Deutsches Rechnungslegungs Standards Committee e. V.
German Accounting Standards Committee e. V.
® Der Standardisierungsrat

CL 67

DRSC • Charlottenstr. 59 • 10117 Berlin

Telefon +49 30 206412-12
Telefax +49 30 206412-15
E-Mail info@drsc.de

Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street

London EC4M 6XH
United Kingdom

Berlin, 7. März 2003

Dear Sir David

Exposure Draft ED 2 – Share-based Payment

This letter is in response to the request for comment on the International Accounting Standards Board (IASB) Exposure Draft ED 2 *Share-based Payment.* We appreciate the opportunity to comment on this proposal.

In general, we are in strong agreement with the IASB´s fundamental approach

- to recognise share-based payment transactions as an expense when the goods or services received are consumed, and
- to measure the transactions at fair value.

We also support the board's view, that with respect to transactions with employees, the fair value is determined at grant date. Thus, we fully support that the underlying assumption of the IASB´s approach is focused on the services received.

E-GAS 11 and the proposed ED 2 have many similarities and hence no further comments are considered to be necessary with regard to these issues. In some respect, ED 2 proposes regulations that represent a further development of the approach set out in E-GAS 11, e.g. specification of a method by which the entity should determine the amount to attribute to each unit of service received. Those developments will be implemented in E-GAS 11 for re-exposure on the grounds for further convergence.

ED 2, however, also contains proposals on which we do not fully agree.

The following comments are focused on the latter issues and are therefore intended to suggest ways to improve implementation of ED 2 rather than to express disagreement with the basic model for accounting for share-based payment transactions that is proposed in ED 2.

Yours sincerely,

Dr. Frank Trömel
Vice President

Executive summary of GASB's comments on ED 2 Share-based Payment:

1. Date of measurement for directly measured transactions (Question 4):

We disagree with the proposal that service date is the date to determine the fair value of directly measured share-based payment transactions. We are of the opinion that this approach creates an inconsistency compared with the grant date measurement of share based payment transactions measured indirectly. We therefore recommend grant date as the appropriate date for measurement of fair value.

2. Mandatory application of the indirect method to determine fair value for transactions with employees (Question 7)

We generally agree that in most cases the fair value of employee services received is more readily determinable by reference to the fair value of the equity instrument granted. However, there are employee services, for which the fair value might be more readily determinable by direct measurement. Therefore we propose to the board to permit direct measurement for transactions with employees if the entity is able to refer to an active market for these services.

3. "Service period" and "vesting period" (Question 8)

We support the board's view, that the services rendered by the employee or a third party are received during any specified period of service that has to be completed before the equity instruments vest. However, we believe that it is misleading and in some cases wrong to assume that this period is the "vesting period". In our view there should be a strict distinction between service conditions and vesting conditions. Thus, the term "service period" should be used rather than "vesting period" when referring to the period that is solely determined by service conditions.

4. Reload features (Question 14)

We are unconvinced that the proposed requirements for reload features, set out in paragraph 25, are appropriate to provide users with sufficient information. We are particularly concerned regarding reload features in conjunction with service units related to the combined grant. Therefore we propose to the board to require that reload options be accounted for as a new option grant.

5. Cancellation of a grant of share options (Question 18)

We disagree with the proposed requirement to account for services rendered by the counterparty during the remainder vesting period after cancellation and do not support the proposal to treat the payment as a repurchase of an equity interest. We are of the opinion, that the termination should already be considered as a repurchase of options whereas any additional payment should be expensed immediately.

6. Tax effect of share-based payment transactions (Question 23)

We support the proposal to recognise all tax effects in the income statement rather than in equity. We are concerned however, that the proposed regulation is neither comprehensive nor sufficient to deal with the fact that tax treatments of share-based payment transactions may differ between national jurisdictions. We therefore propose to the board to set out a general principle on how the tax effect shall be measured and define the underlying assumption for the existence of deferred taxation in this respect in IAS 12 *Income Taxes*.

7. No subsequent adjustment

For the avoidance of doubt we emphasise that we fully support the board´s view that no subsequent adjustment to total equity shall be accounted for. However, we would like to bring to your attention that in a public forum held by the GASB some people raised concerns as to whether the prohibition of subsequent adjustments fully reflects economic reality.
Therefore, we encourage the board to enhance the Basis for conclusions in this respect.

B. Comments on ED 2 Share-based Payment

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?

Yes, the proposed scope of the standard 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 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?

Yes, the recognition requirements for share-based payment transactions are appropriate.

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?

Yes, the proposed measurement principle is appropriate.

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?

No, we do not agree that the fair value of transactions measured directly should be determined at the date when goods or services are received. In our view, this proposal generates an inconsistency as goods or services are measured at either the date they are received or at the date the equity instruments are granted, depending on whether the fair value of the goods or services or the fair value of the equity instruments is more readily determinable. Furthermore, services rendered by third parties and services rendered by employees may be measured at different dates although there is no apparent reason for such a differentiation.
We therefore propose to the Board to consider grant date as the measurement date for share-based payment transactions independently of whether the fair value is measured indirectly or directly.

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?

Yes, we agree that grant date is the appropriate measurement date for equity instruments granted in a share-based payment transaction.

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?

Yes, we agree that the fair value of goods or services received other than employee services is usually more readily determinable than the fair value of the equity instruments granted. This presumption, however, may not be applicable if goods or services received are highly specialised and no market prices exist for comparable goods or services.

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?

Yes, we agree that the fair value of equity instruments granted is generally more readily determinable than the fair value of employee services received. However, we are concerned that the current proposal is too restrictive and contradicts the principle stated in par. 7 ("whichever fair value is more readily determinable"). We therefore propose to permit entities to measure the fair value of the employee services received directly if the entity is able to refer to an active market for these services.

