  General case

- When the asset or service received is readily identifiable, the date or period of exchange can generally be easily identified in conformity with Accounting principle 3, and measurement takes place at that date in conformity with Accounting principle 5.

  Specific case

- When the asset or service received is not readily identifiable, such as in the case of services received from employees, the date or period of exchange is determined by reference to the contract and in particular by reference to the vesting period where applicable, as explained in specific cases dealt with in applying Accounting principle 3.
- As stated in Accounting principle 5 above, equity-settled share-based payments for employee services are measured at the fair value of the equity instruments given up.
- This fair value is determined at “grant date”[8].

Accounting principle 7

- **Subsequent measurement of share-based payment transactions reflects the nature of the related reference items (debt or equity) according to the general principles of accounting for exchange transactions.**

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[8] This analysis will not challenge the statement that “grant date” is an appropriate surrogate measure of the fair value of the services rendered. This basic assumption, which has been extensively discussed when IFRS 2 was initially elaborated, forms part of the frame of reference of the project. Arguments are only provided as a reminder.

General case

- o For cash-settled transactions, where the reference item is a liability, the latter is re-measured at each reporting date to reflect changes in the fair value of the related equity instruments according to the terms of the contract.
- o For equity-settled transactions the fair value of the instrument used to measure the transaction is not re-measured subsequent to the grant date.

Comment

- o Although the liability representing a cash-settled share-based transaction shall be subsequently re-measured, one should take into consideration arguments developed in order to justify the use of the “grant date” for equity-settled share-based transactions. In particular, the statement that it is unlikely that subsequent changes in the fair value of an equity instrument to be issued could be considered as highly correlated with changes in the fair value of services received should also be applied to subsequent changes in the fair value of liabilities which are indexed on an equity instrument. In order to be consistent with the grant date approach to measurement of equity-settled share-based transactions, changes in the fair value of a liability representing a cash-settled share-based transaction should not affect the fair value of services received. Instead these fair value changes should rather be recognised as financial expense or income (not as an operational expense or income).
- o The application of this presentation approach for cash-settled share-based transactions would have the merit of making recognition of operational expenses related to share-based payment transactions comparable whether they are settled in cash or in equity instruments.

APPENDIX 2 : ACCOUNTING OBJECTIVES OF IFRS 2

(extract from the Report Back Paper presented at the Frankfurt NSS meeting in September 2009)

2.1 The analysis of how to apply the key accounting principles underlying IFRS 2 raises the issue of what the standard is setting out to portray. Once this objective has been determined, the key recognition and measurement principles should reflect a common accounting approach in line and consistent with this main objective.

2.2 The ANC working group noted two possible main accounting objectives that could be assigned to IFRS 2:

1. **To represent assets acquired by or services received** by the reporting entity as part of a share-based payment transaction irrespective of whether there is an identifiable payment made by the entity (or by a entity's shareholder or another entity of the group).
2. **To represent share-based payments** made by the reporting entity (or by an entity's shareholder or another entity of the group) irrespective of whether there is an identifiable service received by the entity.

a. These two objectives focus respectively on the two different facets of the exchange and may lead to different representations of the transaction.

b. For example, if we consider equity-settled schemes for employees including a vesting period, which are common transactions, services may be received from employees in the expectation of remuneration without ever actually giving rise to a payment e.g. if any of the conditions of payment are not satisfied. In a transaction with a 3 year vesting period an employee may leave after 2 years and 11 months and therefore not meet the payment condition. If we consider only the objective of representing the payment of the transaction, in this case nothing will be recognized because the vesting condition has not been satisfied.

c. Nevertheless, the employee may be perceived as having "performed" during his period of employment in the expectation of remuneration. He will have been present for the greater part of the vesting period and may therefore the entity has substantially received the required services. If we consider the objective of representing services received from the employee, it would appear logical to recognize as an expense the fair value of services received before the employee's departure.

d. This question has been analysed in particular in IFRS 2 BC 207 to 213 and the conclusions were that the objective of the standard should be to account for the services subsequently received, rather than the cost of the equity instruments issued (in the case of a equity-settled share-based payment transaction). However, there is an issue as to whether services should be recognized even when there is no payment, considering the two following aspects:

- Payment will be made only if all the service and performance conditions included in the initial contract agreed on by both parties at "grant date" are completely fulfilled; therefore, it may be considered that services received are closely linked to the fulfilment of these conditions; if these conditions are not completely fulfilled, one may consider that the related services have not been received; analysing services received in such a way could justify a focus on representing the payment of share-based payment transactions as the materialization of the rendering of the related services;
- Even if one may consider that services have been partially received, the absence of payment may be interpreted as these services being received for free; therefore these services should

not be recognized in the accounts as they would be measured for nil; one may question the consistency of such an interpretation with the accounting principle that equity instruments issued should not be re-measured; it might be argued that it is the services that are measured, not the instruments, and that the instruments have finally not been issued.

