EFRAG
European Financial Reporting Advisory Group

March 10, 2003

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
UK

Dear David,

Re: ED 2 Share-based Payment

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft ED 2 *Share-based payment*. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issues.

We support the objective of the proposed standard to recognize an expense when the goods or services received or acquired under a share-based payment transaction are consumed. The draft standard ensures that an entity recognises all share-based payment transactions in its financial statements, measured at fair value, so that IFRS financial statements meet the qualitative characteristics of understandability, relevance, reliability and comparability. In general, we believe the draft standard is well supported by the comprehensive Basis for Conclusions. Nonetheless, our discussions of the Exposure Draft revealed areas where we believe further consideration of the Board is required. These points are summarised in Appendix 1. Appendices 2-4 set out our answers to the questions raised in the draft standard.

If you would like further clarification of the points raised in this letter Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely

Johan van Helleman
EFRAG, Chairman

Summary of EFRAG's comments on ED 2 *Share-based Payment*

We support the objective of the proposed standard to recognise an expense when the goods or services received or acquired under a share-based payment transaction are consumed. In the light of global convergence, we strongly support the Norwalk Agreement as well as the FASB's issuance of an Invitation to Comment on the *Accounting for Stock-Based Compensation* which demonstrates the Boards' commitment to promoting international convergence of high-quality accounting standards.

ED 2 ensures that an entity recognises all share-based payment transactions in its financial statements, measured at fair value, so that IFRS financial statements meet the qualitative characteristics of understandability, relevance, reliability and comparability. Nonetheless, we believe the Board should consider clarifying the definition of an expense in the Framework so that no reference needs to be made to pronouncements of other standard-setting bodies as is currently done in BC 42.

We believe the proposed draft of the standard will achieve these objectives if the following observations are addressed by the Board:

Clarification of the standard's scope

We became aware of the great concern among our constituents that all share purchase plans would be automatically scoped in by the proposed standard. We fully support the IASB's view, as explained in paragraph 13 of its Basis for Conclusions, that it is reasonable to exempt an employee share purchase plan if it has substantially no option features and the discount is small. In order to (i) clarify the principle that share purchase plans are within the scope of this standard and (ii) address the concern of consistent application of share purchase plans under the standard, we recommend that the Board should (a) to include share purchase plans in the examples in Appendix B and (b) to develop implementation guidance for share purchase plans. Such implementation guidance should expand on the analysis of the compensation nature and significance of share purchase plan features when assessing whether a plan can be exempted or not.

Clarification of the preferred measurement date

As mentioned in paragraph 7, equity-settled share-based payment transactions must be measured indirectly, by reference to the fair value of the equity instruments granted, if this value is more readily determinable than the fair value of the goods or services received. In such cases, the standard prescribes that the fair value be determined at grant date instead of service date. The Board takes this approach because it considers that there is unlikely to be a high correlation between changes in the fair value of the equity instrument and the fair value of the services received. We support the Board's approach but believe that the concluding statement in BC 84 that "grant date is the appropriate measurement date" may be misunderstood. The latter was evidenced by the comments received by EFRAG. We therefore recommend the Board to modify its explanations to indicate more clearly that (i) it is using a service date method and that (ii) the grant date measurement used in the indirect method is only a surrogate.

Clarification of the use of option pricing models

- We recommend that no reference is made to any specific option pricing model (such as Black-Scholes) or any specific kind of option pricing model (e.g. binomial model). Instead, we prefer the standard to refer to "the most relevant generally accepted option pricing model". Certain models such as Black-Scholes were developed for perfect markets and intended for traded options with a short life. Therefore, their application may result in some overstatement of value when measuring share options that are not readily marketable.

- A prime concern of some respondents is how an option pricing model should be applied when no past performance information is available (e.g. for unlisted or start-up companies). The Board addresses such situations in its Basis for Conclusions (139,142,174-176) as well as its Implementation Guidance. The current (primarily US) practice of setting volatility at zero for unlisted or start-up companies is explicitly excluded by the Board, as explained in BC 76-78. For clarification purposes, we recommend the Board to include some of the guidance on the estimate of expected volatility in the standard.

Unnecessary restrictions

- We believe that the requirement for transactions with employees "to measure the fair value of the employee services received by reference to the fair value of the equity instruments granted" is too restrictive. In practice, we expect that entities will most often perform both a direct and indirect measurement before entering into a share-based payment transaction. In our opinion, the following rare situations could justify reliance on the direct measurement method:

    a) Entities for which equity instruments are not (or are only recently) traded, will often experience the greatest difficulties in measuring reliably the value of their equity instruments granted. In addition, in such entities a grant of options is often meant to be the largest part of the remuneration package. In such cases, the cash salary will not be comparable with the average salary offered to employees with similar skills.

    b) A share-based payment transaction whereby employees are given the opportunity to substitute a portion of their cash salary by equity instruments of the entity which have the same value as the portion of cash salary given up.

  However, we agree that in many cases it will not be possible to measure directly the services received. Consequently, we recommend the Board considers modifying paragraphs 11 and 12 so that they introduce a rebuttable presumption that, for equity-settled transactions with employees, the fair value of the equity instruments granted is more readily determinable than the fair value of the employee services received.

- We find the Board's requirement to ignore the cancellation of a share or option grant during the vesting period too restrictive. For instance, in the case of business combinations, share options are sometimes cancelled and replaced by cash remuneration (increased monthly salary). If the entity were to be required to "continue to account for services rendered during the remainder of the vesting period, as if the grant had not been cancelled", we believe that such accounting would result in inappropriate financial reporting. We therefore recommend the Board to amend paragraph 29 so that no future expensing is required for genuine cancellations.

