FASB Emerging Issues Task Force

Issue No. 13-D

Title: Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period

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Previously distributed EITF materials: Issue Summary No. 1, dated May 30, 2013; Issue Summary No. 1, Supplement No. 1, dated August 30, 2013

Background

1. At the September 13, 2013 EITF meeting, the Task Force considered the issue of how to account for a performance target that could be achieved after the requisite service period. In such cases, the award does not forfeit after the requisite service is completed. The Task Force reached a consensus-for-exposure that awards within the scope of this Issue should be accounted for as a performance condition that affects the vesting of an award. The Task Force decided that this accounting treatment should apply to all such awards, including when an employee is eligible to retire or is otherwise eligible to terminate employment before the end of the period in which a performance target could be achieved. An exposure draft was issued for public comment on October 23, 2013.

2. The Task Force will have the opportunity to consider the comment letters and informal communications received as part of the redeliberations. The Task Force will then be asked whether it would like to affirm its consensus-for-exposure on this Issue as a final consensus.

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* **The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Summary of Comment Letters Received and FASB Staff Analysis and Recommendations

3. Twelve comments letters were received on the proposed Update. Respondents included:

Constituency Group	Number of Comment Letters
Accounting Firms	3
Preparers	7
Professional Accounting Associations	2
Total	**12**

4. Respondents were asked to comment on the following questions in the proposed Update:

> **Question 1:** Do you agree that a performance target that could be achieved after the requisite service period should be treated as a performance condition that affects vesting?
>
> **Question 2:** Are there circumstances in which a performance target that could be achieved after the requisite service period should be treated as a nonvesting condition?
>
> **Question 3:** The amendments in the proposed Update do not require any incremental disclosures for share-based payments in which a performance target could be achieved after the requisite service period. Should incremental disclosures be required for those awards?
>
> **Question 4:** Do you agree that the proposed amendments should be applied prospectively to all share-based payments granted or modified on or after the effective date? Should early adoption be permitted? Under the proposed Update, retrospective adoption would not be allowed. Should retrospective adoption be allowed?
>
> **Question 5:** The proposed amendments would apply to public and nonpublic entities. Should the proposed amendments be different for nonpublic entities? If so, please describe how and why they should be different.
>
> **Question 6:** What is the level of effort and time needed to implement the proposed amendments?

5. The staff has analyzed the comment letters received, reached out to some of the respondents, and included the significant comments on the following areas:

- Performance condition approach
- Performance targets that should not be treated as performance conditions
- Disclosures
- Transition and early adoption
- Effective date
- Request for additional guidance and potential amendments

Performance Condition Approach

6. In Question 1, respondents were asked whether a performance target that could be achieved after the requisite service period should be treated as a performance condition. All but one comment letter respondent supported the proposed Update. Most respondents cited (a) the conceptual merits and (b) the grant-date measurability aspects as the basis for supporting the performance condition approach. For example, two respondents (CL5 and CL10) stated that this approach provides consistency with the definitions of "performance condition" and "vest" and reflects the compensation cost for the actual number of awards that transfer to the recipient. Most respondents commented that the grant-date fair value measure is less complex under the proposed Update as a primary reason for supporting the proposal. Should the performance target have been treated as a non-vesting condition, respondents raised concerns regarding the reliability and subjectivity of the grant-date fair value. Several respondents referred to the Board's original basis for conclusions when it developed Statement No 123 (revised 2004), *Share-Based Payment*; that is, under the non-vesting condition approach, the grant-date fair value measure would be insufficiently reliable for financial reporting purposes.

7. While acknowledging the conceptual merits associated with the proposed Update, one respondent (CL2) did not support the proposed guidance. This respondent stated that they would prefer a single converged approach between U.S. GAAP and IFRS and that divergence in this area would create operational complexity for multi-national companies.

