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UNITEC
INSTITUTE of TECHNOLOGY
Te Kura Puukenga o Wairaka

Michael E. Bradbury PhD, FCA, CMA
Professor
Accountancy, Law and Finance
UNITEC Institute of Technology
Private Bag 92025, Auckland, New Zealand
Tel: (649) 849 4180 ext 8083
Fax: (649) 815 2904
Email: mbradbury2@unitec.ac.nz

The Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6 XH
United Kingdom

Dear Sir David

ED – 2 Share-based payments

Attached is my response to the Exposure Draft 2 *Share-based Payments*

I support the IASB in providing guidance on this topic. In particular I support the need to recognise share-based payments to employees as an expense.

My response is divided into 3 parts. In Part A I outline my response to the invitation to Comment Questions. Part B provides additional comments in relation to the invitation to comment. Part C includes some editorial suggestions.

Sincerely

Michael Bradbury
March 7, 2003

Comments on ED-2
Section A: Invitation to Comment Questions

Responses to Invitation to Comment Questions

Question	Subject
1	**Scope and exemptions (para 1-3)** I agree that there are to be no exemptions, apart from transactions within the scope of other IFRS.
2, 4	**Recognition (para 2 –6)** See comments in Section B.
3, 5, 6, 7	**Measurement** See comments in Section B.
8	**Assumptions regarding receipt of service in relation to vesting period (para 13-14)** It seems a natural assumption that the services are received over the vesting period.
9	**Unit of service approach** See comments in Section B.
10	**No subsequent adjustment of amounts recognised in equity (para 16)** See comments in Section B.
11	**Equity instrument valuation** I agree that an (unspecified) option pricing model should be applied to obtain the fair value of options. I concur with the guidance given in the proposed IFRS.
12	**Valuation – transferability (para 21 and 22)** I agree with the proposals in para 21 and 22.
13	**Valuation – vesting conditions (para 24)** I agree with the proposals in para 24.
14	**Valuation – reload feature (para 25)** I agree with the proposals in para 25.
15	**Valuation – other features** I have no suggestions.
16	**Non-specification of option model** I concur with the approach taken.

Question	Subject
17	**Subsequent modification of grant conditions (para 26 to 28)** I agree with the proposed approach that treats the repricing as a new option grant. I disagree with the alternative (averaging) treatment.
18	**Treatment of cancellation (para 29)** I disagree with the proposals in para 29. that an entity continues to account for a cancelled grant until the end of the original investing period. To continue reporting a transaction that has been cancelled cannot be "representationally faithful". We do not allow firms to continue depreciating an asset on the original schedule when the asset is no longer in service. It is reasonable to assume that in the event a grant has been cancelled there is no longer any value to either party. Any negotiated method of replacement compensation ought to be accounted for at fair value as a new transaction.
19	**Cash-settled share based payments (para 31-34)** I agree with the principles in paras 31 to 34..
20	**Compound share-based payment transactions (para 35)** I agree with the principle in para 35.
21	**Disclosures (para. 25-53)** I generally agree with the disclosures.
22	**Transitional Provisions (para 54 –55)** No comment.
23	**Tax considerations** No comment.
24	**Comparisons to SFAS 123** In all but two cases I consider the proposed IFRS is better than SFAS 123: (1) If during the vesting period the entity settles in cash then I consider the equity instruments should be regarded as immediately vested (as per SFAS 123). My reasoning is provided under question 18 above. (2) I consider both SFAS 123 and the proposed IFRS are incorrect in the treatment in question 24 (b) second bullet. I think equity is issued at grant (c.f. SFAS 123) and can be adjusted for subsequent re-estimation of the number of equity instruments over the vesting period (c.f., ED-2). See Section B and the example in Appendix A.

Comments on ED-2
Section B: Additional Comments

Question 2 and 4: Date of Recognition (para 4 to 6)

ED-2 paragraph 4 focuses recognition on the asset/expense side of the transaction. This is further reinforced by BC60 which states that the primary accounting objective is to account for the goods and services received as consideration. This is somewhat of a simplistic statement as both debit and credit sides of each transaction need to be determined simultaneously. Specifying that the focus be on the debit side is arbitrary, simplistic and unnecessarily restrictive. It is not clear to me why equal emphasis cannot be given to the act of issuing an equity instrument as the basis for recognition.[1]

Furthermore, the focus should be the date of recognition not the particular side of the transaction. The date of recognition should be the same, regardless of which side of the transaction is recognised or more readily fair valued.