- While we accept the proposed calculation methods as illustrated in examples 1 and 2 of Appendix B, we have set out in Appendices 3 and 4 to this letter a proposed alternative approach which is based on a combination of ED 2 and SFAS 123. Several commentators expressed a strong desire to achieve global convergence on the measurement method.

Determination of the service (period) – reflection of vesting conditions

In general, we believe that the standard needs to be further developed to address the relationship between vesting conditions and service (period). For instance, the Board may wish to debate (i) whether a targeted share price is a proper reflection of management's performance and (ii) whether the achievement of a targeted share price can be reasonably estimated. The Board should also consider how an "event driven" vesting (e.g. when the entity goes public) should be accounted for and include its conclusions in the Implementation Guidance of the standard.

Excessive disclosure requirements

We believe that the minimum disclosure rules labelled (i),(ii),(iii),… in paragraphs 46,48 and 52 are, with the exception of paragraph 48 (a) (i), burdensome for preparers and may obscure the key messages to the users of financial statements. They should be treated as illustrative of the sort of disclosure needed to meet the requirements set out in the bold paragraphs rather than mandatory and should therefore be included in Appendix D.

Prospective and retrospective application of the standard

Because of the grant date surrogate measurement for certain equity-settled share-based payment transactions, any prospective application requirement has also a retrospective character. In general, we believe that an accounting standard should only be applicable prospectively from the date it is issued. Therefore, we suggest the Board should only require prospective application for share-based payment transactions entered into after the date the standard is issued, with an option to apply the standard prospectively for existing plans at the date of issuance of the standard. The standard should also explicitly provide an option for retrospective application.

Taxation

We are concerned that the IAS 12 *Income Taxes* definition of temporary differences scopes out the accounting for the timing effect of income taxes on expenses of equity-settled share-based payment transactions. We recommend the Board to consider this concern and to make the necessary amendments to IAS 12. To answer the question as to how to account for the tax effects of share-based payment transactions we believe the question "what triggers the tax benefit" is critical. For instance, in certain tax jurisdictions, the tax benefit is triggered when the option is converted into a share. When the tax benefit is based on values different from the compensation expense/asset recognised, we believe that any difference compared with the initially recognised deferred tax should be considered to be a directly attributable transaction gain/loss to the equity instrument issued (to be allocated directly to equity). We recommend the Board to include such guidance in IAS 12 and to amend the proposed example accordingly.

Q1. Paragraphs 1-3 of the draft IFRS set out the proposed scope of the IFRS. There are no proposed exemptions, apart from for transactions within the scope of another IFRS.
Is the proposed scope appropriate? If not, which transactions should be excluded and why?

Response

We agree with the IASB proposal that, apart from exemptions for transactions within the scope of another IFRS, no exemptions are foreseen in the *Share-based Payment* standard. However, we became aware of the great concern among our constituents that all share purchase plans would be automatically scoped in by the proposed standard. We support the IASB's view, as explained in paragraph 13 of its Basis for Conclusions, that it is reasonable to exempt an employee share purchase plan if it has substantially no option features and the discount is small. To (i) clarify the principle that share purchase plans are within the scope of this standard and (ii) address the concern of consistent application of share purchase plans under the standard, we recommend the Board (a) to include share purchase plans in the examples in Appendix B and (b) to develop implementation guidance for share purchase plans. Such implementation guidance should expand on the analysis of the compensation nature and significance of share purchase plan features when assessing whether the plan can be exempted or not.

Further, we are concerned that it is currently not sufficiently clear that ED 2 is applicable when an entity buys its own equity instruments and subsequently sells them at a discount to its employees. We therefore recommend the Board to include in Appendix B an example whereby treasury shares are sold to employees. Such an example should illustrate that the difference between the market value of the treasury share at the date of grant (sale) and the value at which the treasury share is sold to the employee has to be considered as an employee benefit under ED 2.

Q2. Paragraphs 4-6 of the draft IFRS propose requirements for the recognition of share-based payment transactions, including the recognition of an expense when the goods or services received or acquired are consumed.

Are these recognition requirements appropriate? If not, why not, or in which circumstances are the recognition requirements inappropriate?

Response

We agree with the IASB proposal for the reasons given in the Basis for Conclusions. Nonetheless, we encourage the Board to clarify the definition of an expense in the Framework so that no reference needs to be made to pronouncements of other standard-setting bodies as is currently done in BC 42.

Q3. For an equity-settled share-based payment transaction, the draft IFRS proposes that, in principle, the entity should measure the goods or services received, and the corresponding increase in equity, either directly, at the fair value of the goods or services received, or indirectly, by reference to the fair value of the equity instruments granted, whichever fair value is more readily determinable (paragraph 7). There are no exemptions to the requirement to measure share-based payment transactions at fair value. For example, there are no exemptions for unlisted entities.

Is this measurement principle appropriate? If not, why not, or in which circumstances is it not appropriate?

Response

We agree with the IASB proposal for the reasons given in the Basis for Conclusions. However, we have made some recommendations regarding the proposed measurement approach in our answers to question 4,7,9,11 and 13. We believe the Board should consider these recommendations when finalising the drafting of the standard.

Q4. If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured directly, the draft IFRS proposes that fair value should be measured at the date when the entity obtains the goods or receives the services (paragraph 8).

Do you agree that this is the appropriate date at which to measure the fair value of the goods or services received? If not, at which date should the fair value of the goods or services received be measured? Why?

