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National Office

CL 106

International Accounting Standards Board
30 Cannon Street
London
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United Kingdom

For the attention of Kimberley Crook

7 March 2003

Dear Sirs

ED 2 – SHARE-BASED PAYMENT

Grant Thornton welcomes the opportunity to comment on the proposals set out in ED 2. In this letter, we set out the comments of our international organisation.

We support the general principles set out in the Exposure Draft. We believe it is paramount that the IASB deliver a share-based payment standard that reports an expense for such transactions. We recommend that the IASB issues an IFRS so that experience of charging for share-based payment can be gained in territories where it does not currently exist.

We believe that global convergence in accounting for share-based payments is essential and we urge the Board to work closely with FASB in the USA to achieve this. However, we believe that it is essential that an IFRS is in place by 2005, when the EU Regulation comes into force, and global convergence should not impede this.

We question whether it will be practicable to determine the numerical information required with sufficient reliability, especially for unquoted or recently quoted entities. We favour the use of a grant date basis of measurement for all equity-settled share-based payments, including those where the value of goods or services is measured directly. We believe that the costs of awards to employees should be recognised over the period in which the employees render the relevant services, which may not coincide with the vesting period. We propose that the transitional requirements be reconsidered and that, in particular, full retrospective application should be permitted where the relevant information is available.

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We respond in detail to the questions raised in the ED in the appendix. If you would like us to amplify our comments, please contact Robert Carroll on +44 (0)870 991 2210.

Yours faithfully

Grant Thornton

Grant Thornton is a leading financial and business adviser to smaller quoted companies and their owners. Our international organisation provides a comprehensive range of business advisory services in 110 countries bringing together 22,000 personnel in 585 offices worldwide. Although not a global partnership, Grant Thornton firms share a commitment to common standards and methodologies and provide the same high quality service to their clients wherever they choose to do business.

RESPONSES TO SPECIFIC QUESTIONS

Question 1: 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?

We support the basic principle that there should be no exclusions other than those indicated in the draft. However, we suggest that the Board reconsiders the boundary between the proposed IFRS and IAS 19 'Employee Benefits'. Where an entity operates an employee share ownership plan that meets the definition of a defined contribution plan in IAS 19.7, we recommend that the Board clarifies that IAS 19 should be applied. For IAS 19 to apply, the employer entity would need to have no risk beyond the contributions it makes into the plan. Our reason for putting forward this proposal is that we see no distinction in substance between the employer's risks and benefits under such a plan and any other defined contribution plan.

We note that some commentators favour including exemptions along the lines of those in US standard SFAS 123 for employee share plans where the discount given is small and other specific conditions are met. However, we believe that this would represent a rules-driven approach that would be inconsistent with the general principles on which the proposed standard is based. In our view, it would also be impracticable to define exemptions that would be workable internationally without creating potential for abuse.

Question 2: 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?

We agree with the proposed recognition requirements. The IASB may consider it helpful to revise the definition of an expense in the Framework to ensure consistency with its proposals in the Exposure Draft.

Question 3: 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?

We agree in principle, though we foresee practical difficulties in arriving at a fair value for awards to employees in unquoted and recently quoted entities. Particular difficulties are likely to arise in estimating volatility and the expected level of forfeitures due to employees not completing the required period of service or not meeting other conditions. In our view, the potential difficulties in obtaining a valuation could seriously undermine the reliability of the information provided. In that regard, we request the final standard provide some guidance to assist those companies in the determination of those particular factors.

In BC139, the IASB indicates that a privately-held company that determines fair value based on net assets or earnings should estimate the volatility of whichever one is used. It is not clear to us how a company would estimate the volatility of net assets or earnings. It would be helpful if the Board were to provide more clarity on how this should be done. In addition, the Board comments that a company with an "internal market" may have a sufficient basis for estimating its volatility. In our view, even companies that make a number of equity issuances will be unlikely to have enough information to create a statistically valid measure.

Question 4: 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?

