FASB EXPOSURE DRAFT

Proposed Accounting Standards Update

Issued: October 23, 2013
Comments Due: December 23, 2013

Compensation—Stock Compensation (Topic 718)

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

a consensus of the FASB Emerging Issues Task Force

This Exposure Draft of a proposed Accounting Standards Update of Topic 718 is issued by the Board for public comment. Comments can be provided using the electronic feedback form available on the FASB website. Written comments should be addressed to:

Technical Director
File Reference No. EITF-13D

Financial Accounting Standards Board

The *FASB Accounting Standards Codification*® is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft and is requesting comments by December 23, 2013. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at Exposure Documents Open for Comment
- Emailing a written letter to director@fasb.org, File Reference No. EITF-13D
- Sending written comments to "Technical Director, File Reference No. EITF-13D, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

Do not send responses by fax.

All comments received are part of the FASB's public file. The FASB will make all comments publicly available by posting them to the online public reference room portion of its website.

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FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Proposed Accounting Standards Update

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October 23, 2013

Comment Deadline: December 23, 2013

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Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

Entities commonly issue share-based payment awards that require a specific performance target to be achieved for employees to benefit from the awards. Examples of performance targets include an entity attaining a specified profitability metric or selling shares in an initial public offering. Generally, an award with a performance target also requires an employee to render service until the performance target is achieved. In some cases, however, the terms of an award may provide that the performance target could be achieved after an employee completes the requisite service period. That is, the employee would be entitled to benefit from the award regardless of whether the employee is rendering service on the date the performance target is achieved.

Current U.S. generally accepted accounting principles (GAAP) do not contain explicit guidance on how to account for such share-based payments. Many reporting entities account for performance targets that could be achieved after the requisite service period as performance conditions that affect the vesting of the award and, therefore, do not reflect the performance target in the estimate of the grant-date fair value. Other reporting entities treat those performance targets as nonvesting conditions that affect the grant-date fair value of the award. This proposed Update is intended to resolve the diverse accounting treatment of those awards in practice.

Who Would Be Affected by the Amendments in This Proposed Update?

The amendments in this proposed Update would apply to all reporting entities that grant their employees share-based payments in which the terms of the award provide that a performance target could be achieved after the requisite service period. That would be the case 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 (for example, an initial public offering or change in control event) could be achieved and still be entitled to benefit from the award if and when the performance target is achieved.

What Are the Main Provisions?

The proposed amendments require that a performance target that could be achieved after the requisite service period be treated as a performance condition that affects the vesting of the award. A reporting entity would apply existing guidance in Topic 718 as it relates to awards with performance conditions that affect vesting. That is, compensation cost would be recognized if it is probable that the performance condition would be achieved. The total amount of compensation cost recognized during and after the requisite service period would reflect the number of awards that are expected to vest and would be adjusted to reflect those awards that ultimately vest.

How Would the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Would They Be an Improvement?

Current U.S. GAAP does not contain explicit guidance on whether to treat a performance target that could be achieved after the requisite service period as a performance condition that affects vesting or as a nonvesting condition that affects the grant-date fair value of an award. The amendments in the proposed Update would provide explicit guidance on such awards.

When Would the Amendments Be Effective?

The amendments in the proposed Update would be applied prospectively to all share-based payments granted or modified on or after the effective date. Earlier adoption would be permitted. The effective date will be determined after the Task Force considers stakeholder feedback on the proposed Update.

How Do the Proposed Provisions Compare with International Financial Reporting Standards (IFRS)?

Current IFRS does not contain specific guidance on how to account for share-based payments when the performance target could be achieved after the requisite service period. However, the IFRS Interpretations Committee has proposed an amendment to IFRS 2, *Share-based Payment,* to define the term *performance condition*.

The IFRS Interpretations Committee's proposed definition states that a performance condition is a vesting condition that requires both (1) the counterparty to complete a specified period of service and (2) specified performance targets to be met while the counterparty is rendering the service required in (1). The period of the performance target(s) cannot extend beyond the end of the service period, but it may start before the service period on the condition that the period of the performance target substantially coincides with the service period.

If the IFRS Interpretations Committee's proposed definition is finalized, performance targets that could be achieved after the requisite service period would not be accounted for as performance conditions under IFRS. Rather, those targets would be accounted for as nonvesting conditions that are reflected in the grant-date fair value of the award, which is then recognized over the requisite service period. Therefore, the accounting treatment under IFRS would differ from the amendments in this proposed Update under U.S. GAAP.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

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? If not, please explain why.