8. In reaching its consensus-for-exposure, the Task Force considered, at length, the IFRS Interpretations Committee's proposed definition of a performance condition under IFRS 2, which was issued as a final amendment by the IASB in December 2013. Task Force members decided that

the treatment of awards within the scope of this Issue as performance conditions was consistent with the Board's original basis for conclusions when it developed Statement 123R. The Board concluded at that time that reflecting a performance condition in the grant-date fair value of an award was generally not considered to be measurable with sufficient reliability for financial reporting purposes. Developing probability distributions that reflect the likelihood of achieving the performance target was, in most cases, not reliable because of the limited data on which to base that information. Accordingly, the Board concluded at that time that vesting conditions should be ignored when calculating the grant-date fair value of the awards. Instead, the outcome of vesting conditions should reflect the amount of compensation cost that is ultimately recognized on the basis of the number of awards that vest to the recipient. The Task Force noted that performance targets that could be achieved after a requisite service period are no less difficult to measure at the grant date than other awards that contain performance conditions.

9. Moreover, the Task Force observed that the definition of a performance condition requires (a) an employee to render service for a specified period of time and (b) achieving a specified performance target that is defined solely by reference to the employer's own operations. The Task Force decided that both (a) and (b) from the definition are present in all awards within the scope of this Issue. It was acknowledged that the two time periods, that is, the requisite service period and the performance target period, are unequal in duration; however, Task Force members did not believe that the Board's original basis for conclusions suggested that this occurrence should change the recognition and measurement attributes of the performance target.

10. The Task Force acknowledged that its consensus-for-exposure would diverge from IFRS. However, the Task Force ultimately decided that its consensus was more consistent with the Board's original basis for conclusions on share-based payments for the aforementioned reasons, and noted that the clarification provided in this guidance would improve U.S. GAAP by reducing diversity.

11. Two respondents specifically expressed support that the scope of the proposed guidance applies to retirement-eligible employees. One respondent (CL10) noted that for immediately retirement-eligible employees, there is effectively a one-day requisite service period. Another

respondent (CL5) indicated that most compensation plans have retirement eligibility features and that the performance condition approach reduces complexity for awards with these features.

Performance targets that should not be treated as performance conditions

When a performance target is considered to be non-substantive

12. The staff received an inquiry immediately prior to issuing the proposed Update about whether the proposed guidance would apply to share-based payment arrangements in which the performance target is considered to be a non-substantive feature. In response to this inquiry, the staff specifically included Question 2 in the proposed Update and asked respondents whether there are any circumstances in which the performance target should be treated as a non-vesting condition. One respondent (CL6) referred to these types of instances. The staff has prepared an example in Exhibit 13-DA to illustrate how the accounting for such an arrangement may differ from the guidance in the proposed Update.

13. Under the current application of U.S. GAAP, the staff understands that certain performance targets are ignored for the purposes of the arrangement if they are deemed non-substantive. The target is not incorporated into the grant-date fair value and is not considered the point at which the awards vest to the recipient. This application appears consistent with paragraph 718-10-25-15, which states that the *substantive* terms and conditions determine the recognition and measurement of an award.

14. The staff's outreach confirms that awards such as these are uncommon in practice; however, when these awards are granted, it is typically by nonpublic business entities through arrangements in which the performance target could be achieved after the requisite service period, such as the IPO example illustrated in Exhibit 13-DA. That said, the outreach also confirmed that these types of awards make up a small subset of arrangements in which the performance target could be achieved after the requisite service period.

Staff comments

15. The staff believes that determining whether a performance condition is or is not a substantive term is outside of the scope of this Issue and is of a broader nature. The staff believes that the Task

Force did not intend to change or clarify U.S. GAAP on this issue, nor did it intend to expand the scope of the proposed Update to include performance targets that, under the current interpretation of U.S. GAAP, would not be considered substantive.

16. More importantly, the staff is concerned that providing guidance on non-substantive performance conditions within the scope of this Issue may be used analogously in other share-based payment arrangements. Accordingly, the staff believes that no changes should be made to the scope of the proposed Update other than clarifications in wording. The staff has presented the proposed changes in Exhibit 13-DB. The staff also will clarify in the basis for conclusions that the Task Force did not intend to change current U.S. GAAP with respect to the evaluation of whether a performance target should be considered substantive.

Question 1: Does the Task Force wish to affirm its decision that a performance target that could be achieved after the requisite service period should be treated as a performance condition that affects vesting?

Disclosures

17. In Question 3, respondents were asked whether incremental disclosures should be required in the proposed Update. Most respondents who answered this question agreed that additional disclosures should not be required. One respondent (CL6) suggested that the Task Force could clarify that disclosure is required under current U.S. GAAP for awards with performance conditions that are not considered "probable" within the unrecognized compensation cost disclosure. The staff does not believe that further clarification is necessary in this respect because no changes have been proposed to the existing disclosure requirements.

