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No. 2014-12
June 2014

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

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

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June 2014

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Summary

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

Entities commonly issue share-based payment awards that require a specific performance target to be achieved in order for employees to become eligible to vest in 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 eligible to vest in 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 do 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 of the award. Other reporting entities treat those performance targets as nonvesting conditions that affect the grant-date fair value of the award. This Update is intended to resolve the diverse accounting treatment of those awards in practice.

Who Is Affected by the Amendments in This Update?

The amendments in this Update apply to all reporting entities that grant their employees share-based payments in which the terms of the award provide that a performance target that affects vesting could be achieved after the requisite service period. That is the case when an employee is eligible to retire or otherwise terminate employment before the end of the period in which a performance target (for example, an initial public offering or a profitability target) could be achieved and still be eligible to vest in the award if and when the performance target is achieved.

What Are the Main Provisions?

The amendments require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. A reporting entity should apply existing guidance in Topic 718 as it

relates to awards with performance conditions that affect vesting to account for such awards. As such, the performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. As indicated in the definition of vest, the stated vesting period (which includes the period in which the performance target could be achieved) may differ from the requisite service period.

How Do the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Are They 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 this Update provide explicit guidance for those awards.

When Will the Amendments Be Effective?

For all entities, the amendments in this Update are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Earlier adoption is permitted. The effective date is the same for both public business entities and all other entities.

Entities may apply the amendments in this Update either (a) prospectively to all awards granted or modified after the effective date or (b) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. If retrospective transition is adopted, the cumulative effect of applying this Update as of the beginning of the earliest annual period presented in the financial statements should be recognized as an adjustment to the opening retained earnings balance at that date. Additionally, if retrospective transition is adopted, an entity may use hindsight in measuring and recognizing the compensation cost.

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

In December 2013, the International Accounting Standards Board issued an amendment to IFRS 2, *Share-based Payment*, to define the term *performance condition*. Under the new definition in IFRS 2, a performance target cannot extend beyond the end of the service period. That is, a performance target that could be achieved after the requisite service period would not meet the definition of a performance condition. Rather, those targets are accounted for as nonvesting conditions that are reflected in the grant-date fair value of the award. Therefore, the accounting treatment under IFRS differs from the amendments in this Update under U.S. GAAP.

Amendments to the *FASB Accounting Standards Codification*®

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–5. 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 that affects vesting could be achieved after an employee completes the requisite service period. That is, the employee would be 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. As such, the performance target shall not be reflected in estimating the fair value of the award at the grant date. Compensation cost shall be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service already has been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining</u>

unrecognized compensation cost for which requisite service has not yet been rendered shall be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period shall reflect the number of awards that are expected to **vest** and shall be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. As indicated in the definition of vest, the stated vesting period (which includes the period in which the performance target could be achieved) may differ from the requisite service period.

3. Amend paragraph 718-10-55-88, with a link to transition paragraph 718-10-65-3, as follows:

Implementation Guidance and Illustrations

> Illustrations

> > Example 1: Estimating the Requisite Service Period

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 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.

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

> Transition Related to Accounting Standards Update No. 2014-12, *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. 2014-12, *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 annual periods and interim periods within those annual periods, beginning after December 15, 2015.
b. The pending content that links to this paragraph may be applied prospectively to all share-based payment awards that are granted or modified on or after the effective date.
c. The pending content that links to this paragraph also may be applied retrospectively to all awards with performance targets that are

outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. If retrospective transition is adopted, the cumulative effect of applying the pending content that links to this paragraph as of the beginning of the earliest annual period presented in the financial statements shall be recognized as an adjustment to the opening retained earnings balance at that date. Additionally, if retrospective transition is adopted, the use of hindsight is permitted in the measurement and recognition of compensation cost.

d. Earlier application of the pending content that links to this paragraph is permitted.

e. 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.

5. Amend paragraph 718-10-00-1, by adding the following items to the table, as follows:

718-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph Number	**Action**	**Accounting Standards Update**	**Date**
718-10-30-28	Added	2014-12	06/19/2014
718-10-55-88	Amended	2014-12	06/19/2014
718-10-65-3	Added	2014-12	06/19/2014

The amendments in this Update were adopted 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 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 in order for employees to become eligible to vest in 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 the employee completes the requisite service period. That is, the employee would be eligible to vest in the award regardless of whether the employee is rendering service on the date the performance target is 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 of the award. 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 Update is intended to resolve the diverse accounting treatment of those awards in practice.