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? If yes, please explain why.

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? If yes, please explain why.

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? If yes, please explain why.

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?

Amendments to the *FASB Accounting Standards Codification*®

Summary of Proposed Amendments to the Accounting Standards Codification

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–3. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is <u>underlined</u>, and deleted text is ~~struck out~~.

Amendments to Subtopic 718-10

2. Add paragraph 718-10-30-28, with a link to transition paragraph 718-10-65-3, as follows:

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.

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

3. Add paragraph 718-10-65-3 and its related heading as follows:

> Transition Related to Accounting Standards Update No. 2013-XX, *Compensation—Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period*

718-10-65-3 The following represents the transition and effective date information related to Accounting Standards Update No. 2013-XX, *Compensation—Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period:*

a. The pending content that links to this paragraph shall be effective for fiscal years and interim periods within those years, beginning on or after [date to be inserted after exposure].
b. The pending content that links to this paragraph shall be applied prospectively to all share-based payment awards that are granted or modified on or after the effective date.
c. Earlier application of the pending content that links to this paragraph is permitted.
d. An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-3 in the period the entity adopts the pending content that links to this paragraph.

The amendments in this proposed Update were approved for publication by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Daryl E. Buck
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Task Force's considerations in reaching the conclusions in this proposed Update. It includes the Board's basis for ratifying the Task Force conclusions when needed to supplement the Task Force's considerations. It also includes reasons for accepting certain approaches and rejecting others. Individual Task Force and Board members gave greater weight to some factors than to others.

Background Information

BC2. Entities commonly issue share-based payment awards that require a specific performance target to be achieved for employees to benefit from the award. Examples of performance targets include an entity attaining a specified profitability metric or selling shares in an initial public offering. Generally, an award with a performance target also requires an employee to provide service until the performance target is achieved. In some cases, however, the terms of an award may provide that the performance target could be achieved after the employee completes the requisite service period. That is, the employee would be entitled to benefit from the award regardless of whether the employee is rendering service on the date the performance target could be achieved.

BC3. Current U.S. GAAP does not contain explicit guidance on how to account for those share-based payments. Many reporting entities account for performance targets that could be achieved after the requisite service period as performance conditions that affect the vesting of the award and, therefore, do not reflect the performance target in the estimate of the grant-date fair value. Other reporting entities treat those performance targets as nonvesting conditions that affect the grant-date fair value of the award. In rare cases, reporting entities account for them as liability-classified awards. This proposed Update is intended to resolve the diverse accounting treatment of those awards in practice.

Scope

BC4. The Task Force decided that the amendments in this proposed Update would apply to all reporting entities that grant their employees share-based payments in which the terms of the award provide that the performance target could be achieved after the requisite service period. That would be the case 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 (for example, an initial public offering or change in control event) could be achieved and still be entitled to benefit from the award if and when the performance target is achieved.

Performance Condition Treatment

BC5. The definition of a performance condition in U.S. GAAP does not specifically require that an employee be rendering service at the time the performance target is achieved. Therefore, it is not clear from the definition whether a performance target that could be achieved after the requisite service period should be treated as a performance condition or as a nonvesting condition that affects the grant-date fair value of the awards. The Task Force decided that a performance target that could be achieved after the requisite service period should be treated as a performance condition that affects the vesting of the awards.

BC6. For awards within the scope of this proposed Update, the Task Force decided that a reporting entity would apply existing guidance in Topic 718 as it relates to share-based payments with performance conditions that affect vesting. Consistent with that guidance, performance conditions that affect vesting would not be reflected in estimating the fair value of an award at the grant date. Compensation cost would be recognized if it is probable that the performance condition will be achieved. The total amount of compensation cost recognized during and after the requisite service period would reflect the number of awards that are expected to vest and would be adjusted to reflect those awards that ultimately vest.

BC7. 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 an employer's own operations. When an employee is eligible to retire at the grant date, the existing guidance in paragraphs 718-10-55-86 through 55-88 indicates that there is, effectively, a one-day requisite service period, being the day of the grant. The Task Force therefore noted that both (a) and (b) from the definition are present in awards within the scope of this proposed Update. Accordingly, the Task Force decided that treating those performance targets as performance conditions would be consistent with the definition of a performance condition.