Question 2: Does the Task Force wish to affirm its decision that no incremental disclosures are required in the final Update?

Transition and early adoption

Transition Approach

18. In Question 4, respondents were asked whether the amendments in the proposed Update should be applied on a prospective basis and whether a retrospective basis should be allowed. Of those respondents who answered the question, all supported a prospective transition for share-based payments granted or modified after the effective date.

19. Respondents had opposing views as to whether retrospective transition should be allowed as an option. Several respondents recommended that the Task Force allow transition alternatives and permit reporting entities to adopt the proposed Update on a retrospective basis if they so desire to enhance comparability. Alternatively, other respondents believe that a retrospective transition should not be allowed because it would require the use of hindsight in estimating the grant-date fair value of awards and assessing the reporting period in which the performance target became probable of being achieved.

20. Under a full retrospective approach, entities that applied a different accounting method from the proposed Update would estimate a new grant-date fair value for all awards within the scope of this Issue granted or modified since Statement 123(R) became effective in 2005. Some believe that estimating the new grant-date fair value would not be difficult because the old grant-date fair value would already incorporate all the assumptions needed to determine the new value. The adjusted grant-date fair value would be recognized over the requisite service period (or after the requisite period) in the periods that the performance target is considered probable of being achieved. This would require hindsight to determine in which reporting period the probable threshold was met.

21. Under a modified retrospective approach, entities that applied a different accounting method from the proposed Update would be required to make similar adjustments as they would under the full retrospective approach; however, only for awards in which the performance target is still outstanding on or after the beginning of the first annual period presented as of the adoption date.

Staff comments

22. The staff does not believe that a full retrospective adoption approach is practicable or desirable because it would require going back and adjusting net equity for all awards granted or modified. The staff acknowledges that a modified retrospective approach could be permitted, as an option, for awards with outstanding targets as of the earliest period presented. However, to operationalize this approach, the staff believes that the Task Force would need to allow for hindsight. Accordingly, the FASB staff supports affirming the consensus-for-exposure to adopt the guidance only under a prospective transition approach for the following reasons: (a) there is greater comparability across entities because there is no option as to whether some entities adopt a modified retrospective approach and (b) hindsight would not be necessary.

Question 3: Does the Task Force wish to affirm its decision that the amendments in the final Update shall be applied on a prospective basis to all share-based payments granted or modified on or after the effective date? Early adoption would be permitted.

Question 4: Does the Task Force also wish to allow, as an option, the application of the amendments on a modified retrospective basis for performance targets outstanding on or after the beginning of the first annual period presented as of the adoption date? Hindsight would be permitted. Early adoption would also be permitted.

Transition Disclosures

23. The proposed Update requires the transition disclosures on accounting policy changes in Subtopic 250-10 to apply in the period of adoption. While respondents were not asked to specifically comment on this aspect, there were no opposing views to such a requirement.

Question 5: Does the Task Force wish to affirm its decision that the transition disclosures in Subtopic 250-10 would apply in the final Update?

Effective date

Public business entities

24. In Question 6, respondents were asked about the effort and time needed to implement the amendments in the proposed Update. Most respondents who answered the question commented that significant efforts would not be needed. Several respondents commented that most reporting entities currently apply the performance-condition approach to awards within the scope of this Issue.

25. The staff has considered the feedback and proposes that the amendments in the final Update should be effective for annual reporting periods for *public business entities* beginning after December 15, 2015, including interim reporting periods within those years, with early adoption permitted. This would provide companies with sufficient time for adoption after the issuance of the final Update.

Entities other than public business entities

26. In Question 5, respondents were asked whether the amendments in the proposed Update should be different for nonpublic entities. Of those respondents who answered the question, all indicated that they do not see a need for there to be a difference between public and nonpublic entities.

27. The staff has considered this feedback together with the FASB's Private Company Decision-Making Framework (Framework) published in December 2013. Paragraphs 4.1 and 4.2 of the Framework state that:

> …generally, the amendments in a FASB Accounting Standards Update should be effective for private companies one year after the first annual period for which public companies are required to adopt them.
>
> Generally, amendments for private companies should be effective first for annual periods and then for interim periods thereafter. Private companies generally should not be required to adopt amendments during an interim period within the initial fiscal year of adoption.