- Current provisions of IFRS 2 may be confusing in this respect, as they may be interpreted as a mix of both approaches. For example, the recognition of services received is cancelled retrospectively when an employee does not fulfil service or non-market performance conditions. This accounting treatment may appear as aiming to represent the payment (through the kind of approach chosen in terms of measurement method determined at "grant date"), although it could be argued that the employee has at least partially received required services. The measurement principle applied to cash-settled share-based payment transactions appears consistent with the objective of representing the payment rather than the value of services received, especially as no distinction between the measurement of services received and fair value changes of the liability due to changes in the fair value of the equity instrument used as an index is required.
- On the other hand, cancellation of share-based payment agreements by the employer does not result in the recognition of services received being cancelled retrospectively (their recognition is even accelerated), which does not appear consistent with the payment approach. Moreover, it is a core principle of IFRS 2 that an entity shall recognize services as they are received in a share-based payment transaction (see Accounting principle 1 above).
- It therefore appears that a clarification of the accounting objectives of IFRS 2 is necessary.
- In order to make IFRS 2 appear more principles based, one should make a clear choice between these two objectives and approaches and develop detailed provisions of the standard consistently. In particular, recognition and measurement principles should reflect the chosen objective and approach. As noted above, this includes clarification of how the notion of service received is understood.

APPENDIX 3 : DEFINITION OF THE NOTION OF SERVICES RECEIVED

(extract from the Report Back Paper presented at the Frankfurt NSS meeting in September 2009)

3.1 When applying the objective of representing services received it is necessary to consider what is meant by "service". Does the service consist of completing the required vesting period in full and being present on the vesting date? Or could it be that service implies presence and a form of performance over a period of time irrespective of whether the employee is still there on the vesting date? If the service relates to performance, could the performance be achieved in part or in full, even if an employee does not complete the vesting period? In other words might it be possible to consider service as performance not based exclusively on employee presence?

3.2 The ANC working group therefore considered the following possible definitions of the notion of service received:

1. Services are supposed to be received regularly on an accrual basis and are supposed to be proportional to the employee's presence; this definition seems consistent with the objective of representing service received and could facilitate the achievement of this objective;
2. Services are received if service (and performance) conditions are fully completed, which implies that they are received if the employee is present at the end of a vesting period, if any; this definition seems consistent with the objective of representing payment of share-based payment transactions.
3. Services received are an additional element not based on the sole presence of the employee during or at the end of a vesting period. This service would consist in an expected additional performance to be received during the presence of the employee and linked with productivity, quality of the work performed or other kind of motivation.

a. The ANC working group thought that such a definition would help in building a conceptual basis for the current provisions in IFRS 2 that result in applying a different accounting treatment when vesting/non vesting conditions are fulfilled or not, as well as when forfeiture/cancellation occurs. Such an approach would explain these different treatments by referring to the respective initiative and responsibility of the employees or employers in not respecting the conditions or terms of the initial contract agreed at "grant date". When the breach of the contract is at the initiative of the employee, it would justify the retrospective cancellation of recognized services on the grounds that this initiative evidenced a lack of motivation or performance from the employee that could be supposed to exist since the beginning of the vesting period. On the contrary, a breach at the initiative of the employer could justify not cancelling the recognition of services retrospectively on the grounds that this event does not prevent the employee from performing the expected service at least until the date of the breach.

b. Having said that, the ANC working group acknowledged that this approach may result in various application difficulties similar to those currently experienced. This creates difficulties in differentiating vesting and non vesting conditions, in particular non-market performance conditions where fulfilment could be under the control of the employee and market conditions that would be beyond his control. There would also be difficulties in making the distinction between events resulting in breach of the contract at the employee's or the employer's initiative. For example, some resignations may be caused by employers whereas some redundancies may be at the employee's demand. Trying to solve these issues may imply developing rules based approaches that would not be in line with the objective of the review project.

APPENDIX 4 : DESCRIPTION OF THE UNIT OF SERVICES APPROACH

1 – Background on the Unit of Service method

4.1 The Units of Service method was introduced by ED 2 and considered by the IASB as a conceptually sound approach to representing services received. The method was finally abandoned by the IASB after comments received on ED 2 because it was believed to entail practical application difficulties (see assessment of complexity in part 3.7 below).

4.2 In addition, the Unit of Service method described in ED2 includes certain rules for which the working group could find no conceptual justification. These rules, which have been adopted in the current version of IFRS 2 relate in particular to the treatment of modifications and cancellations. They include the requirement for an entity to recognize as a minimum services received measured at the grant date fair value of the equity instruments granted on cancellation and disadvantageous modification as well as the accelerated vesting rule applicable on cancellation.