Response

We agree with the IASB proposal based on the fact that in a bargained transaction the service date fair value of the goods/services (to be) obtained is of relevance. However, most often, under the historical cost measurement basis it is assumed that the value of the consideration given is the same as the value at contract (grant) date of the purchased good/service (to be) received. As a result, under the historical cost measurement basis, assets/services are recognised at the fair value of the consideration given to acquire them at the time of their acquisition. A historical cost approach is not possible in the case of equity-settled share-based payment transactions because the entity does not sacrifice any cash or other assets. As explained in BC 35-36, the expense arises from the consumption of resources received as consideration for the issue of equity instruments. Therefore, the fair value should be determined at the date when the entity obtains the goods or receives the services (so called "service date measurement basis").

As mentioned in para 7, equity-settled share-based payment transactions must be measured indirectly, by reference to the fair value of the equity instruments granted, if this value is more readily determinable than the fair value of the goods or services received. In such cases, the standard prescribes that the fair value be determined at grant date instead of service date. The Board takes this approach because it considers that there is unlikely to be a high correlation between changes in the fair value of the equity instrument and the fair value of the services received (BC 89). We support the Board's approach but believe that the concluding statement in BC 84 that "grant date is the appropriate measurement date" may be misunderstood. The latter was evidenced by the comments received by EFRAG. We therefore recommend the Board to modify its explanations to indicate more clearly that (i) it is using a service date measurement approach and that (ii) the grant date measurement used in the indirect method is only a surrogate.

Q5. If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured by reference to the fair value of the equity instruments granted, the draft IFRS proposes that the fair value of the equity instruments granted should be measured at grant date (paragraph 8).

Do you agree that this is the appropriate date at which to measure the fair value of the equity instruments granted? If not, at which date should the fair value of the equity instruments granted be measured? Why?

Response

We agree with the IASB proposal for the reasons given in the Basis for Conclusions.

Q6. For equity-settled transactions with parties other than employees, the draft IFRS proposes a rebuttable presumption that the fair value of the goods or services received is more readily determinable than the fair value of the equity instruments granted (paragraphs 9 and 10).

Do you agree that the fair value of the goods or services received is usually more readily determinable than the fair value of the equity instruments granted? In what circumstances is this not so?

Response

We agree with the approach as explained in para 10.

Q7. For equity-settled transactions with employees, the draft IFRS proposes that the entity should measure the fair value of the employee services received by reference to the fair value of the equity instruments granted, because the latter fair value is more readily determinable (paragraphs 11 and 12).

Do you agree that the fair value of the equity instruments granted is more readily determinable than the fair value of the employee services received? Are there any circumstances in which this is not so?

Response

We agree that usually the fair value of equity instruments granted will be more readily determinable than the fair value of the employee services received. However, we believe that in practice, entities will most often perform both a direct and indirect measurement before entering into a share-based payment transaction. If not, there is a risk that the (estimated) value of the equity instruments granted will not be aligned to the (estimated) value of the resources to be received, which would cause a violation of managements' fiduciary duties. In our opinion, the following (rare) situations could justify reliance on the direct measurement method:

a) Entities for which equity instruments are not (or are only recently) traded, will often experience the greatest difficulties in reliably measuring the value of their equity instruments granted. In addition, in such entities a grant of options is often meant to be the largest part of the remuneration package. In these cases, the cash salary will not be comparable with the average salary offered to employees with similar skills.
b) A share-based payment transaction whereby employees are given the opportunity to substitute a portion of their cash salary by equity instruments of the entity which have the same value as the portion of cash salary given up.

Consequently, we recommend the Board considers modifying paragraphs 11 and 12 so that they introduce a rebuttable presumption that, for equity-settled transactions with employees, the fair value of the equity instruments granted is more readily determinable than the fair value of the employee services received.

Q8. Paragraphs 13 and 14 of the draft IFRS propose requirements for determining when the counterparty renders service for the equity instruments granted, based on whether the counterparty is required to complete a specified period of service before the equity instruments vest.

Do you agree that it is reasonable to presume that the services rendered by the counterparty as consideration for the equity instruments are received during the vesting period? If not, when are the services received, in your view?

Response

While we agree with the IASB proposal we believe it is not always appropriate to presume that the services rendered by the counterparty as consideration for the equity instruments are received during the vesting period. We therefore recommend the Board to include in the first sentence of paragraph 14 the words “in the absence of evidence to the contrary”. For the same reason, we suggest that in the last sentence of paragraph 14 “vesting period” be replaced by “service period”.

Q9. If the services received are measured by using the fair value of the equity instruments granted as a surrogate measure, the draft IFRS proposes that the entity should determine the amount to attribute to each unit of service received, by dividing the fair value of the equity instruments granted by the number of units of service expected to be received during the vesting period (paragraph 15).

Do you agree that if the fair value of the equity instruments granted is used as a surrogate measure of the fair value of the services received, it is necessary to determine the amount to attribute to each unit of service received? If not, what alternative approach do you propose? If an entity is required to determine the amount to attribute to each unit of service received, do you agree that this should be calculated by dividing the fair value of the equity instruments granted by the number of units of services expected to be received during the vesting period? If not, what alternative method do you propose?

Response

We agree that it is necessary to determine the amount to attribute to each unit of service to be received and accept the proposed method as described in para 15 and illustrated in Appendix B – example 1. Our deliberations of the comments received as well as a detailed analysis of the differences in measurement philosophy between ED 2 and SFAS 123 (see following paragraphs) brought us to the conclusion to modify our initial position in supporting full truing up.