28. The Framework also states that in determining whether the effective date should be the same as the first annual period for both private and public companies, the Board should consider whether

the amendments are being issued to clarify existing guidance. Conversely, if the amendments are required to be applied using a retrospective method of transition, then the Framework indicates that the effective date should be delayed by more than one year after the first annual period required for public companies.

29. The staff proposes that the amendments in this Issue are effective for all other entities one year after the effective date of public business entities, that is, annual periods beginning after December 15, 2016, and interim periods thereafter, irrespective of whether a modified retrospective adoption is allowed as an option.

Question 6: Does the Task Force agree with the FASB staff recommendations on the effective date in the final Update as follows:

a. **For public business entities: annual periods beginning after December 15, 2015, <u>including interim reporting periods</u> within those annual periods**
b. **For all other entities: annual periods beginning after December 15, 2016, and for <u>interim reporting periods thereafter</u>.**

Request for additional guidance and potential amendments

30. The staff received a number of comments from reviewers prior to issuing the proposed Update requesting additional guidance and amendments as a result of the Task Force's consensus-for-exposure on this Issue. Many of those same comments were also raised by a comment letter respondent (CL8). The most significant comments from reviewers and respondents are discussed below.

Removal of "performance condition" from paragraph 718-10-55-88

31. The staff-draft of the proposed Update initially included a strike-out amendment in paragraph 718-10-55-88 to delete the reference to "performance condition." However, that deletion appeared to have caused some confusion among reviewers because a number of non-related comments were received about it. For that reason, the staff removed the strike-out amendment in the proposed Update. Subject to the Task Force reaching a final consensus on this Issue, the staff proposes that

this strike-out amendment be reintroduced in the final Update. The staff has presented this amendment in Exhibit 13-DB.

Performance conditions and other factors that affect the grant-date fair value

32. Some reviewers and respondents suggested that additional amendments should be made to paragraph 718-10-30-10 on the "vesting versus nontransferability" guidance and to paragraph 718-10-30-13, which provides guidance on performance conditions that affect grant-date fair value. Those who support this view believe that additional amendments to these two paragraphs would help situate the guidance in the proposed Update throughout the "Initial Measurement" section of the Codification and aid in the navigation of Topic 718.

33. The staff concluded that additional amendments to these paragraphs were not necessary for two reasons. First, these paragraphs provide guidance on "factors or restrictions that impact the determination of fair value at grant date," as indicated in the subject heading. On the contrary, the proposed Update provides guidance on performance conditions that affect vesting which do not affect the grant-date fair value. Second, the amendments in the proposed Update create a new paragraph at 718-10-20-28. The placement of this new paragraph is under the subject heading "market, performance and service conditions" and immediately follows the guidance on performance conditions that affect vesting. The staff believes, however, that the order of the words in the proposed amendment should be rearranged to clarify the Task Force's intent that the consensus relates only to performance targets that affect vesting; as opposed to targets that affect exercisability, exercise price, or grant-date fair value. The staff has presented this change in Exhibit 13-DB.

34. Some reviewers also suggested that additional amendments should be made to paragraph 718-10-25-2 in relation to the "recognition principle for share-based payment transactions" to state that awards within the scope of this Issue are an exception to the recognition principle. The staff considered that additional amendments to this paragraph were not necessary for two reasons. First, the consensus-for-exposure does not provide a general exception from recognizing compensation cost over the requisite service period. It does, however, provide that compensation cost is recognized for the actual number of awards that transfer to the recipient, which, in some cases, may

be after the requisite service period. Second, while it is well intentioned, including additional amendments to this and other paragraphs for such narrow-scope clarifications often complicates the meaning of the guidance because it becomes tedious to read and difficult to understand.

Illustrative guidance

35. Some reviewers and respondents suggested that the staff should provide illustrative examples of awards within the scope of this Issue within the Implementation Guidance. The staff concluded that illustrations were not necessary for two reasons. First, other than clarifying that the performance target should be treated as a performance condition, the consensus-for-exposure was not developing any other guidance. Topic 718 already contains a large catalog of examples on how to account for share-based payments and reporting entities already apply the existing recognition and measurement guidance as it relates to awards with performance conditions that affect vesting. Second, the staff was informed that most reporting entities currently treat these performance targets as performance conditions. Accordingly, there was no compelling reason for the staff to provide illustrations or examples for what is the common accounting practice for such awards.