4.3 The working group considered that the requirements for cancellations and disadvantageous modifications in ED 2 were not consistent with the principle of representing "services received".

4.4 According to the accelerated vesting rule applicable on cancellation, an entity recognizes immediately all outstanding expense as if all the related services had been received and the employees had completed the vesting period. However, there is no objective reason or material facts to consider that the related services have been provided on an accelerated pace. The employees would also not have particular reason to accelerate the rendering of these services, especially in such circumstances.

4.5 Concerning the minimum services received to be measured at the grant date fair value of the equity instruments granted in case of cancellation and disadvantageous modification, this rule does not seem consistent with the rationale underlying Accounting principle 1 (see Appendix 1) that justify the recognition of services received as balanced counterpart of share-based payments promised at the grant date.

4.6 However, on forfeiture where the employee leaves before completing the vesting period, ED2 requires recognition of an expense up until the resignation date.

4.7 The working group noted that the treatment of forfeitures and cancellations proposed by ED2 was not consistent with one another. It was therefore decided to adapt the Unit of Service method to enable a consistent principles based representation for forfeitures, modifications and cancellations.

2 – General description of the Unit of Service method

4.8 The objective of this method is to represent services received from employees in exchange for share-based payments.

4.9 The method is based on the assumption that there is a balanced agreement at the grant date such that the fair value of services expected to be received is equivalent to the fair value at that date of equity instruments expected to be issued.

Proposal

4.10 Services received are recognized proportionally according to the duration of service during the vesting period.

4.11 A fair value per unit of service is determined by dividing the grant date fair value of the equity instruments to be issued, allowing for all vesting conditions and including the expected rate of forfeiture, by the number of units of service expected to be received.

4.12 The actual number of units of service received is measured at the fair value per unit of service.

3 – Treatment of forfeitures using the Unit of Service Method

Proposal

4.13 When an employee leaves without completing the vesting period the services received from the employee prior to leaving are recognized up until the departure date. No further remuneration expense of services received is recognized once the employee has left.

Rationale and comments

4.14 The number of units of service actually received by the employing entity until the employee leaves is measured at the grant date fair value per unit of service calculated as indicated above. As a result the employing entity recognizes remuneration expense for the period during which the employee is present even though no share-based payment will be made for that period because the vesting condition has not been fulfilled.

4.15 The rationale for this treatment is that the entity is considered to have received service during the period the employee was present even though he did not complete the vesting period and would not therefore be entitled to a share-based payment.

4.16 This approach contrasts with the current requirements of IFRS 2 under which the remuneration expense in case of forfeiture is revised to reflect the number of instruments expected to vest. Under current requirements, where an employee leaves before vesting date, the service expense recognized prior to the employee leaving is cancelled. The current requirements of IFRS 2 with respect to forfeitures could therefore be said to reflect an approach based on “services paid” rather than “services received”.

4 – A principles-based approach to modifications and cancellations using a Unit of Service method

Proposal

4.17 An entity recognizes services received up until the occurrence of a modification or a cancellation on the basis of the initial agreement between employer and employee, i.e. the entity recognizes the actual number of units of service received up until the date of modification or cancellation measured at the initial grant date fair value per unit of service. No adjustment to this expense recognized before the modification or cancellation is made.

Warning: the following paragraphs (in grey) are a copy of what was presented to the NSS in April 2010 and are subject to changes as a result of conclusions that will be reached regarding the general discussion on modifications and cancellations (see part 4.3 of the main document).

4.18 Changes in the fair value of the share-based payment resulting from a modification or cancellation reflects a change in the fair value of services expected to be received as from the date the new balanced agreement takes place. This change is taken into account in recalculating the unit value of services expected to be received as from this date. Changes to the initial agreement are applied prospectively over the outstanding vesting period, if any, otherwise immediately.

4.19 The fair value change taken into account in recalculating the unit value of services expected to be received is measured by comparison - at the new grant date related to this agreement - between the fair value of instruments granted according to the new agreement and the fair value of instruments granted according to the initial agreement.

Rationale

4.20 The working group considered that a consistent principles-based approach to representing services received should be based on the agreement between employer and employee. The initial balanced agreement between employer and employee takes place at the grant date, as stated by Accounting Principle n°6 (see appendix 1). However, this agreement may be modified subsequently and the modification might be either advantageous or disadvantageous for the employee or result in a cancellation with or without compensation. The accounting should therefore reflect the changes in the agreement as and when they occur on a prospective basis to recognize services received in accordance with the new balanced agreement achieved at the new grant date. Moreover, the accounting treatment should be symmetrical for advantageous and disadvantageous modifications, as the accounting consequences of the new balanced agreement should be recognized the same way whatever the difference with the old one is.

