CL 26

ED 2 SHARE –BASED PAYMENTS

Institute of Chartered Accountants of Zimbabwe

QUESTION 1

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

RESPONSE

We agree that the proposed scope is appropriate.

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 and services received and acquired are consumed.
Are these recognition requirements appropriate? If not, why not, or in which circumstances are the recognition requirements inappropriate?

RESPONSE

The recognition requirements may not be appropriate for the following reasons:-

a. The cost borne by the shareholders is recognised in the dilution of earnings per share; if the transaction is recognised in the entity's accounts, the resulting charge to the income statement would mean that EPS is 'hit twice'.
b. Requiring the recognition of a charge may have adverse economic consequences, because it may discourage entities from introducing or continuing employee share plans.

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 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

Fair value, which is the amount at which an equity instrument granted could be exchanged between knowledgeable, willing parties in an arm's length transaction, captures both intrinsic and time value and therefore provides a measure of the value of the equity instrument granted.

QUESTION 4

If the fair value of 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 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

Yes, we agree that service date measurement most suitably measures the fair value of an equity instrument at the same time as the services are received. However there is unlikely to be a high correlation between the fair value of services received and the fair value of equity instruments granted at later measurement dates. At grant date, however, it is reasonable to presume that the fair value of both sides of the contract are the same, thus grant date is deemed to be the most appropriate measurement date for the purpose of providing a surrogate measurement of the fair value of the services received.

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?

RESPONSE

Yes, we believe that the grant date is the most appropriate date at which to measure the transaction, as it is when the parties to the transaction become entitled to the fruits of the transaction. However if employees are required to complete a specified service period to become entitled to the shares it should be assumed that the services are received during the vesting period.

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 more readily determinable than the fair value of the equity instruments granted? In what circumstances is this not so?

RESPONSE

Yes.

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 is not so?

RESPONSE

Yes.

QUESTION 8

Paragraphs 13 and 14 of the draft IFRS propose requirements for determining when the couterparty 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

Yes.

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?

RESPONSE

Yes we agree with the approach whereby the fair value of the shares or options granted, measured at grant date and allowing for all vesting conditions, is divided by the number of units of service expected to be received to determine the deemed fair value of each unit of services subsequently received.
Other treatments may require the use of intrinsic value and minimum value a measurement basis as opposed to fair value.

An alternative approach would be to divide the fair value of the shares/options granted by the maximum number of units of service that <u>could be received</u> during 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 (paragraph16). 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 that the lapsing of an option does not represent a gain to the entity and has no effect on the entity's financial position. One type of equity interest, namely the option holder's interest, thus becomes part of another type of equity interest-the shareholders interest The only accounting entry that may be required is a movement within equity, to reflect that the options are no longer outstanding.

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 dividend 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

Yes we agree, although for unlisted and newly listed entities there are difficulties in determining the current market price of a share and its expected volatility . In these circumstances, it might be more appropriate to use the minimum value method which excludes the effects of expected volatility, even though this method produces a value that is lower than those produced by methods to estimate the fair value of an option.
In some circumstances an unlisted entity may employ another methodology to value its shares, namely to value its shares on the basis of net asset values or earnings, in which case it could use the expected volatility of those net asset values or earnings as a basis for estimating share price volatility.

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 (paragraph22).

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 inappropriate?

RESPONSE

Yes, we believe that it is appropriate, although the holder maybe able to mitigate the effects of non-transferability through the use of derivatives. No, we agree that the grant date valuation should be reduced to allow for the possibility of forfeiture due to failure to satisfy the vesting conditions.

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?

RESPONSE

We agree that the valuation of rights to options or share granted to employees or other parties should take into account all types of vesting conditions. The grant date valuation should be reduced to allow for the possibility of forfeiture due to failure to satisfy vesting conditions. The approach would be to estimate the possibility of forfeiture at grant date and reduce the value produced by an option pricing model accordingly.

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?

RESPONSE

Yes, however, if significant uncertainties exist, such as the number and timing of expected grants of reload options, it might not be practicable to include the reload feature in the grant date valuation. However if an entity did apply a different method to fair valuing at grant date, it would have to explain its departure from the standard.

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?

RESPONSE

No, they are effectively covered.

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 guidance should be given.

RESPONSE

Although the IFRS does not contain prescriptive guidance, the Board has considered such issues as recognition and reliability of measurement and the differences in valuation between employee options and traded options. It has also drawn conclusions and adjustments that should be made to the inputs to option pricing models, or to the values produced by these models to allow for these differences.
We agree that this is sufficient. However, in our opinion, we do not have the sophistication and resources to apply valuation methods stated rather than following a 'reliable method' as stated In IAS 39.