BC4. The Board issued a proposed Accounting Standards Update on October 23, 2013, with a comment period that ended on December 23, 2013, and received 12 comment letters on the proposed Update.

Scope

BC5. The Task Force decided that the amendments in this Update should apply to all reporting entities that grant their employees share-based payments in which the terms of the award provide that a performance target that affects vesting could be achieved after the requisite service period. That would be the case when an employee is eligible to retire or otherwise eligible to terminate employment before the end of the period in which a performance target (for example, an initial public offering or a profitability target) could be achieved and still be eligible to vest in the award if and when the performance target is achieved.

BC6. Respondents to the proposed Update generally agreed with the scope of awards that would be included within this Update. Respondents suggested, however, that the amendments clarify that the guidance only relates to performance targets that affect vesting as opposed to performance targets that may affect other terms of the award, for example, the exercise price. The Task Force agreed with this suggestion and clarified that the Update applies to performance targets that affect vesting.

BC7. Some respondents also questioned whether the scope of the Update would include a performance target that is considered to be a nonsubstantive vesting condition. The Task Force considered this feedback and concluded that the amendments should not apply to nonsubstantive vesting features, which is consistent with current U.S. GAAP. That is, current U.S. GAAP requires that the accounting for an award reflects the substantive terms of an arrangement, consistent with paragraph 718-10-25-15. The amendments in this Update do not change current U.S. GAAP with respect to the evaluation of whether or not a performance condition is substantive.

Performance Condition Treatment

BC8. The definition of a performance condition in U.S. GAAP does not require specifically 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 affects vesting and that could be achieved after the requisite service period should be treated as a performance condition. Almost all respondents agreed with the Task Force’s consensus-for-exposure on the performance condition treatment.

BC9. For awards within the scope of this Update, the Task Force decided that a reporting entity should 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 should not be reflected in estimating the fair value of an award at the grant date. Compensation cost should be recognized when it is probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest.

BC10. The Task Force observed that the definition of 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 the service condition is nonsubstantive, meaning 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) above are present in awards within the scope of this Update. Accordingly, the Task Force decided that treating those performance targets as performance conditions is consistent with the definition of a performance condition.

BC11. Some Task Force members also emphasized that the treatment of awards within the scope of this 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 generally was 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 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 Update to be treated differently from other awards with performance conditions that affect vesting.

BC12. In supporting its decision, the Task Force also observed that the nonvesting condition approach would have required entities to assess at the grant date whether certain employees are retirement eligible or will become retirement eligible during the performance period for purposes of valuing the awards. Entities would have had to undertake at least two different valuations for the same performance-based award, for example, one for retirement-eligible employees and another for all other employees. While entities already have to track different awards separately today, the Task Force noted that the nonvesting condition approach would have introduced incremental complexity.

Attribution Period of the Compensation Cost

BC13. The Task Force acknowledged 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 when the performance target becomes probable of being achieved after the requisite service period, for example, when there is a highly uncertain performance target such as an initial public offering. In this instance, there may be no compensation cost attributed to the reporting periods in which the employee's service is rendered, and the entire compensation cost would be recognized in the period in which the initial public offering becomes probable. Alternatively, compensation cost might not be recognized because the performance target might never become probable.

BC14. Furthermore, an employee may be immediately eligible to retire and is granted awards that include a performance target based on the company's profitability in three years' time. The terms of the award provide that the employee could retire before the outcome of the profit target is known and be entitled to receive the same awards that would have vested to the employee as if that employee had remained in service. In this case, the requisite service already has been rendered. If the entity initially determines that the performance target is probable, then the entire compensation cost would be recognized on the grant date. If the entity determines that the performance target is probable in a subsequent reporting period, then the entire compensation cost would be recognized in that subsequent period. Alternatively, compensation cost might not be recognized at all because the performance condition might never become probable of being achieved.

BC15. The Task Force noted that the lack of compensation cost during the service period in these circumstances is not unique to the awards within the scope of this Update; other types of performance conditions also would produce the same accounting result of no compensation cost being recognized during the service period 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.