4.21 It is therefore proposed that an entity should recognize services received up until the occurrence of a modification or a cancellation on the basis of the initial agreement between employer and employee. The entity would therefore recognize the actual number of units of service received up until the date of modification or cancellation measured at grant date fair value per unit of service. According to the services received approach, subsequent modifications or cancellation would not affect services already received as part of the initial agreement between employer and employee and there should therefore be no adjustment to the remuneration expense initially recognized.

4.22 This absence of re-measurement of previously recognized services received is also further justified in case of equity-settled share-based payment transactions, where the equity interests granted which are the measurement basis for services received should not be re-valued afterwards (Accounting principle n°7 in appendix 1).

4.23 It follows that changes to the initial agreement will be applied prospectively over the outstanding vesting period. According to accounting principle 5 set out in appendix 1, "The asset or service received is measured at the fair value of what is received or of what is given up according to the general principles applicable to exchange transactions". If an entity modifies the value of the share-based payment it implies that this modification reflects a change in the value of services expected to be received as from the date the new balanced agreement takes place.

4.24 The working group considered that the fair value of instruments granted should be reassessed at the date when a change to the initial agreement occurs. Where, for example, the employer changes the exercise price of an option, the effect on the fair value of the instruments granted in comparison to the fair value at the date of the modification of the instruments initially granted is considered to reflect a change in the value of services received in exchange as from the date of change. The effect of this difference in value would be taken into account in recalculating the unit value of services expected to be received. An illustration of how this difference is taken into account is set out in Appendix 5. Taking into account only the fair value change of the instruments at the date of the modification is consistent with current approach applied in IFRS 2 to advantageous modification and with Accounting principles 6 (use of the initial grant date as reference for fair value measurement in some circumstances as long as the initial agreement is maintained, use of the new grant date as a reference for fair value measurement as from its occurrence) and 7 (no further re-measurement of equity interest already acquired in an equity-settled share-based payments) as described in Appendix 1. The working group considers that this approach should apply to both advantageous and disadvantageous modifications in order to achieve a principles-based approach.

Comments

4.25 In those cases where the modification or cancellation is beneficial to the employee this will result in an increase of remuneration expense to be recognized over the outstanding vesting period. As illustrated in Appendix 5, the remuneration expense to be recognized over the outstanding vesting period will comprise a portion as calculated under the initial grant plus an increase due to the beneficial modification or cancellation. It may be noted that in some cases, a consequence of this prospective imputation of value changes on services received may result in a sharp rise of the fair value of these services compared to those recognized before the change. One may question such a difference in the valuation of services which substance remains globally the same. This is an effect of the Accounting principles obliging to refer to the grant date fair value in circumstances indicated in part 1 of the Paper and prohibiting further re-measurement of equity-settled share-based payments.

4.26 The working group considered that it might also be possible that under certain exceptional circumstances, such as in times of economic and financial crisis, employees might be forced to accepting changes which might be disadvantageous. In a principles-based approach, the treatment of disadvantageous modifications or cancellations should be symmetrical to that of beneficial changes.

4.27 Disadvantageous modifications and cancellations would result in negative adjustments to remuneration expense as illustrated in Appendix 5. It might be possible for total remuneration expense for a period to be negative (i.e. a credit) subsequent to a modification which is disadvantageous for employees.

4.28 It is considered that such cases would be rare as normally employees would refuse cancellation or disadvantageous modifications when granted share-based payments have a high fair value at the time of the renegotiation (case A in appendix 5). This may rather occur when the fair value of the granted instrument is so low that reducing or cancelling them will not make a significant difference (case B in appendix 5). In such cases, remuneration expense would be reduced but would generally still have a positive value, as the reduction of an already low current fair value would normally be slight.

4.29 Nevertheless, were such a situation to arise, the appropriateness of the accounting treatment may be questioned. One may consider that negative remuneration is not plausible. This could imply that the method for representing remuneration may be inappropriate at least in this case. It was observed

that even where the employee accepts a significant drop in remuneration as compared to the fair value of the instrument at the date of modification, the instrument still has a positive value and the disadvantageous modification should therefore not give rise to negative remuneration expense. However, the approach that charges the fair value change prospectively from the date of the change to services still to be received, while consistent principles underlying the “services received” approach, cannot prevent in all cases situations where the negative value of service received may be perceived as apparent representational anomalies. These kinds of situations also result from the use of the grant date fair value as a reference in circumstances described in part 1 of the Paper and the prohibition to re-measure equity-settled share-based payments afterwards.

4.30 The working group considered if it might be necessary to adopt a “rule” to cover those circumstances e.g. remuneration can never be less than zero and a flooring adjustment is therefore necessary to correct negative remuneration. However, the objective of this project is to establish principles-based accounting treatment for share-based payment transactions in all circumstances within the scope of IFRS 2 while not questioning the reference to the grant date fair value in some circumstances. If we want to achieve this objective while respecting these conditions, we should accept the perspective of having situations in which application of the principles-based approach together with reference to the grant date fair value result in negative expenses to be recognized.