The IASB's proposal differs significantly from the FASB's SFAS 123 method. Several commentators have expressed their strong desire to achieve global convergence on the measurement method. In this context, we considered it useful to suggest an alternative method which is a combination of the ED 2 and SFAS 123 method. This alternative, as illustrated in Appendix 3, differs from the ED 2 approach in that it does not use the unit of service method and does not require to "cast in stone" the expected forfeiture at grant date by incorporating it in the deemed fair value per unit of service. Instead, under the proposed alternative it is argued that it is not necessary to reduce the fair value at grant date of the instrument granted to reflect any vesting conditions. This is explained by the fact that the main objective of ED 2 is not to measure the **expected** services to be received but those **actually** received.

Under our proposed alternative approach step b) "estimate at grant date the number of units of service expected to be received during the vesting period" and step c) "divide the fair value of the equity instruments granted by the number of units of service expected to be received during the vesting period" of para 15 are no longer necessary. We therefore consider our alternative less complex. It differs from SFAS 123 in that we propose not to have a catch-up (true-up) adjustment to ultimately reflect only the value of the instruments that vest. The reason is that we support the main objective of ED 2 which is recognition of the services received.

In our opinion, our proposed alternative better reflects actual services received which is the primary objective of the standard. The effect of the ED 2 limitation becomes even more apparent in the case of performance forfeiture, as commented upon in our answer to question 13. We believe that this limitation of ED 2 is in conflict with the increased requirement for re-assessment of estimates in other IASB standards.

Q10. In an equity-settled share-based payment transaction, the draft IFRS proposes that having recognised the services received, and a corresponding increase in equity, the entity should make no subsequent adjustment to total equity, even if the equity instruments granted do not vest or, in the case of options, the options are not exercised (paragraph 16). However, this requirement does not preclude the entity from recognising a transfer within equity, ie a transfer from one component of equity to another.

Do you agree with this proposed requirement? If not, in what circumstances should an adjustment be made to total equity and why?

Response

We agree with the IASB proposal for the reasons given in the Basis for Conclusions.

Q11. The draft IFRS proposes that the entity should measure the fair value of equity instruments granted, based on market prices if available, taking into account the terms and conditions of the grant (paragraph 17). In the absence of a market price, the draft IFRS proposes that the entity should estimate the fair value of options granted, by applying an option pricing model that takes into account various factors, namely the exercise price of the option, the life of the option, the current price of the underlying shares, the expected volatility of the share price, the dividends expected on the shares (where appropriate) and the risk-free interest rate for the life of the option (paragraph 20). Paragraph 23 of the proposed IFRS explains when it is appropriate to take into account expected dividends.

Do you agree that an option pricing model should be applied to estimate the fair value of options granted? If not, by what other means should the fair value of the options be estimated? Are there circumstances in which it would be inappropriate or impracticable to take into account any of the factors listed above in applying an option pricing model?

Response

We agree with the IASB proposal for the reasons given in the Basis for Conclusions. However, we recommend that no reference is made to any specific option pricing model (such as Black-Scholes) or any specific kind of option pricing model (e.g. binomial model). Instead, we prefer the standard to refer to "the most relevant generally accepted option pricing model". Certain models such as Black-Scholes were developed for perfect markets and intended for traded options with a short life. Therefore, their application may result in some overstatement of value when measuring share options that are not readily marketable.

A prime concern of some respondents is how an option pricing model should be applied when no past performance information is available (e.g. for unlisted or start-up companies). The Board addresses such situations in its Basis for Conclusions (139,142,174-176) as well as in its Implementation Guidance. The current (primarily US) practice to set volatility at zero for unlisted or start-up companies is explicitly excluded by the Board, as explained in BC 76-78. For clarification purposes, we recommend the Board to include some of the guidance on the estimation of expected volatility in the standard.

Q12. If an option is non-transferable, the draft IFRS proposes that the expected life of an option rather than its contracted life should be used in applying an option pricing model (paragraph 21). The draft IFRS also proposes requirements for options that are subject to vesting conditions and therefore cannot be exercised during the vesting period (paragraph 22).

Do you agree that replacing an option's contracted life with its expected life when applying an option pricing model is an appropriate means of adjusting the option's fair value for the effects of non-transferability? If not, do you have an alternative suggestion? Is the proposed requirement for taking into account the inability to exercise an option during the vesting period appropriate?

Response

We agree that replacing an option's contracted life with its expected life is appropriate. However, we believe that the expected life may be highly subjective. For example, past experience of a large company in a bull market may be no guide for a newly listed company in a bear market.

Q13. If a grant of shares or options is conditional upon satisfying specified vesting conditions, the draft IFRS proposes that these conditions should be taken into account when an entity measures the fair value of the shares or options granted. In the case of options, vesting conditions should be taken into account either by incorporating them into the application of an option pricing model or by making an appropriate adjustment to the value produced by such a model (paragraph 24).

Do you agree that vesting conditions should be taken into account when estimating the fair value of options or shares granted? If not, why not? Do you have any suggestions for how vesting conditions should be taken into account when estimating the fair value of shares or options granted?