Furthermore, the second sentence in paragraph 4 implies that a cash-settled share-based payment must always result in a reduction of a liability (i.e., it implies that a liability must be created before it is settled). However, if management pay a voluntary bonus based on share price, the entry would be DR expense CR cash. No liability is recorded.

I therefore disagree with paragraph 4 and the underlying logic contained in the basis for conclusions BC58-BC63 and BC85-BC90. I first address the logic and then recommend a solution.

The logic of BC58-63 is as follows. BC58 is indisputably correct (i.e., it is a mathematical equality). This leads to BC60 concluding that an equity-settled share-based payment transaction should be accounted for in the same way as other issues of equity by recognising the consideration received (the change in net assets) and a corresponding increase in equity. It follows (BC61) that the change in net assets arises when the goods and services are received.

However, this conclusion is very restrictive as it precludes the possibility of an equity-claim being issued, the effect of which is solely within equity (i.e., shares issued for expenses where no change in net assets is involved).

Just because equity is a residual from a balance sheet equation perspective – it does not mean that an equity instrument is a residual in terms of accounting for (i.e., recognising) a transaction. From a Hicksian view (on which the *Framework* is based) it is the income component of equity that is the residual.

The problem is that BC 58 provides only the balance sheet form of the double entry equation. A more realistic approach would be to incorporate the income statement (written in debit=credit form):

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[1] I believe the focus should be on both sides of the transaction, but if I had to decide on which side came first the chicken or the egg, I think I would vote for the credit. In the absence of a contract the entity cannot be forced to issue equity. Hence, it might easily be argued that the decision to issue equity should be the focal point of recognition, at least for an equity-settled share based transaction.

Assets = Liabilities + [Income + (net) Contributions]

This now provides a platform where an increase in contributions (i.e., the issue of an equity instrument) can lead to or arise from (1) a decrease in income (i.e., an expense), (2) an increase in assets or (3) a decrease in liabilities.

A solution
The recognition of a financial instrument arises when the entity becomes a party to the contractual provisions of the instrument (IAS 39.27). An equity instrument issued under a share-based payment transaction is a financial instrument. This suggests that the equity instrument (under an equity-settled SBPT) or liability (under a cash-settled SBPT) should be recognised at grant date (i.e., the date at which the contractual terms are agreed). By not using a similar recognition criterion to IAS 39, ED-2 allows the possibility that the holder and the issuer of an equity instrument might recognise the same transaction at different points in time.

I recommend that paragraphs 4 and 5 are written:

> **4. The entity shall recognise the equity instrument it has issued when it becomes a party to the contractual provisions of an equity-settled share-based payment transaction. Similarly, the entity shall recognise a liability when it becomes a party to the contractual provisions of a cash-settled share-based payment transaction. The entity becomes a party to the contractual provisions of share-based payment transaction at grant date.**
>
> **5. When the goods and services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognised as expenses.**

Paragraph 5 is not strictly necessary, however, it does provide a useful reminder to preparers. Similarly, I am not sure that it is necessary, but paragraph 4 could also state:

> **In recognising the equity instrument it has issued the entity shall record a corresponding asset, expense or reduction in liability.**

<u>Question 3: Measurement (para7, 8)</u>
I agree that fair value should be the basis of measurement. While, in a perfect capital market, it should not matter which side of the transaction is fair valued practical considerations will mean that one side will be preferred. However, the basis should not be "…whichever fair value is more readily determinable" but rather "whichever fair value is more reliably determined." This emphasises the quality of measurement rather than the ease of measurement.

In the *Framework* (paragraph 38), reliability is must be complete within the bounds of materiality and cost. Hence, ease of measurement is already factored into the notion of reliability.

Furthermore, consistent with the above comments on recognition, the date of measurement should be grant date regardless of which side of the transaction is fair valued. It is at grant date when both parties come to an agreement of the share-based payment transaction, at this date the transaction should be measured. Different recognition dates should not be allowed just because different sides of the transaction are used to measure fair value.

The terms “either directly” and “or indirectly” should be eliminated from paragraph 7. How does “directly determine” differ from “readily determine”? Any difference is likely to be very subtle and beyond most readers of accounting standards. Paragraph 7 seems to be implying that measuring goods and services is the most direct and determinable method. However, the standard could also be written in terms that equity was to be directly fair valued as the consideration given or indirectly measured as the consideration received. Any view on what is direct and indirect is somewhat arbitrary?