4.31 It may be noted that the current provisions of IFRS 2 obliging to recognize as a minimum the initial grant date fair value in case of cancellation or disadvantageous modification also represent a “floor rule”. As noted before, it is also inconsistent with the principles-based approach that the project aims at developing. It is even more inconsistent compared to the “zero floor rule” than it may apply in more circumstances.

4.32 The working group considered whether “negative remuneration” might, in those rare circumstances where it occurs, have some economic basis. It might, for example, be possible to assimilate all or a part of modifications or cancellations to a repurchase or exchange of the instruments initially granted (or equity interests acquired thereof) followed by a new grant of instruments of a different value. Where the agreement between employer and employee is renegotiated to the employee’s disadvantage in exceptional circumstances under which the employee “makes a sacrifice”, there would not necessarily be any direct relationship between the terms of the renegotiation and the value of the employee’s services. The “profit” of the entity on renegotiation is of an exceptional nature and might be compared to the action of a creditor (the employee) that is prepared to write off a part of the debt of its debtor (the entity) as part of an ongoing relationship. In such a perspective, all or a part of the fair value change measured at the modification or cancellation date would rather be charged on repurchase or exchange of previously granted equity interests at a advantageous price for the entity. However, there are still pending questions on how to justify and determine this part and to recognize the related “profit” (in the income statement, as a financial profit, or directly in equity as a transaction with owner of equity elements of the entity). Moreover, this interpretation approach of disadvantageous modifications and cancellations should also be applied to advantageous ones in order to be principles-based.

4.33 Another aspect which might be considered is that share-based payments are often only one component of a remuneration package such that a reduction in one component may be compensated by an increase in another component. However, this should not be presumed. The transfer between the different elements of the remuneration package should de identified, which may not be easy.

5 - Treatment of compensation payments in respect of cancellation

Proposal

4.34 If the compensation is subject to a vesting condition, it is recognized over the vesting period. In this case the compensation remunerates expected services to be received after the cancellation date. It is the basis for determining a new fair value per Unit of service. However, where no such vesting condition exists the compensation does not remunerate expected future services and therefore should be recognized immediately.

4.35 Any difference arising between the amount of the compensation and the fair value of the instruments granted at cancellation date is treated as an adjustment (increment or decrement) to remuneration expense, as in the general cases of modification/cancellation described above.

Rationale

4.36 Where an employer cancels a share-based payment plan employees may receive total or partial compensation for the loss of benefits.

4.37 The working group considered that compensation payments were in substance similar to a new agreement between employer and employee and should therefore be treated in the same way as a cancellation replaced by a new agreement. Finally, such a situation could be considered as a modification of the initial plan.

4.38 The compensation might be granted subject to a vesting condition, in which case it should be recognized over the vesting period. In this case the compensation remunerates expected services to be received after the cancellation date. It would be the basis for determining a new fair value per Unit of service.

4.39 However, where no such vesting condition exists the compensation does not appear to remunerate expected future services and therefore recognition should be immediate.

4.40 The working group considered the payment of compensation to be the same in substance as a modification to the original agreement between employer and employee. Any difference arising between the amount of the compensation and the fair value of the instruments granted at cancellation date is treated as an adjustment (increment or decrement) to remuneration expense under the original agreement in the period of cancellation. This approach is illustrated in Appendix 5. When there is a positive adjustment for the entity's benefit resulting in a negative remuneration charge in the period, this may appear counter-intuitive. The same discussion on negative value of services received may occur as in the general case of modification and cancellation.

Comments

4.41 An alternative approach would be to consider the payment of compensation as a repurchase of the instruments originally granted at their value at the date of cancellation. Any difference arising between the amount of the compensation and the fair value of the instruments granted at cancellation date is treated as a profit or loss on repurchase which , in the case of a profit, is less counter-intuitive than considering the adjustment as negative remuneration.

4.42 IFRS 2 §28 considers the payment of compensation as a repurchase of equity instruments that vest immediately on cancellation. According to this analysis, the payment made to the employee should be deducted from equity (which is not the accounting treatment currently applied in IFRS 2). There is not clear evidence that a cancellation should be interpreted as an accelerated vesting of the

instruments granted and their immediate repurchase, as discussed in part 3.4. Compensation may however be interpreted as a repayment for accumulated partial rights to the instruments granted.

6 – Assessment of the Unit of Service proposal

Faithful representation of service received

4.43 This Unit of Service method arguably provides a faithful representation of services effectively received by an entity, assuming that these services are received gradually. It seems compatible with the main accounting objective to represent services received and with the definition of services received on an accrual basis proportionally to the presence of the employee during the vesting period.