The proposed approach results in two different measurement dates, according to whether the goods or services or the equity instruments are measured. In our view, it would be better to measure all equity-settled transactions at grant date, otherwise there may be an element of remeasurement between grant and delivery, which goes against the principle referred to elsewhere in the ED that equity is not remeasured. Grant date measurement would be consistent with that for employee awards, where the value of the equity instruments is measured, and is the conclusion the Board arrives at in paragraph BC104 of the Basis for Conclusions. Grant date is the date on which the bargain is struck.

Question 5: 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?

We agree with this proposal. However, we believe the Board should consider again whether grant date measurement is the most appropriate answer in all circumstances, such as those seen during the "dot-com" boom in the USA where equity arrangements were the primary (and, in some cases, the sole) means of compensating service providers (including employees) and declines in the fair value of those equity instruments had an adverse impact on the service provider's decision to continue providing services. While we agree a service provider will not provide twice as much service to the grantor when the fair value of the equity instruments doubles, there may be some arrangements where services are withheld if the fair value of those instruments declines in which case a grant date measurement may not be the best measure of the fair value of goods or services to be received. We are not suggesting that the Board should attempt to develop a standard on accounting for behaviour generally, because employees may view awards in a significantly different manner from employers.

Question 6: 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?

Although the fair value of the goods or services may be more readily determinable, in our view, this may not be so in many cases, as indicated by the following examples.

If unique legal or consultancy services are provided to a listed company, the fair value of equity instruments may well be determinable more reliably than the value of the services. In the venture capital sector, advisers are sometimes granted options exercisable on listing or acquisition, where it may be at least as difficult to value the services provided as it is to value the options. A broadcasting company may have standard rates for advertising but, in practice, these prices are often subject to negotiation. Unless similar advertising is sold for cash regularly, it may not be practicable to determine a reliable fair value for the services provided, whereas a fair value for equity instruments issued in exchange may be readily determinable from market information.

In summary, in our view, in the vast majority of non-employee share-based payment transactions, the fair value of the equity instrument granted will be more readily determinable than that of the goods and services provided.

Of more importance, however, in a principles-based standard, is the understanding that the key requirement here is expressed in paragraph 7, in the phrase, "whichever fair value is more readily determinable". The rebuttable presumption in paragraphs 9 and 10 are thus of little moment, and should be expressed in that vein. As a related issue, we recommend deleting the disclosure required by paragraph 50, particularly in view of the detailed disclosures required elsewhere of how fair value was determined.

Question 7: 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 not so?

We agree that this will be so in the vast majority of cases. Where an employee is offered equity instruments or a cash alternative, the value of which is not share-based, it might be argued that the alternative provides a readily determinable fair value for the equity option. However, in our view, the mere fact that such an offer is made does not necessarily indicate that the fair values of the alternatives are equal, especially where significantly more employees choose one option than choose the other. The IASB may wish to consider revising its proposals to include a rebuttable presumption that the approach set out will provide the more reliable measure of fair value, except where it is clear that the fair value can be determined directly, for example by reference to alternatives where they are clearly intended to be of equal value.

Please note also our response to Question 6 concerning the primacy of the phrase, "whichever is more readily determinable".

Question 8: 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?

Yes, in most cases. However, there may be situations where an award is made largely in recognition of past performance, but with some vesting conditions attached, such as the requirement to complete a further period of service. We believe that this may create potential for abuse. If a company grants options that vest immediately on the basis of past performance, there will be an immediate charge to the profit and loss account under the current proposals. However, by including a 'token' (or tax-related) vesting condition, this charge will be spread forward over the vesting period.

Another situation in which an award may be subject to a vesting condition requiring a further period of service, but which nevertheless relates to past performance, is where annual awards are tied to a pre-determined formula (such as one linked to net income) or to a specific event (such as the sale of a division). These awards relate to service in the period covered by the formula or in which the event occurred and should therefore be recognised in that period, otherwise the charge relating to one year's performance will go into subsequent years' results, even if performance in those later years did not merit an award.