Requisite Service Period and Vesting Period

BC16. Several respondents commented that existing guidance in Topic 718 illustrates that the requisite service period is often considered to be the same duration as the vesting period. The Task Force observed that, for awards within the scope of this Update, the *requisite service period* is the period during which an employee is required to provide service in exchange for an award and would end when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. As indicated in the definition of vest, the stated vesting period (which includes the period in which the performance target could be achieved) may differ from the requisite service period for awards within the scope of this Update.

Comparison with International Financial Reporting Standards

BC17. In December 2013, the IASB issued an amendment to IFRS 2 to define the term *performance condition.* Under the new definition, the performance target period cannot extend beyond the end of the service period. That is, performance targets that could be achieved after the requisite service period would not be accounted for as performance conditions. Rather, those targets would be accounted for as nonvesting conditions that are reflected in the grant-date fair value of the award.

BC18. In reaching its consensus on the amendments in this Update, the Task Force considered, at length, the IASB's amendments to IFRS 2. The Task Force acknowledged that the amendments in this Update would diverge from IFRS but ultimately decided that its consensus was more consistent with the Board's original basis for conclusions on share-based payments and more consistent with the predominant interpretation of U.S. GAAP under current practice.

Strike-out Amendment to the Illustrative Guidance

BC19. The Task Force observed that the example in paragraph 718-10-55-88, which illustrates how to estimate the requisite service period for retirement-eligible employees, would inadvertently conflict with its consensus on this Issue. The Task Force concluded that that paragraph was not meant to provide guidance on awards within the scope of this Update; rather, it was meant to illustrate how the requisite service period is estimated. During deliberations, the Task Force initially decided to recommend that the conflicting language within this paragraph be amended in the Board's Technical Corrections project. However, several respondents to the Exposure Draft suggested that the Task

Force include this amendment as part of this Update. The Task Force agreed with that suggestion and decided to modify paragraph 718-10-55-88 as part of this guidance and to remove the conflicting language. The Task Force concluded that this modification does not change the substance of or the conclusions in that illustration.

Disclosures

BC20. The Task Force decided 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 Update. Respondents generally agreed with the Task Force's conclusion not to add incremental disclosures.

Transition and Transition Disclosures

BC21. The Task Force decided that the amendments in this Update should be applied prospectively to share-based payment awards granted or modified on or after the effective date. Earlier adoption is permitted. A number of respondents recommended that the Task Force allow transition alternatives and permit entities to adopt the amendments in this Update on a retrospective basis if they wanted to enhance comparability. The Task Force agreed with that suggestion and decided to permit retrospective adoption for all awards with performance targets that are outstanding on or after the beginning of the first annual period presented in the financial statements at the date of adoption. The Task Force also decided that the use of hindsight should be allowed to provide relief in those cases in which retrospective transition would otherwise require significant judgment in determining the exact prior period in which the outcome of the performance target may have become probable (for example, a profitability-based performance target for which it may be unclear on the transition date when the target became probable of being achieved).

BC22. The Task Force decided that the transition disclosures in Subtopic 250-10 on accounting changes should apply in the period of adoption. Respondents did not express any opposing views to these requirements.

Effective Date

BC23. Respondents were asked about the time and effort needed to implement the amendments in this Update and whether there should be a difference in the requirements between public business entities and all other entities. Most respondents who answered those questions commented that significant effort would not be needed and that there should not be a difference between public business entities and all other entities. The Task Force considered that feedback together with the FASB's Private Company Decision-Making Framework. While the framework generally recommends that private companies (a) should be given an additional year to adopt new guidance and (b) should not be required to adopt amendments during an interim period within the initial fiscal year of adoption, the Task Force decided that those guidelines were not necessary for the amendments in this Update because the amendments are largely providing clarifying guidance and can be applied on a prospective basis. Task Force members also noted that private companies would have adequate time before the effective date to go through their learning cycle.

Benefits and Costs

BC24. 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.

BC25. For most reporting entities, the Task Force does not anticipate that the amendments in this Update will introduce significant costs and expects that recurring costs of applying the amendments will 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 Update could be viewed as more conceptually appropriate; however, the Task Force ultimately decided that the cost and complexity of applying that approach will outweigh the benefits. The amendments will provide the benefit of improving consistent application of U.S. GAAP by reducing diversity in practice.

Amendments to the XBRL Taxonomy

The amendments to the *FASB Accounting Standards Codification*® in this Accounting Standards Update do 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 through ASU Taxonomy Changes provided at www.fasb.org.