Complexity

4.44 This method was not finally adopted by the Board for practical reasons (complex to apply) rather than reasons of principle. These reasons include the difficulties of estimating the grant date fair value of certain non-market performance conditions and the need to track individual employees where all employees do not have identical rights under a scheme. Tests on numerical examples confirm that the Unit of Service method may be complex, as it requires tracking each employee individually.

4.45 However, the modified grant date also includes some complexity as it requires periodic revisions of probability related to vesting conditions. And the need to track groups of employees that do not have the same rights seems to be common characteristics of both methods. Finally, it may be envisaged that some non-market performance conditions could be treated as vesting conditions under a Unit of Service approach. The working group is working specifically on this issue (see below).

Representation of service received related to performance required

4.46 Another question is the appropriate representation of performance, which may necessitate revision of the notion of services received. For example, where an employee is present at the vesting date but a performance condition has not been met, has the entity received the required services? The IASB took the position in ED 2 that services had been received and that the corresponding expenditure should be recognized, although this position was not shared by many commentators. The current provisions of IFRS 2 therefore do not allow performance conditions to be considered as vesting conditions independently from presence conditions.

4.47 A variant of the Unit of Service method separating realisation of performance conditions which have to be performed directly by the employee from the grant date fair value might also be considered. This implies that these performance conditions are under the control of the employee and their achievement is representative of the achievement of the service expected from the employee. The distinction between these performance conditions and other conditions may be difficult to assess.

4.48 Another question would be how to assess if and to which extent these performance conditions are met. By analogy with the definition of service as received on an accrual and proportional basis, the performance conditions could be considered as partially met using a proportional measurement method. However, it may be difficult to determine which kind of measurement process could be

applied. The ANC working group is analysing in a separate paper if and how some performance conditions could be separated from the initial fair value measurement at grant date and used as vesting conditions.

Treatment of negative expenses

4.49 Finally, there is still a question on how to treat fair value differences arising from modifications or cancellations especially if they result in negative amounts that would make the services received after the change having a negative value. In a principles-based approach, one should accept the result as it is, even if it seems counter-intuitive to have negative expenses in some (normally rare) circumstances; this would be seen as the potential result of a principles-based approach developed together with reference to the grant date fair value in specific cases. However, the working group may explore other avenues:

- the first one would consist in imposing a "floor" at zero to the fair value of services received, which would avoid the "abnormal" situation of negative expense; however, this provision would be rules-based and therefore would not allow to achieve a principles-based approach;
- the second one would be to keep the current provisions of IFRS 2 imposing a "floor" at the initial grant date fair value; however this provision would be as rules-based as the previous one and would apply to more situations (even when subsequent amounts remain positive but lower than the initial grant date fair value);
- the third one would consist in considering that not all of the change should be charged as services expense; one part would be considered as resulting from repurchase/replacement of equity interest already potentially acquired by employees in the course of the initial share-based payment agreement; this part could be recognized apart from service expense (either as financial profit and loss or as equity directly); there are still questions on how to justify the alternative qualification of part of the fair value change and on how to distinguish this part.

o It may be noted that most of the difficulties in developing a principles-based approach come from the reference to the grant date fair value used in theoretically specific circumstances - but concerning in fact the most usual cases of share-based payment transactions between employers and employees.

o For numerical examples of this approach refer to IFRS 2 report presented to the NSS in Seoul in April 2010.

APPENDIX 5 : DESCRIPTION OF THE PAYMENT APPROACH

1 – General description of the Payment Approach

5.1 The objective of this method is to represent "services paid" " i.e. services received in exchange for effective share-based payment. In the case of equity-settled transactions payment takes the form of instruments that effectively vest. Under this approach services are only deemed to be received to the extent that a payment is made.

5.2 The rationale for this approach is that:

- Under this view, the service received in a share-based payment transaction corresponds to the fulfilment of the vesting conditions. Where vesting conditions are only partially met, then no services will be deemed to be received. Services that may have been rendered in expectation of payment are ignored if vesting does not ultimately take place. Under the service approach set out in appendix 4. above, such services would be recognized.
- Services received in exchange for most types of remuneration (salary, bonus etc) are generally only recognized to the extent that a payment is expected to take place. It would in most cases be impracticable and entities are not required to identify and recognize "free services received" from employees considered to be in addition to those covered by their remuneration package. It would not therefore to be consistent to recognize services received for share-payments that do not ultimately vest whereas such services would not be recognized if the remuneration took the form of a cash bonus.

5.3 This approach is based on the existence of a balanced agreement between employer and employee. The initial agreement is based on the terms of exchange fixed at grant date but may subsequently be modified or cancelled.