I recommend that paragraph7 is written:

> **7. For equity-settled share-based payment transactions, the entity shall measure the fair value of the equity instruments granted or the fair value of the goods and services received whichever fair value can be more reliably determined.**

Note that there is no need to mention grant date as this is covered in paragraphs 4 and 5 (see above revision). Also my preference is to state the “measurement of equity” before “goods and services” because in New Zealand companies the directors have a legal responsibility to issue equity at “fair cash value”. There may well be other jurisdictions that have legal requirements with regard to issuing equity because it is an important step in protecting shareholders. A hierarchy similar to financial instruments could be included in grey letter explanation. That is, the first stop should be the market price of equity (if the firm is traded in an active market) and thereafter look at valuing shares or the consideration received whichever is more reliable.

I disagree with paragraph 9 (and even more so that it is a rebuttable presumption). In this particular issue it is not clear to me that trying to estimate the fair value of a third party’s goods and services is more reliable than estimating the fair value of your own shares where there is a deep and active equity market. Furthermore, in my opinion rebuttable presumptions should be used with caution. They become a *de facto* rule rather than require preparers to make an appropriate decision. Paragraph 7 (in bold type) requires the preparer to make a decision. In principle, a grey letter (paragraph 9) should clarify black letter, not amend it by making a rebuttable presumption.

Question 10: No subsequent adjustment of equity

There are two possible types of equity adjustments. The first is to adjust equity for current estimates of the *number* of equity instruments it expects to issue. The second is the adjustment for the change *in value* of the equity instruments.

Clearly the latter changes in equity should not be adjusted. Equity should not be remeasured for subsequent changes *in value*, because there has been no change in the entity’s net assets. At grant date the fair value per unit of equity issued was established by way of an exchange transaction and any subsequent changes in value accrue to the employee as an equity holder.

However, I see no reason why the estimate of the number equity instruments to be issued (such as a forward contract to issue options where the actual number of options will depend on vesting conditions) cannot and should not be adjusted at subsequent reporting date when better estimates of the likely forward transaction are known.

For example assume the entity has entered into a forward contract to issue its own options, subject to some vesting conditions. On initial recognition the entity records a credit to equity of $1,000 because it expects (say 3 years in the future) to issue 100 options each with a fair value of $10. At the next balance date it now estimates that it will issue 110 options (in 2 years) and the current fair value of the options is now $15.

I would require the entity to recognise an increase of $100 in equity being to correct the estimate of the additional 10 options at the original fair value of $10. I would not allow any adjustment for change in fair value.

Question 9: Unit of Service Approach

The unit of service approach as described in paragraph 15 is too prescriptive. Other approaches would be possible (e.g., based on units of production). Paragraph 15 would be better placed in Appendix B to provide guidance of a possible method of allocation. Paragraph 14 probably should be black letter stating the principle that the goods and services related a share-based payment transaction should be amortised over the vesting period in the manner that best reflects the use of those services.

I disagree with the last sentence in paragraph 14, which states that equity gradually increases corresponding to the recognition of service cost. The equity instrument is issued at grant date, even thought the future number of options and shares must be estimated.

Question 9 of the Invitation to Comment asks what alternative method (to units of service) do you propose?" In Appendix A I include a numerical example, based on the example in Appendix B of ED-2.

At the end of year 0 the entity grants 500 employees 100 options at a current fair value of 15cu per option. Each grant is conditional upon the employee working for the entity over the next three years. The entity's best estimate is that 20 percent of the employees will leave over the next three years and will therefore forfeit their rights to the options. It expects that future forfeitures will be spread evenly over the three year vesting period.

At year 0, the entity records the equity instrument at is expected fair value of 600,000CU (500*80%*100*15cu).

At the end of year 1 actual departures are 23 (lower than the estimated 33). On this basis the entity now estimates that it expects the total forfeitures to be 14%. It therefore re-estimates the options to be issued at 659,100 (500*86%*100*15cu) and records the appropriate adjustment. Note this does not involve adjusting equity for changes in value.

The process of re-estimating the number options and adjusting equity is repeated in years 2 and 3. At year 3, this results in equity equalling the actual number of options that vest.

The deferred compensation/expense side of the share-based payment (the initial estimate and any estimation adjustments) is amortised evenly over the three year vesting period.

Comments on ED-2
Section C: Editorial Suggestions

Title

This standard is concerned with **equity-based payments.** It includes other forms of equity instruments, not just shares. The title of the standard should reflect the wide scope of standard.