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 on 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 re-pricing 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 the more, appropriate? Why?

RESPONSE

We agree that through the repricing of an option the entity will receive additional or enhanced employee services equivalent in value to the incremental value of the repriced options. This incremental value given should be recognised as a remuneration expense. Although in the example indicated both methods give the same result, we agree that the first method is more appropriate as it reflects the full impact of the repriced option, rather than its result being diluted through averaging the two grants and recognising the averaged amount over the last two years.

QUESTION 18

If an entity cancels a share or option grant during the vesting period (other than a grant cancelled by –7-
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 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

The two treatments discussed in the basis of conclusions are to either continue to recognise the services received over the remainder of the original vesting period or to immediately recognise an expense for the amount of compensation expense that would otherwise have been realised during the remainder of the original vesting period. The latter is difficult to apply given that there is not a specific amount of unrecognised compensation expense in that the amount recognised in the future depends on the number of units of service received in the future.

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.

RESPONSE

What form settlement takes place will depend on whether the employee has choice of settlement or the entity has choice of settlement. However we agree that the liabilities in respect of cash-settled share based payment transactions should be remeasured to its fair value at each reporting date until its date of settlement.

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.

RESPONSE

We agree that the entity first needs to determine whether it has an obligation to settle in cash. The entity will have an obligation to settle in cash if the choice of settlement in equity is not a substantive one, or if the entity has a past practice or a stated policy of settling in cash.

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) ?

RESPONSE

We agree that these disclosures are appropriate.

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 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

We consider these transitional provisions appropriate.

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?

RESPONSE

Although it might be appropriate to debit/credit to equity the tax effect of the difference between the amount of the tax deduction and the total recognised expense where the difference relates to changes in the value of equity interests, normally the tax effects of share-based payment transactions should be recognised in the income statement by being taken into account in the determination of tax expense.
Under certain tax regimes, it might be treated as a permanent difference, which might cause a conflict with other standards like 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 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).

RESPONSE

- If one is going to accept that an exemption is appropriate specifying its scope would be problematic. Further more if the rights given to employees do not have a significant value, this suggests that the amounts involved are immaterial. As it is not necessary to include immaterial information in the financial statements, there is no need for a specific inclusion.
- By applying the intrinsic value, the practice set out in APB 25 results in an expense for performance related options, but usually no expense for fixed options. Such a result is anomalous as fixed options are usually more valuable at grant date than performance related options.
- Using minimum value does not capture the effects of volatility. Option holders benefit from the effects of volatility `because the have the right to participate in gains from increases in the share price during the option term without having to bear the full risk of loss from decreases in the share price.

  By ignoring the effects of volatility, the minimum value method produces a value which is often much lower than the values produced by methods designed to estimate the fair value of an option.

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 this equity instruments at grant date. However:

- Under SFAS 123,the estimate of the faire value of an equity instrument at grant date is not reduced for the possibility of forfeiture due to failure to satisfy 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

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.

RESPONSE

- We agree that the possibility of forfeiture should be taken into account as it exists at grant date. Thus expectations of forfeiture due to employee departures are taken into account when estimating the fair value of options granted as well as expected employee departures when determining the fair value of services to be received in return.

- We do not support the SFAS 123 approach as the valuation rights to options or shares granted to employees (or other parties) should take into account all types of vesting conditions, including both service conditions and performance conditions. In other words, the grant date valuation should be reduced to allow for the possibility of forfeiture due to failure to satisfy the vest*ing conditions.*

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.

RESPONSE

Although the approach adopted by SFAS 123 seems appropriate, it is difficult to apply in the context of the proposed accounting method in the draft IFRS, given that there is not a specific amount of unrecognized compensation expense, namely that the amount recognized in the future depends on the number of units of service received in the future.

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 1.) the date a performance commitment is reached or 2.) 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.

RESPONSE

It has been concluded that this is not a desirable outcome, and that the same measurement basis and date applied in the context of share-based payment transactions with employees should also be applied in transactions with other parties.

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 by 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 BC70-81 of the Basis for Conclusions for a discussion

of intrinsic value, time value and fair value).

RESPONSE

Measuring SARs at intrinsic value would be inconsistent with the measurement basis proposed in the rest of the draft IFRS. Also intrinsic value measurement basis does not include time value and thus is not an adequate measure of either the SAR liability or the cost of services consumed.

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 and loss, as part of tax expense.

RESPONSE

- We agree that in the case of employee share options the tax benefit relates to employee remuneration expense, an income statement item, and therefore the tax effects of the benefit should be recognised in the income statement.

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.

QUESTION 25

Do you have any other comments on the Exposure Draft?

RESPONSE

Has the Board noted any consequences in respect of IAS 29.