Response

We accept the Board's proposed method as described in paragraph 24 and illustrated in Appendix B – Example 2. However, the IASB's proposal differs significantly from the FASB's SFAS 123 method. Several commentators have expressed their strong desire to achieve global convergence on the measurement method. In this respect, we considered it useful to propose an alternative method which is a combination of the ED 2 and SFAS 123 method. This alternative, as illustrated in Appendix 4, differs from the ED 2 approach in that is does reflect the most recent expected outcome of the performance condition. So, similarly to the SFAS 123 approach, the element of variability in employee compensation is reflected in the expense recognised. We believe that such an approach better embraces the main objective of ED 2 which is the recognition of the actual services received, instead of the recognition of services expected to be received, as currently proposed by ED 2. As a result, only the fair value of the equity instrument granted, not taking into account any vesting conditions, is of relevance when measuring services received. Differently from SFAS 123, we propose not to have a catch-up (true-up) adjustment to ultimately reflect only the value of the instruments that vest. The reason is that we support the main objective of ED 2 which is recognition of the services received.

In general, we believe that the standard needs to be further developed to address the relationship between vesting conditions and service (period). For instance, the Board may wish to debate (i) whether a targeted share price is a proper reflection of management's performance and (ii) whether the achievement of a targeted share price can be reasonably estimated. The Board should also consider how an "event driven" vesting (e.g. when the entity goes public) should be accounted for and include its conclusions in the Implementation Guidance of the standard. We believe that any options granted in the expectation of an initial public offering should assume a volatility that reflects the move from unquoted to quoted status.

Q14. For options with a reload feature, the draft IFRS proposes that the reload feature should be taken into account, where practicable, when an entity measures the fair value of the options granted. However, if the reload feature is not taken into account in the measurement of the fair value of the options granted, then the reload option granted should be accounted for as a new option grant (paragraph 25).

Is this proposed requirement appropriate? If not, why not? Do you have an alternative proposal for dealing with options with reload features?

Response

We agree with the IASB proposal for the reasons given in the Basis for Conclusions. However, some commentators have raised questions on how reload features actually work. While we believe the definition of a reload feature in the Glossary is correct, we recommend the Board to illustrate in Appendix B how such features work and should be accounted for under ED 2. With regard to the definition of reload option, we wonder whether the words "granted for a share" are necessary?

Q15. The draft IFRS proposes requirements for taking into account various features common to employee share options, such as non-transferability, inability to exercise the option during the vesting period, and vesting conditions (paragraphs 21-25).

Are there other common features of employee share options for which the IFRS should specify requirements?

Response

We believe that the following features of employee share options affect the theoretical value of an option:

a) The dilution effect of the option when a large number of shares are involved;
b) Specific time buckets (e.g. during the four weeks following the quarterly earnings release) during which the options can be exercised.

However, minor adjustments can be made to the option value predicted by conventional option pricing models to adjust for the exercise restrictions in the same way as for vesting conditions.

Q16. The draft IFRS does not contain prescriptive guidance on the estimation of the fair value of options, consistently with the Board's objective of setting principles-based standards and to allow for future developments in valuation methodologies.

Do you agree with this approach? Are there specific aspects of valuing options for which such guidance should be given?

Response

We support the Board's approach not to prescribe in detail how the fair value of options should be estimated.

Q17. If an entity reprices a share option, or otherwise modifies the terms or conditions on which equity instruments were granted, the draft IFRS proposes that the entity should measure the incremental value granted upon repricing, and include that incremental value when measuring the services received. This means that the entity is required to recognise additional amounts for services received during the remainder of the vesting period, i.e. additional to the amounts recognised in respect of the original option grant. Example 3 in Appendix B illustrates this requirement. As shown in that example, the incremental value granted on repricing is treated as a new option grant, in addition to the original option grant. An alternative approach is also illustrated, whereby the two grants are averaged and spread over the remainder of the vesting period.

Do you agree that the incremental value granted should be taken into account when measuring the services received, resulting in the recognition of additional amounts in the *remainder of the vesting period? If not, how do you suggest repricing should be dealt with? Of the two methods illustrated in Example 3, which is more appropriate? Why?*

Response

We agree that if an entity reprices a share option, or otherwise modifies the terms or conditions on which equity instruments were granted, it should measure the incremental value granted upon repricing and include that incremental value when measuring the services received during the remainder of the vesting period. We believe that the alternative method illustrated in example 3 of Appendix B is the most appropriate method because under this method the total expense of the services received is better matched with the periods in which the service is actually received (i.e. year 3 and 4 in example 3). After all, the Board concluded (BC 60) that, when accounting for an equity-settled share based payment transaction, the primary accounting objective is to account for the goods or services received as consideration. This is better reflected by charging the same amount for each period from the date of the second grant to the vesting date of that grant. In addition, the alternative method reflects the fact that a repricing took place instead of assuming that the original option grant is still in place, as is done under the first method.

Further, we think that in example 3 of appendix B the calculation of the incremental value (page 41 bottom) should be modified to take into account the weighted average probability that the employees will complete the required service period, as it was done in example 1. It is our understanding that this is a drafting oversight.

Q18. If an entity cancels a share or option grant during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied), the draft IFRS proposes that the entity should continue to recognise the services rendered by the counterparty in the remainder of the vesting period, as if that grant had not been cancelled. The draft IFRS also proposes requirements for dealing with any payment made on cancellation and/or a grant of replacement options, and for the repurchase of vested equity instruments.

Are the proposed requirements appropriate? If not, please explain why not and provide details of your suggested alternative approach.

Response

We find the Board's approach as described under para 29 (a) (BC 220) too restrictive. For instance, in the case of business combinations, share options are sometimes cancelled and replaced by cash remuneration (increased monthly salary). If the entity were to be required to "continue to account for services rendered during the remainder of the vesting period, as if the grant had not been cancelled", we believe that such accounting would result in inappropriate financial reporting. We therefore recommend the Board to amend para 29 so that no future expensing is required for genuine cancellations. As a result, we suggest replacement of the second part of the first sentence of paragraph 29 (b) "except to the extent … " by "to the extent that the payment is not higher than (i) the fair value of the repurchased equity interest at repurchase date and (ii) the amount of the equity component previously recognised to account for the grant of the equity instrument". Consequently, "such" can be deleted in the second sentence of paragraph 29 (b). To clarify this requirement, we recommend the Board to illustrate this accounting requirement in an example in appendix B.