Definitions

The definitions employed could be improved:

1. *Equity instruments*. While I agree with this definition, as it is consistent with IAS 32, it is not clear to me whether this definition of equity interest includes preference shares or financial instruments on shares (such as forwards and options). I think that it should cover both of these and that this should be clarified in grey letter.

I note that some clarification for equity instruments is found in other definitions! For example, from the definition cash-settled share-based payment transaction we learn that it applies to "… the entity's shares or other equity instruments". This would seem to admit the possibility of preference shares as being "other equity instruments". Also, the definition of equity-settled share based payment transaction we find that equity instrument includes "shares or share options". Hence derivatives would appear to be equity instruments.

Suggestion

That expansion of what is to be understood by equity instrument is contained within that definition and deleted from other definitions. For example,

An **equity instrument** is:

> *A contract that evidences a residual interest in the equity of an entity. The most common form of equity instrument is a share in an entity. For the purposes of this standard, equity instrument also includes conditional and unconditional claims (e.g., share options and forward contracts) on shares.*

2. The distinction between *cash-settled* and *equity-settled* share-based payment transactions is not immediately obvious. In the cash-settled SBPT the entity "acquires" goods and services. In the equity-settled SBPT the entity "receives" goods and services. Is there a subtle difference between "receive" and "acquire"? The cash-settled definition focuses on "incurring a liability" rather than "paying cash". A liability may or may not arise in such a transaction but cash will always be (and was intended to be) paid to satisfy the receipt of goods or liability.

Suggestion

A **cash-settled share-based payment transaction** is:

> *A cash payment by an entity for receipt of goods and services or a reduction in liability, the amount of which is based on the price (or value) of the entity's equity instruments.*

An **equity-settled share based payment transaction** is:

A share-based payment transaction in which the entity issues its own equity instruments as consideration for receipt of goods and services or a reduction in liability.

Appendix A/1

	year 0				
	Value of equity instrument issued (conditional forward contract) at grant date assuming full payout				
	Employees	Options	FV (in CU)*		
	500	100	15		750000
Expected forfeiture					
y1	-33			-6.6%	-49500
yr2	-34			-6.8%	-51000
yr3	-33			-6.6%	-49500
	400	Expected issue of options		80.0%	600000
	year 1				
	Employees	Options	FV (in CU)*		
	500	100	15		600000
Actual forfeiture					
yr 1	-23				
	477			-4.6%	715500
Expected forfeiture					
yr2	-24			-4.8%	-28800
yr3	-23			-4.6%	-27600
	430	Expected issue of options		86.0%	659100

year 0			
DR	Deferred compensation	600000	
CR	Equity		600000
year 1			
DR	Deferred compensation	59100	
CR	Equity		59100
Re-estimation of equity to be issued			
Current estimate		659100	
Carrying amount		600000	
Change in equity		59100	

Appendix A/2

year 2					
	Employees	Options	FV (in CU)*		
	500	100	15		600000
Actual forfeiture					
yr 1	-23			-4.6%	
yr 2	-30			-6.0%	
	447				670500
Expected forfeiture					
yr 3	-30			-6.0%	-36000
	417	Expected issue of options		83.4%	634500

year 2			
DR	Equity	24600	
CR	Deferred compensation		24600
Re-estimation of equity to be issued			
Current estimate		634500	
Carrying amount		659100	
Change in equity		-24600	

year 3					
	Employees	Options	FV (in CU)*		
	500	100	15		600000
Actual forfeiture					
yr 1	-23			-4.6%	
yr 2	-30			-6.0%	
yr 3	-25			-5.0%	
	422	Actual issue of options			633000

year 3			
DR	Equity	1500	
CR	Deferred compensation		1500
Re-estimation of equity to be issued			
Current estimate		633000	
Carrying amount		634500	
Change in equity		-1500	

Deferred compensation				**Expense**	
Initial estimate	year 0	600000			
Estimate revision - year 1	year 1	59100			
		659100			
Amortise to income	1/3	-219700		year 1	219700
Carrying amount	year 1	439400			
Estimate revision - year 2	year 2	-24600			
		414800			
Amortise to income	1/2	-207400		year 2	207400
Carrying amount	year 2	207400			
Estimate revision - year 3	year 3	-1500			
		205900			
Amortise to income	1/1	-205900		year 2	205900
Carrying amount	year 3	0			633000