We therefore suggest that the IASB consider whether the standard should include a requirement for immediate expense recognition where it is clear that the award relates to a past period, although we acknowledge that such a requirement may present practical difficulties where only part of an award relates to past performance.

We also recommend that the IASB consider adopting a form of words similar to that contained in the UK ASB's UITF 17 'Employee Share Schemes' (paragraphs 11 and 14). This requires an award to be charged over the period to which the performance criteria relate. Where a further period of continued employment is required before the participants become unconditionally entitled to the shares, the period over which the cost is recognised should not normally include that period, unless it is clear that the effect of the award is to reward services over the longer period.

It may be that the Board intended the words "during the vesting period" in paragraph 14 to be interpreted as "within the vesting period" rather than "over the vesting period". Such an interpretation would enable the cost of awards to be charged appropriately to the substance of how and when they were earned, and would deal with the examples above. If so, the IFRS should indicate more clearly the potential for cost allocation.

Some awards have vesting conditions (of performance and continuing employment) and also a delay period before the option is exercisable, with no requirement for continued employment during this period. It would be helpful if the definition of vesting period made clear whether it included such delay periods, since they are neither service nor performance conditions.

Question 9: 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?

We 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 will be necessary to determine the amount to attribute to each unit of service received. We also 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, subject to our comments in response to question 8 above regarding the use of the performance period rather than the vesting period.

Question 10: 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?

In the context of the definitions in existing IFRS, including the Framework, we agree that the Board's proposals on this point are the logical result of the Board's conclusion that an equity instrument has been issued at grant date.

As equity is not remeasured, we agree that there should be no credit to the income statement to reverse amounts already expensed in the event that an equity-settled award does not vest or options are not exercised. If such a credit to the income statement were to be made, it would run the risk that it would cause that year's results not to be presented fairly, as they would incorporate a credit not attributable to the release of an obligation nor a negative amount of services provided.

We note that the Board's proposals give rise to several awkward consequences, including an inconsistency of expense charged in cash-settled schemes compared with equivalent equity-settled schemes, and different approaches to scheme cancellation consequences. We know that there are deeply held differences of opinion on these matters, and we observe that other conceptual frameworks take a different view of when an equity instrument comes into existence.

In our view it is paramount that the IASB deliver a share-based payment standard that reports an expense for such transactions. We therefore recommend that the IASB issues an IFRS that takes the current approach of an equity instrument issued at grant date, so that experience of charging for share-based payment can be gained in territories where it does not currently exist. It may then be necessary to revisit some issues at a later date when more fundamental and wide-ranging issues regarding equity and debt have been addressed.

Question 11: 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?

In principle, we agree that an option pricing model should be applied to estimate the fair value of options granted. However, in countries with no history of valuing such options for accounting purposes, we foresee significant practical difficulties in arriving at a sufficiently reliable measure of fair value, given the potential subjectivity of the assumptions that will need to be made. As noted in our response to question 3, this may be a problem for unquoted or recently quoted companies in particular, as they are unlikely to have sufficient data to make reliable estimates of the inputs required into a valuation model, such as volatility or expected dividends, and also forfeiture.

We believe it is likely that new option pricing models will evolve, which are intended more specifically for employee share options. Hence, it is important that the standard does not preclude the application of such models, provided that they meet the standard's objectives.

We recommend that the IASB expand the material in the Implementation Guidance to the standard to include more practical illustrations of the application of option pricing models to employee share options, in particular for unquoted companies. In particular, we believe that more specific and practical guidance on how to estimate expected volatility is essential as inaccurate or ill-founded estimates may distort significantly the values obtained by applying a model.

Question 12: 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?

We support these proposals in principle for the reasons set out in the Basis for Conclusions. However, in our view, making adjustments to allow for the special characteristics of employee options may also be subjective and difficult to build into established models (such as Black-Schöles) even for quoted entities. We suggest that the Board consider adding more illustrative material to the implementation guidance on this issue.

Question 13: 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?