5.4 The initial agreement between employer and employee at grant date defines the conditions subject to which remuneration will be granted to the employee in exchange for services received. Subject to the fulfilment of the agreed conditions, the employee therefore has a "right" to and the employer a "liability" for remuneration. The amount recognized for services received over the vesting period is based on the expected outcome

Proposal

5.5 The fair value and the number of instruments expected to vest is determined at grant date.

5.6 The fair value does not include any elements that may prevent payment occurring. All these elements are included in the estimate of the number of instruments expected to vest. They all are considered as vesting conditions. Therefore, these vesting conditions include not only service or non-market performance conditions, but also market conditions and other types of conditions, if any, that may prevent effective payment of the instruments granted.

5.7 Fair value corresponds to initial grant date fair value until a modification or a cancellation occurs.

5.8 "Services paid" are measured at the grant date fair value of instruments expected to vest.

5.9 Expense is recognized on an accrual basis over the vesting period on the basis of the number of instruments expected to vest in order to represent services expected to be paid. The number of instruments expected to vest is reviewed and adjusted as necessary at each reporting date depending on changes in estimates related to the different payment conditions. Ultimately expense is adjusted according to the actual number of instruments that vest.

5.10 As a consequence, where an entity has provided for expenditure for which the payment conditions are not ultimately satisfied, the expenditure will be reversed accordingly.

5.11 The fair value and/or the number of instruments expected to vest is revised on modification or cancellation.

2 – Forfeitures

Proposal

5.12 When an employee leaves without completing the vesting period the number of instruments expected to vest is adjusted and the accrued remuneration expense relating to that employee is cancelled.

Rationale

5.13 The rationale for this treatment is that the entity has not received the required service because the employee has not satisfied the vesting condition. This is consistent with a definition "all or nothing" of services expected to be received, the main substance of the service consisting in fulfilling the vesting conditions. This approach is similar to the current requirements of IFRS under which the remuneration expense in case of forfeiture is revised to reflect the number of instruments expected to vest.

3 – Modifications and cancellations

5.14 Modifications and cancellations are similar in substance and should therefore be accounted for in a consistent manner.

Warning: the following paragraphs (in grey) are subject to changes as a result of conclusions that will be reached regarding the general discussion on modifications and cancellations (see part 4.3 of the main document).

5.15 Modifications and cancellations are considered to be re-negotiations of the initial grant date agreement between the employer and the employee.

Proposal

5.16 Changes in the initial agreement in the form of modifications or cancellations give rise to a new grant date fair value and/or a new assessment of the number of instruments to vest as from the date of change;

5.17 This new grant date fair value and/or new number of instruments to vest replace(s) those previously recognised. We therefore describe this approach as "cancel and replace".

5.18 Under the payment approach remuneration expense is adjusted to reflect the expected outcome.

5.19 The effect of the modification or cancellation is :

a. An adjustment to accrued expense already recognized at the date of modification or cancellation giving rise to a profit or loss on re-negotiation

b. An adjustment to remuneration expense to be recognized over the outstanding vesting period on the basis of the new agreement.

5.20 Modification and cancellations might be regarded as :

i. A transaction between employer and employee modifying the employee's terms of remuneration

ii. A transaction between shareholders

Under view i. the resulting adjustment to remuneration expense would be recognized through profit or loss.

Under view ii. the resulting adjustment to remuneration expense would be recognized through equity

5.21 Although IFRS 2 currently ignores modifications disadvantageous for the employee , it is our view that such modifications may also occur e.g. employees might accept a reduction in remuneration in a situation of crisis. In a principles-based approach we propose a consistent accounting treatment for all modifications and cancellations.

Rationale

5.22 In a "payment approach" service expense is only recognized to the extent that instruments vest. It is a "all or nothing" approach in terms of services received considering that the main substance of the expected service is that the counterparts fully complete the vesting conditions. The new fair value of instruments granted at the date of the cancellation or modification therefore applies to the whole service expected in exchange, including the part already rendered that cannot be considered as separated. Therefore service expense is corrected globally at each modification or cancellation date to represent over the new vesting period – including the part of the previous one already passed if the change can be considered as a modification of an existing plan - the cumulative fair value of instruments expected to vest and is ultimately adjusted to represent the fair value of the instruments that actually vest.

Comments

5.23 This "cancel and replace" approach has been questioned because many members of the group thought that the proposed approach does not respect in practice the Accounting principle n°7 in Appendix 1 that prevent to re-measure equity-settled share-based payments transactions (more specifically equity interest already potentially acquired by employees in the course of the share-

based payment plan) which fair value has been determined at the grant date (Accounting principle n°6 in Appendix 1).

5.24 Therefore, the working group considered an alternative approach by which the amount of the payment is re-measured on modification or cancellation taking into account the original grant date fair value and an incremental/decremental fair value adjustment at the date of modification or cancellation. The increment or decrement is based on the fair value of the instrument at the date of modification or cancellation. The fair value change is therefore measured the same way as it is described for the Unit of Service method in paragraph 3.5. As a result, this approach gives the same results for modification or cancellation as for the Unit of Service method illustrated in Appendix 5. this alternative approach would be consistent with Accounting Principles n°7 noted above. However, it would result in equity instruments vested being recognized partly at the initial grant date fair value, partly at the modification/cancellation grant date fair value. Moreover, this approach may result in negative value of vested instruments to be recognized in some cases, which may appear counter-intuitive (as for service received in the Unit of Service method).