Based on our proposed amendments, a consequential change to paragraph 41 is needed. We therefore suggest replacing the second part of the first sentence of paragraph 41 by "that cash payment shall be considered as a repurchase of the equity instrument for the amount of equity previously recognised. Any excess shall be recognised as an expense." The remainder of paragraph 41 should then be deleted.

Q19. For cash-settled share-based payment transactions, the draft IFRS proposes that the entity should measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity should remeasure the fair value of the liability at each reporting date, with any changes in value recognised in the income statement.

Are the proposed requirements appropriate? If not, please provide details of your suggested alternative approach.

Response

We agree with the IASB proposal for the reasons given in the Basis for Conclusions.

Q20. For share-based payment transactions in which either the entity or the supplier of goods or services may choose whether the entity settles the transaction in cash or by issuing equity instruments, the draft IFRS proposes that the entity should account for the transaction, or the components of that transaction, as a cash-settled share-based payment transaction if the entity has incurred a liability to settle in cash, or as an equity-settled share-based payment transaction if no such liability has been incurred. The draft IFRS proposes various requirements to apply this principle.

Are the proposed requirements appropriate? If not, please provide details of your suggested alternative approach.

Response

We believe that the proposed requirement in paragraph 41 will result in double counting when the counterparty opts for full cash settlement while the entity had anticipated an equity-settlement. We refer to our proposed amendments included in our answer to question 18 in this respect.

Q21. The draft IFRS proposes that an entity should disclose information to enable users of financial statements to understand:

a. the nature and extent of share-based payment arrangements that existed during the period,

b. how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined, and

c. the effect of expenses arising from share-based payment transactions on the entity's profit or loss.

Are these disclosure requirements appropriate? If not, which disclosure requirements do you suggest should be added, deleted or amended (and how)?

Response

We support the disclosure principles set out in paras 45,47 and 51 but believe that the minimum disclosure requirements (labelled (i),(ii),(iii),… in paragraphs 46 and 48) are, with the exception of paragraph 48 (a) (i), burdensome for preparers. After all, the disclosures should support the understanding and interpretation of the amounts recognised and should not be considered as stand-alone information. Disclosure should concentrate on the factors to which estimated amounts are the most sensitive, particularly if they relate to an assumption that is essentially subjective, such as the expected volatility and expected life of an option. The proposed level of disclosure might also obscure the key messages to the users of financial statements. The object of disclosure should not be to enable users to check the calculations made by the entity.

The disclosure of concrete numbers of expected dividends (paragraph 48 (b) (iii)) rather than a general disclosure of the dividend policy is considered commercially/share price sensitive information while its weight in an option pricing model is limited. We therefore suggest the Board to consider requiring a description of the dividend policy that was applied to determine the input to the option pricing model.

Consequently, we recommend that the disclosure requirements labelled (i),(ii),(iii),… in paragraphs 46,48 and 52, with the exception of paragraph 48 (a) (i), be treated as illustrative rather than mandatory. They should therefore be included in Appendix D.

Q22. The draft IFRS proposes that an entity should apply the requirements of the IFRS to grants of equity instruments that were granted after the publication date of this Exposure Draft and had not vested at the effective date of the IFRS. It also proposes that an entity should apply retrospectively the requirements of the IFRS to liabilities existing at the effective date of the IFRS, except that the entity is not required to measure vested share appreciation rights (and similar liabilities) at fair value, but instead should measure such liabilities at their settlement amount (ie the amount that would have been paid on settlement of the liability had the counterparty demanded settlement at the date the liability is measured).

Are the proposed requirements appropriate? If not, please provide details of your suggestions for the IFRS's transitional provisions.

Response

Because of the grant date surrogate measurement (see also our answer to question 4 above) for certain equity-settled share-based payment transactions, any prospective application requirement has also a retrospective character. In general, we believe that an accounting standard shall

only be applied prospectively from the date it is issued. Therefore, we ask the Board to require only prospective application for share-based payment transactions entered into after the date the standard is issued with an option to apply the standard also prospectively for plans existing at the date of issuance of the standard.
We also believe that the reference to the publication date of the exposure draft (7 November 2002) in the transitional provisions and consequential amendments to IFRS [X] *First-time Application of International Financial Reporting Standards* can cause major problems for first-time adopters (e.g. when the transition date is January 1, 2010 the entity would have to go back more than 7 years).

Para 55 states that for liabilities arising from share-based payment transactions existing at the effective date of this (draft) IFRS, an entity is not required to measure vested share appreciation rights (and similar liabilities) at fair value. When we take into account the next sentence of para 55 we believe it is currently not clear enough whether preparers have a choice to apply the standard retrospectively or not. We believe it is the Board's intention to provide preparers with a choice (which we support in order to address any ramp up effect) and therefore suggest that the Board (i) adds the following words at the beginning of the last sentence in para 55: "If not dealt with retrospectively," and (ii) explicitly states that retrospective application is allowed.

Q23. The draft IFRS proposes a consequential amendment to IAS 12 (revised 2000) *Income Taxes* to add an example to that standard illustrating how to account for the tax effects of share-based payment transactions. As shown in that example, it is proposed that all tax effects of share-based payment transactions should be recognised in the income statement.