In principle, we agree that vesting conditions should be taken into account. However, we foresee practical difficulties in making sufficiently reliable estimates of forfeiture rates, especially for smaller quoted entities, which may not have sophisticated information systems. An entity may need to segment its employee population in order to estimate forfeiture rates because option grants are not normally distributed evenly (for example, different rates may be needed for directors, senior management and other employees, who may also need to be sub-segmented).

In our response to question 11, we recommended that more practical guidance be provided on applying option valuation models. Similarly, we believe that additional implementation guidance should be provided on dealing with forfeiture.

We are also concerned that the approach to taking into account possible forfeiture illustrated in Appendix B Example 2 may be over simplistic and inconsistent with the fundamental principles of option pricing theory. We therefore suggest that the Board clarifies the meaning of "the weighted average probability that the specified performance target will be achieved". In particular, we suggest that the Board clarifies that the weighting should take account of the value of the option under each possible performance outcome. We suggest the IFRS does not refer to "making an appropriate adjustment" without elaboration, because this suggests the use of a single multiplier.

Question 14: 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?

We support this proposal.

Question 15: 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?

We are not aware of any other common features.

Question 16: 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?

We concur with the approach.

Question 17: 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, ie 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?

We agree that the incremental value granted should be taken into account when measuring the services received. We favour the alternative approach (averaging). We consider that this gives a better reflection of what has occurred than assuming that the original option continues with the addition of a separate incremental award, ie a repricing and extension of the period over which the employee will be required to provide services in order to earn the award. We believe that one approach should be standardised upon and the other eliminated in the final standard.

Question 18: 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.

In our view, it appears odd that when an employee leaves, the charge stops, but when an award is cancelled but the employee remains, the charge continues even though there is no possibility in either case that a benefit will be obtained by the employee. In both cases, the agreement between the employee and the entity that gave rise to the accounting will have come to an end. We consider that there should be no further recognition of an expense in either case subsequent to the date on which an employee leaves or an award is cancelled.

We believe the model reflected in SFAS 123 in the USA provides a more representationally faithful method of accounting for settlements of unvested awards. Recognising previously unrecognised expense when an unvested award is reacquired gives accounting recognition to the fact that the service provider is no longer required to provide services to be entitled to the economic benefits of the award. Continuing to recognise expense after the unvested award has been repurchased could result in an anomalous result if the service provider were to cease providing services. Under the proposed IFRS, the issuer would no longer recognise expense for the fair value of the "services" it will no longer receive. However, the service provider has already realised the value of the unvested award through the settlement. That treatment results in accounting for the settlement of an unvested option in the same manner as a settlement of a vested award.

We support the proposed requirements for dealing with payments made on cancellation, a grant of replacement options, and for the repurchase of vested equity instruments.

Question 19: 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.

We support these proposed requirements for the reasons set out in the Basis for Conclusions.

Question 20: 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.

We support these proposed requirements for the reasons set out in the Basis for Conclusions.

Question 21: 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)?

We support the proposed disclosures, except for the following points. The disclosures proposed in paragraph 46(a) of the proposed IFRS may lead to information overload if the disclosures need to be given in full for each scheme, of which entities may have several. We suggest that the standard should allow for aggregation of disclosures for similar types of award. In addition, we do not see the relevance to users of financial statements of the proposal in paragraph 52(b). We believe that this information may confuse or mislead readers, as the entity will not have entered into a equity-settled arrangement in this case, and it is unusual to require disclosure of the effect of transactions not entered into. In addition, as stated in our response to question 6, we recommend deleting the disclosure required by paragraph 50, particularly in view of the detailed disclosures required elsewhere of how fair value was determined.

We believe that relevant disclosures could also include:

- splitting the expense recognised between equity-settled and cash-settled arrangements;
- a reconciliation of the liability for cash-settled arrangements, showing increases and decreases in fair value, forfeitures, cash payments and settlements and new awards.