5.25 In spite of the objections to the "cancel and replace" approach we consider that, for the reasons set out below, it is the most appropriate approach for representing "services paid" when modifications to or cancellation of the original agreement occur:

- If we analyse modifications and cancellations as re-negotiations of the original agreement between employer and employee it appears logical to consider that the original agreement has ceased to exist and is replaced by another. The "cancel and replace" approach therefore reflects the nature of the transaction.
- The "payment approach" bases remuneration expense on the expected outcome in all cases. It is therefore consistent to recognize the new agreement that replaces the existing one since it corresponds to the expected outcome.
- The objection that this approach does not respect Accounting Principle 7 because it can lead to a revaluation can be countered. It can be argued that there is not a revaluation but a new valuation corresponding to a new contract.
- The "cancel and replace" approach is simple to apply and the resulting information relatively easy to understand as compared to the alternative approach described above

o Many members of the working group question the consistency between a "payment" approach and the reference to the grant date fair value. They think that the objective of representing services paid would rather be achieved by using the vesting date as fair value reference date.

Compensation payments in respect of cancellation

o This compensation should be treated in the "cancel and replace" approach - described above for modifications as the first possible approach – as immediate payment or payment subject to a new vesting period (including the part of the previous one already passed if the change can be considered as a modification of an existing plan).

o It would be treated similarly to the incremented / decremented fair value (at the date of the change) approach as for the Units of Service approach, if the alternative approach described above is applied.

4 – Assessment of the Payment Approach

- The main advantages of the payment approach are:

  - The method is based on "vesting" which is an observable triggering event. It appears less subjective than an approach based on "services received" which may be difficult to identify and measure.

  - It could be argued that information on services received which an entity pays for because service and performance conditions are met is more relevant to users of financial statements. Services received may be recognized under the Unit of Service method even though the agreed service and performance conditions are not met, on the grounds that although the target has not been met a service is still deemed to have been received. Arguably where targets are not met the existence of a service is more hypothetical.

  - However, it seems that there is a inconsistency between this approach representing instruments vested (or services received in exchange of instruments effectively vested) and the reference at the grant date fair value. In fact, the base approach that consist in cancelling and replacing instruments granted at the date of a modification/cancellation is not consistent either with reference to the initial grant date fair value nor with no re-measurement rule of already potentially acquired equity interests. The alternative approach would better respect the reference to grant date fair value. However, it would result in a heterogeneous measurement of instruments vested in case of modification/cancellation, as these instruments would be partly measured at the initial first grant date fair value amount and partly at the modification grant date fair value. Some believe that reference to the vesting date fair value would be more appropriate in this approach.

  - This approach appears much simpler to apply than the Unit of Service method.

  - The payment approach enables a more consistent accounting treatment for equity and cash-settled share-based payment transactions.

- The main disadvantages of the payment approach are:

  - It is not compatible, in certain cases, with the application of initial grant date fair valuation. This is not however a discriminating characteristic as it is also necessary to adapt initial grant date fair value under the Unit of Service method in order to find a principles-based treatment for modifications and cancellations.

  - The base approach that consists in cancelling and replacing instruments granted at the date of a modification/cancellation is not consistent either with the no re-measurement rule of already potentially acquired equity interests. The alternative approach would better respect the reference to grant date fair value. However, it would result in inconsistent measurement of instruments vested in case of modification/cancellation, as these instruments would be partly measured at the initial first grant date fair value amount and partly at the modification

grant date fair value. Some believe that reference to the vesting date fair value would be more appropriate in this approach. Moreover, as stated above, if we consider that modifications and cancellations are in substance renegotiations that give rise to a new agreement it may be argued that the "cancel and replace" approach is the most appropriate representation of these transactions.

- As service expense is adjusted globally to reflect the instruments expected to vest, this method may give rise to large fluctuations in the result of any given period. This may question the relevance of what this approach may portray in interim reporting periods included in the global vesting period. The application of this method gives different results to the Unit of Service method. The Payment method requires the adjustment of cumulated service expense to reflect the amount expected to vest. Under the Units of Service method service expense incurred is not corrected retrospectively on the grounds that the services were effectively received.

- The payment approach may not give a faithful representation of services received because it assumes services are only received if service and/or performance conditions are fully met. It may be argued, for example, that where vesting conditions are partially but not fully met the employer has nevertheless received a service. In these circumstances it appears that the Unit of Service method better represents the service received.

o For numerical examples of this approach refer to IFRS 2 report presented to the NSS in Seoul in April 2010.