Are the proposed requirements appropriate?

Response

We are concerned that the IAS 12 *Income Taxes* definition of temporary differences scopes out the accounting for the timing effect of income taxes on expenses from equity-settled share-based payment transactions. We recommend the Board to consider this concern and to make the necessary amendments to IAS 12.

To answer the question how to account for the tax effects of share-based payment transactions we believe the question "what triggers the tax benefit" is critical. For instance, in certain tax jurisdictions, the tax benefit is triggered when the option is converted into a share. When such tax benefit is based on values different from the compensation expense/asset recognised, we believe that any difference with the initially recognised deferred tax should be considered as a directly attributable transaction gain/loss to the equity instrument issued, to be allocated directly to equity. We recommend the Board to include the above guidance in IAS 12 *Income taxes* and to amend the proposed example accordingly.

Q 24 In developing the Exposure Draft, the Board considered how various issues are dealt with under the US standard SFAS 123 *Accounting for Stock-Based Compensation*, as explained further in the Basis for Conclusions. Although the draft IFRS is similar to SFAS 123 in many respects, there are some differences. The main differences include the following:

a. Apart from transactions within the scope of another IFRS, the draft IFRS does not propose any exemptions, either from the requirement to apply the IFRS or from the requirement to measure share-based payment transactions at fair value. SFAS 123 contains the following exemptions, none of which are included in the draft IFRS:

- employee share purchase plans are excluded from SFAS 123, provided specified criteria are met, such as the discount given to employees is relatively small;
- SFAS 123 encourages, but does not require, entities to apply its fair value measurement method to recognise transactions with employees; entities are permitted to apply instead the intrinsic value measurement method in Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees* (paragraphs BC70-BC74 in the Basis for Conclusions give an explanation of intrinsic value); and
- unlisted (non-public) entities are permitted to apply the minimum value method when estimating the value of share options, which excludes from the valuation the effects of expected share price volatility (paragraphs BC75-BC78 in the Basis for Conclusions give an explanation of minimum value).

b. For transactions in which equity instruments are granted to employees, both SFAS 123 and the draft IFRS have a measurement method that is based on the fair value of those equity instruments at grant date. However:

- under SFAS 123, the estimate of the fair value of an equity instrument at grant date is not reduced for the possibility of forfeiture due to failure to satisfy the vesting conditions, whereas the draft IFRS proposes that the possibility of forfeiture should be taken into account in making such an estimate.

- under SFAS 123, the transaction is measured at the fair value of the equity instruments issued. Because equity instruments are not regarded as issued until any specified vesting conditions have been satisfied, the transaction amount is ultimately measured at the number of vested equity instruments multiplied by the fair value of those equity instruments at grant date. Hence, any amounts recognised for employee services received during the vesting period will be subsequently reversed if the equity instruments granted are forfeited. Under the draft IFRS, the transaction is measured at the deemed fair value of the employee services received. The fair value of the equity instruments granted is used as a surrogate measure, to determine the deemed fair value of each unit of employee service received. The transaction amount is ultimately measured at the number of units of service received during the vesting period multiplied by the deemed fair value per unit of service. Hence, any amounts recognised for employee services received are not subsequently reversed, even if the equity instruments granted are forfeited.

c. If, during the vesting period, an entity settles in cash a grant of equity instruments, under SFAS 123 those equity instruments are regarded as having immediately vested, and therefore the amount of compensation expense measured at grant date but not yet recognised is recognised immediately at the date of settlement. The draft IFRS does not require immediate recognition of an expense but instead proposes that the entity should continue to recognise the services received (and hence the resulting expense) over the remainder of the vesting period, as if that grant of equity instruments had not been cancelled.

d. SFAS 123 does not specify a measurement date for transactions with parties other than employees that are measured at the fair value of the equity instruments issued. Emerging Issues Task Force Issue 96-18 *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* requires the fair value of the equity instruments issued to be measured at the earlier of (i) the date a performance commitment is reached or (ii) the date performance is complete. This date might be later than grant date, for example, if there is no performance commitment at grant date. Under the draft IFRS, the fair value of the equity instruments granted is measured at grant date in all cases.

e. SFAS 123 requires liabilities for cash-settled share appreciation rights (SARs) to be measured using an intrinsic value measurement method. The draft IFRS proposes that such liabilities should be measured using a fair value measurement method, which includes the time value of the SARs, in the same way that options have time value (refer to paragraphs BC70-BC81 of the Basis for Conclusions for a discussion of intrinsic value, time value and fair value).

f. For a share-based payment transaction in which equity instruments are granted, SFAS 123 requires realised tax benefits to be credited direct to equity as additional paid-in capital, to the extent that those tax benefits exceed the tax benefits on the total amount of compensation expense recognised in respect of that grant of equity instruments. The draft IFRS, in a consequential amendment to IAS 12 (revised 2000) *Income Taxes*, proposes that all tax effects of share-based payment transactions should be recognised in profit or loss, as part of tax expense.

For each of the above differences, which treatment is the most appropriate? Why? If you regard neither treatment as appropriate, please provide details of your preferred treatment.

Response

We refer to our comments made in our answers to question 1 through 23 above.

Q25. Do you have any other comments on the Exposure Draft?