Exhibit 13-DA

ILLUSTRATION – Accounting comparison of when a performance target is deemed a substantive term with when it is deemed a nonsubstantive term

The FASB staff understands that arrangements with characteristics similar to those described below occur in practice. The staff is not intending to provide guidance on when a term is, or is not, substantive.

- Performance target = Liquidation Event (such as a change-in-control or IPO)
- Measurement period of the performance target = Indefinite
- Requisite service period = 3 years

Fact Pattern

A nonpublic company grants awards to employees that include a three-year service condition. After completing the requisite service, the award entitles the recipient to receive dividends and voting rights in the parent entity that do not expire. The recipient is also able to transfer (that is, sell) the awards to related parties. The terms provide that when the recipient terminates employment, the Company could, at its discretion, repurchase the awards at fair value as determined by the Board; typically, this value is calculated using a discounted cash flow analysis. If at any time there is a liquidation event, the terms provide that the award is immediately converted into equity and acquired based on the acquisition price agreed to in the liquidation event.

There are no expected or actual forfeitures during the service period and the liquidation event occurs in Year 15. The grant-date fair value of the awards is $100 million. The following illustrates the accounting for this grant under the proposed Update assuming (a) the performance target is a substantive term and (b) the performance target is not a substantive term (not in the scope of this issue).

		Income Statement Recognition					
	Measure-ment date	**Service Period**				**Outcome of the performance target**	**Total amount recognized in the P&L**
Liquidation Event	**Grant- date fair value of awards issued**	**Year 1**	**Year 2**	**Year 3**	**Years 4-14**	**Year 15 Incremental/ (Reversal)**	**Cumulative stock comp expense**
(a) Substantive performance target	$100m[1]	0[2]	0	0	0	$100m[3]	$100m
(b) Non-substantive performance target -	$100m[4]	$33.3m[5]	$33.3m	$33.3m	0	0	$100m

[1]Performance conditions that affect vesting are not reflected in the grant-date fair value of $100m.

[2]No compensation cost is recognized during the service period because the liquidation event is not deemed probable.

[3] In Year 15, the period that includes the liquidation event, the Company would recognize compensation cost equal to the entire grant-date fair value of $100m.

[4]The non-substantive performance target is ignored and is not reflected in the grant-date fair value of $100m because achieving the target is not considered necessary in order to earn the right to benefit from the instrument.

[5] The $100m grant-date fair value is recognized ratably over the 3-year service period.

Exhibit 13-DB

PROPOSED FINAL AMENDMENTS

The FASB staff recommends that amendments (a) and (b) are presented in the final Update as described below.

a. Changes from the proposed Update are underlined and deleted text is ~~struck out~~.

Compensation—Stock Compensation—Overall Initial Measurement

> Market, Performance, and Service Conditions

718-10-30-27 Performance or service conditions that affect vesting are not reflected in estimating the fair value of an award at the grant date because those conditions are restrictions that stem from the forfeitability of instruments to which employees have not yet earned the right. However, the effect of a market condition is reflected in estimating the fair value of an award at the grant date (see paragraph 718-10-30-14). For purposes of this Topic, a market condition is not considered to be a vesting condition and an award is not deemed to be forfeited solely because a market condition is not satisfied

718-10-30-28 In some cases, the terms of an award may provide that a performance target that affects vesting could be achieved after an employee completes the requisite service period. That is, the employee would be ~~entitled to benefit from~~ eligible to vest in the award regardless of whether the employee is rendering service on the date the performance target is achieved. A performance target that affects vesting and that could be achieved after an employee's requisite service period shall be accounted for as a performance condition ~~that affects vesting~~.

b. Removal of "performance condition" from paragraph 718-10-55-88

718-10-55-88 Because the employee is eligible to retire at the grant-date, the award's explicit service condition is nonsubstantive. Consequently, Entity A has granted an award that does not contain a ~~performance condition or~~ service condition for vesting, that is, the award is effectively vested and, thus, the award's entire fair value should be recognized as compensation cost on the grant-date. All of the terms of a share-based payment award and other relevant facts and circumstances must be analyzed when determining the requisite service period.