BC8. Some Task Force members also emphasized that the treatment of awards within the scope of this proposed Update as performance conditions is consistent with the Board's original basis for conclusions when it developed FASB Statement No. 123 (revised 2004), *Share-Based Payment.* 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 considered 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 Board decided that 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 with sufficient reliability than other awards that contain performance conditions. The outcome of performance targets, such as a future initial public offering, is also no less difficult to predict today than it was at the time the Board issued Statement 123(R). Therefore, the Task Force decided that there was no compelling reason to require awards within the scope of this proposed Update to be treated differently from other awards with performance conditions that affect vesting.

BC9. The Task Force acknowledged the potential anomaly that, in some cases, the accounting for the performance target as a performance condition would result in no compensation cost being recognized during the period in which the employee services are received. That is the case, for example, when the performance target becomes probable of being achieved after the requisite service period. Alternatively, compensation cost might never be recognized because the performance condition might not become probable of being achieved. This may be the case, for example, when there is a highly uncertain performance target such as an initial public offering or change in control event. The Task Force noted that the lack of compensation cost in such circumstances is not unique to the awards within the scope of this proposed Update; other types of performance conditions also would produce the same accounting result of no compensation cost because compensation cost cannot be recognized until a performance condition is considered probable of being achieved. The Task Force decided that it was preferable to recognize compensation cost after the requisite service period in some cases, such as in the initial public offering case, rather than to recognize a highly subjective compensation cost over the requisite service period. The Task Force also preferred accounting for the performance target as a performance condition because that treatment adjusts the compensation cost for the actual number of awards that vest.

BC10. In supporting its decision, the Task Force also observed another advantage of the performance condition treatment over the nonvesting condition treatment. The alternative approach would have required entities to assess at the grant date whether certain employees are retirement eligible or will become retirement eligible during the period. Entities would have had to undertake at least two different valuations for the same performance-based award and utilize two different measurement and recognition patterns for those awards, for example, one for retirement-eligible employees and another for all other employees. While entities already have to track different awards separately today (for example, awards with service conditions separately from awards with performance conditions), the Task Force noted that the alternative approach would have introduced incremental complexity.

BC11. The Task Force acknowledged that if the IFRS Interpretations Committee's proposed definition of a performance condition under IFRS 2 is finalized, the amendments in this proposed Update would diverge from IFRS. Performance targets that could be achieved after the requisite service period would not be accounted for as performance conditions under the proposed changes to IFRS 2. The Task Force noted that potential difference but ultimately decided that the improvement to U.S. GAAP as a result of the amendments in this proposed Update would take priority over convergence in this aspect of the share-based payments guidance.

Disclosures

BC12. The Task Force reached a consensus-for-exposure not to add incremental disclosure requirements to those already required by Topic 718. The disclosures required by Topic 718 are intended to enable users of the financial statements to understand the nature and terms of the share-based payment arrangements that existed during the period and the potential effects of those arrangements on shareholders. The Task Force noted that those objectives and related disclosures also are appropriate and sufficient for awards within the scope of this proposed Update.

Transition

BC13. The Task Force decided that the amendments in this proposed Update should be applied prospectively to share-based payment awards granted or modified on or after the effective date. Earlier adoption would be permitted. The Task Force considered allowing retrospective adoption but rejected it on the basis that it would require significant hindsight estimates about the probability of achieving the performance target. The Task Force also decided that the transition disclosures in Subtopic 250-10 on accounting changes would apply in the period of adoption.

Benefits and Costs

BC14. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Task Force's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC15. For most reporting entities, the Task Force does not anticipate that the amendments in this proposed Update would introduce significant costs and expects that recurring costs of applying the proposed amendments would be minimal. Some Task Force members observed that reflecting the performance target in the grant-date fair value for awards within the scope of this proposed Update could be viewed as more conceptually appropriate; however, the Task Force ultimately decided that the cost and complexity of applying that approach would outweigh the benefits. The proposed amendments would provide the benefit of improving consistent application of U.S. GAAP by reducing diversity in practice.

Amendments to the XBRL Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would not require changes to the U.S. GAAP Financial Reporting Taxonomy (UGT). Any stakeholders who believe that changes to the UGT are required should provide their comments and suggested changes at www.fasb.org.