Response

1. *Examples in Appendix B*

We find the examples in Appendix B very helpful to understand how to apply the standard. However, no example is included for share-based payment transactions with cash alternatives, for which we consider the accounting method the most difficult. The Implementation Guidance, which is not part of the IFRS, does contain an example of how to estimate the fair value of a compound financial instrument issued under a share-based payment transaction. As the Implementation Guidance is not part of the standard, its publication in the different languages of the European Community will undergo a different process. We therefore strongly recommend the Board to include an example of a compound financial instrument, granted in a share-based payment transaction, in Appendix B of the standard.
It is unclear which accounting entries are required at the grant date, during the vesting period and when the options are exercised. We therefore ask the Board to include in Appendix B a simple but complete example showing the different accounting entries required at the different stages during the life of a share option grant.

2. Transfers of equity instruments to employees

When a shareholder transfers equity instruments to the employees, we disagree with the statement in BC 17 that "the entity has reacquired equity instruments for nil consideration". Instead, we believe that such a transaction should be recognised by the entity as income and valued at fair value (against equity).

Question 9: Illustration of proposed alternative method

Example:

- A grant of 10 share options, vesting after 3 years of service to 10 employees (so 100 options in total)
- Fair value option at grant date = CU 12
- Entity expects that 2 people will leave at the middle of the vesting period
- Ultimately, 50% of the options do not vest due to unusual high turnover of employees: 5 people leave at the middle of year three.

		Annual Expense
Year 1	(100 x CU 12) / 3 =	CU 400
Year 2	(100 x CU 12) / 3 =	CU 400
Year 3	(75 x CU 12) / 3 =	CU 300
		total: CU 1.100

Note : 75 in year 3 is determined as follows: a full year of service for 5 employees (5 x 10 = 50) plus a half year of services received from the 5 employees that left the entity (25 = (5 x 10)/2).

The alternative method differs from the ED 2 approach in that it does not use the unit of service method and does not require to "cast in stone" the expected forfeiture at grant date by incorporating it in the deemed fair value per unit of service.

For comparison reasons, we have illustrated below the ED 2 and SFAS 123 treatment of the above example:

ED 2

$$\frac{\text{10 employees x 10 options x CU 12 x 80\% (forfeiture)}}{\text{8 employees x 3 years + 2 employees 1,5 years}} = \textbf{CU 35,56}$$

		Annual Expense
Year 1	(CU 35,56 x 10) =	CU 356
Year 2	(CU 35,56 x 10) =	CU 356
Year 3	(CU 35,56 x 7,5) =	CU 267
		total: CU 979

- **SFAS 123 (first method)**

	Expense :	Cumulative	- Annual
Year 1	(80 x CU 12) x 1/3 =	CU 320	CU 320
Year 2	(80 x CU 12) x 2/3 =	CU 640	CU 320
Year 3	(50 x CU 12) x 3/3 =	CU 600	(CU 400)
		total:	CU 600

- **SFAS 123 (second method)**

	Expense :	Cumulative	- Annual
Year 1	(100 x CU 12) x 1/3 =	CU 400	CU 400
Year 2	(100 x CU 12) x 2/3 =	CU 800	CU 400
Year 3	(50 x CU 12) x 3/3 =	CU 600	(CU 200)
		total:	CU 600

Question 13: Illustration of proposed alternative method

Assume a company has an option plan under which the number of options ultimately awarded depends on the cumulative increase in pretax income over a 3 year period as follows:

Increase in pretax income over the 3 year period from the date of grant	Number of options earned
More than 45%	3,000
More than 30%, but no more than 45%	2,000
More than 15%, but no more than 30%	1,000
15% or less	0

The fair value of the option at the date of grant, determined using an option pricing model, is CU 5. The options vest 100% at the end of 3 years. On the date of grant, the company's best estimate of its increase in pretax income over the 3 year period is 16%. Therefore, the company estimates that in total 1,000 options will be earned and vested (no service forfeitures are anticipated-that is, all 10 employees to whom the award has been granted are expected to remain employed in the 3 year period. After the 3 years it turns out that all 10 employees are still with the company). Both under SFAS 123 and ED 2 the (initial) estimate of compensation expense to be recognized over the vesting period of the options is CU 5,000 (1,000 options x CU 5).

Assume that at the end of Year 2 the company estimated that pretax income would increase by only 8%, and consequently no options would be earned. In this case, under SFAS 123 a credit to income would be recognized to adjust cumulative compensation expense for the reduced number of options expected to be earned. Under ED 2, the compensation expense recognised does not change.

Over the 3 years, the following will occur:

<u>SFAS 123 method</u>:

	Cumulative expense	Annual expense
Year 1	(1.000 x CU 5) x 1/3 = CU 1.667	CU 1.667
Year 2	(0 x CU 5) x 2/3 = CU 0	(CU 1.667)
Year 3	(0 x CU 5) x 2/3 = CU 0	CU 0

<u>ED 2 method:</u>

Deemed fair value per unit of employee service:

$$\frac{1.000 \text{ x CU } 5 \text{ x } 1 \text{ (forfeiture effect)}}{10 \text{ employees x } 3 \text{ years}} = \frac{\text{CU } 5.000}{30} = \textbf{CU 166,67}$$

		Annual expense
Year 1	CU 166.67 x 10	CU 1.667
Year 2	CU 166.67 x 10	CU 1.667
Year 3	CU 166.67 x 10	CU 1.667

The main difference in the compensation expense recognised under the two standards is that compensation cost under the proposed IFRS is not changed to reflect the actual outcome of the performance award.

Proposed alternative EFRAG:

		Annual expense
Year 1	(1.000 x CU 5) / 3	CU 1.667
Year 2	(0 x CU 5) / 3	CU 0
Year 3	(0 x CU 5) / 3	CU 0

Our proposed alternative does reflect the most recent expected outcome of the performance condition without reversing previously recognised compensation expense.