We observe that the disclosure requirements are extensive and may be regarded as overly prescriptive. However, we foresee problems with the potential alternative approach of setting out broad principles and indicative disclosures, as this may create a tendency for under-disclosure or selective disclosure. Although we are in favour of principle-based standards rather than a rulebook approach, disclosure is one area where clear, unambiguous requirements are essential to minimise the chances of problems arising. Our view is influenced by our previous experience of difficulties caused by standards that have set out principles and indicative disclosures, notably IAS 32 'Financial Instruments: Disclosure and Presentation'.

We suggest that the Board reconsiders the illustrative disclosures in Appendix D, to see whether more use can be made of a tabular approach, as we believe that this will improve the presentation.

Question 22: 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.

We do not see why the Board has proposed different transitional requirements for equity-settled and cash-settled awards and we therefore propose that the transitional provisions be aligned.

As a general principle on changing the provisions of, or implementing, a standard, full retrospective application should be the option of preference, if practicable. We cannot see why full retrospective application should necessarily be prohibited in this case, especially where the information is likely to be readily available through past compliance with standards in other jurisdictions, such as SFAS 123 in the USA. This seems inconsistent with the proposals on first-time application, where full retrospective application is proposed as an option.

As a matter of principle, we dislike the proposed practice of relating the application date of an IFRS to the date of publication of an Exposure Draft. Quite apart from the issue of the impact of any changes between draft and final standards, the practice smacks of government announcements to curb tax avoidance schemes. We strongly suggest that the Board steers clear of any such styles of expression.

Question 23: 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?

We are not convinced that the tax effects of all share-based payment transactions should be recognised in the income statement.

Paragraph 61 of IAS 12 states that "Current and deferred tax should be charged or credited directly to equity if the tax relates to items that are credited or charged, in the same or a different period, directly to equity." Where a tax deduction arises only if (or when) the holder exercises the option and the proceeds from exercising are credited to capital, it would seem that the benefit relates in part to a capital transaction and in part to a compensatory arrangement, and the allocation of the benefit should reflect that. A distinction may also be drawn between a benefit that arises only if a capital transaction occurs and one that arises solely from the granting of an award. The Board discussed this in BC304 and concluded they were troubled treating the tax benefit that may be received solely by granting an award (when the tax benefit is determined at the time of grant) differently from the tax benefit that may only be received if the employee exercises the award. It is not clear why this should be a problem as the transactions are economically distinct. In the former, the entity is entitled to the deduction whether the employee stays or leaves, exercises or forfeits. In the latter, no benefit is received until the capital transaction piece of the arrangement is completed. To account for economically dissimilar transactions in the same way is misleading to investors.

As to the discussion in BC303 that the government is not an owner of the entity, neither is the investment banker that takes the entity public, but fees paid to the banker are treated as a reduction in the proceeds from the transaction. Providing for a credit to equity when the benefit depends on exercise of the equity instrument is not stretching the principle in paragraph 61 of IAS 12.

Question 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.

We support the approach set out in the Exposure Draft in each case, except in relation to points (c) and (f). Please refer to our responses to questions 18 and 23 respectively for our views on these points. Regarding point (d), we also draw attention to our answer to question 4 above where we state a preference for grant date measurement for equity-settled payments in all cases, including those to non-employees where the value of goods or services is measured directly.

Question 25: Do you have any other comments on the Exposure Draft?

We recommend that the IASB work closely with FASB to achieve international convergence on this issue as it is essential that entities subject to IFRS are not seen to be placed at a disadvantage compared to those following US GAAP, or vice versa. However, we believe that it is essential that an IFRS is in place by 2005, when the EU Regulation comes into force, and global convergence should not impede this.

As we stated in our response to question 10, in our view it is paramount that the IASB deliver a share-based payment standard that reports an expense for such transactions. We therefore recommend that the IASB issues an IFRS so that experience of charging for share-based payment can be gained in territories where it does not currently exist. Meanwhile, the fundamental issues of the definitions of equity and liabilities can be deliberated, with adequate attention paid to consequences outside the share-based payment arena.