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?

In principle, we agree that it is a reasonable assumption that the services rendered by the counterparty in a share-based payment transaction are received during any specified period of service that has to be completed before the employee becomes unconditionally entitled to the equity instruments granted. However, we suggest using the term "service period" rather than "vesting period" when referring to the period of service that has to be completed before the employee becomes unconditionally entitled to the equity instruments granted (e.g. par 15 (a)). Thus, in our view the service period is solely determined with respect to service conditions but not by any other vesting conditions such as performance targets that have to be met before share options vest.
Furthermore, we are concerned that the service period cannot be unambiguously defined in all cases because service conditions and performance conditions may be interdependent. For example assume that an entity grants share options that may vest after two years if (1) the employee remains in the entity's service and (2) a

specific performance target is met. If the performance target is not met during the first two years, however, the service period is automatically prolonged for another year, giving extra time to meet the performance target. Only if the performance target is not met within the additional year, the grant is forfeited and remains unvested.
We wonder how the expected number of service units should be determined in this case according to the method proposed in the exposure draft. It may be based either on the two-year-period, the three-year-period or an expected service period taking into account the probability of meeting the performance target within the first two years. Also, from our understanding of par. 14, if the performance target is not met during the first two years it seems necessary to account for the services received during the third year independently of how the expected number of service units was determined at grant date. Depending on how the latter was done, the overall value attached to the services received may differ significantly.

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?

Yes, we agree that it is necessary to determine an amount to attribute to each unit of service received. We also agree that this amount should be determined by dividing the fair value of the equity instruments granted by the number of units of services expected to be received during any specified period of service that the counterparty has to complete before the equity instruments vest. However, this period should be referred to as the “service period” and not the “vesting period” (see question 8). Compared to the alternative approach suggested by GASB in its comment on the G4+1 discussion paper, i.e. to divide the fair value of the equity instruments (determined without taking service conditions into account) by the maximum number of service units to be possibly received, we consider the IASB’s approach a consequential enhancement that more clearly reflects the economic substance of the transaction.

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, i.e. 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?

Yes, we agree that no subsequent adjustments to the amounts recognised in equity for services received should be made due to changes in the value of the options (including the options becoming valueless and not being exercised) or because vesting requirements are not fulfilled.

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?

Yes, we agree that an option pricing model should be applied to estimate the fair value of options granted.

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?

Yes, we 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 and that the proposed requirement for taking into account the inability to exercise an option during the vesting period is appropriate.

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?

Yes, we agree that vesting conditions should be taken into account when estimating the fair value of options or shares granted and that all conditions shall be applied consistently in accordance with the requirements of the Framework. It may therefore be appropriate to emphasise on the importance of consistency in ED 2. However, we do not think there should be any prescriptive guidance on how to include vesting conditions in the estimation of fair value (see also Q 16).

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 are unconvinced concerning the appropriateness of the requirements proposed for the treatment of options with reload features. Particularly, we are concerned how service requirements related to reload options should be taken into account when estimating the value of service units related to the combined grant. In our view it may be more appropriate to generally require reload options granted to be accounted for as a new option grant.

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?

In order to prevent employees from using insider information when exercising share options, many companies restrict share option exercises to relatively short time periods (e.g. four to six weeks after quarterly earnings announcements). Such requirements may potentially reduce the fair value of share options and thus should be taken into account if applicable.

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?

Yes, we agree with the Board's approach not to include prescriptive guidance on the estimation of the fair value of share options.

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?

Yes, we agree that for repriced or otherwise modified share options the incremental value granted should be taken into account when measuring the services received. Of the two methods proposed we consider the alternative method illustrated in example 3, Appendix B to be more appropriate, because with this method a repricing is dealt with as a new option grant and therefore reflects the economic substance of the transaction more clearly. Furthermore we would like to emphasise, that according to the German corporate governance codex stock options granted to the management board should not be repriced. .

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.

We consider only some of the requirements proposed in paragraph 29 to be appropriate:

We agree that if an entity cancels a grant of share options and replaces it by a similar option grant of higher value, this is in substance identical to a modification of an existing award. Therefore we agree that such transactions should be accounted for as if an existing award had been modified, i.e. in accordance with paragraph 28. However, some guidance under which circumstances a grant of share options should be considered a grant of replacement options would be necessary.

We do not agree with the provisions for cancellations of share option plans, neither with a cash payment nor without any additional payment. In these cases the substance of the transaction is similar to the case that an employee leaves the entity and thereby forfeits his options. Speaking in a non-technical sense, in both cases the employee hands back his options and at the same time is free of any service requirements.

In the case that the employee decides to leave the entity and thereby forfeits his options, no further expense from the original grant should be recorded for the remainder of the service period (because no further units of service are received by the entity). In substance, the entity loses a resource (e.g. intellectual capital which in fact cannot be capitalised, however should be considered as booked theoretically against equity) that is returned to the employee in turn for the option that is returned to the entity. If the entity decides to cancel a share option plan, the employee may stay in the entity's employ. This decision is, however, completely independent of the cancelled option grant if there are no further service conditions. Thus in substance the entity again loses an unrecorded intangible asset while it regains the options held by the employee. The impairment of the unrecorded intangible asset is the price the entity pays for the options that it deprives the employee of.

In our view a consistent way to account for such a transaction is to treat it identically. This implies that no further expense related to the original grant should be recorded after the cancellation independently of whether the employee remains in the entity's employ or not. If, however, the entity makes any payment to the employee this should be recorded as an expense as additional value is transferred to the employee. For this purpose the fair value of the share options at the date of the cancellation should not be counted against the payment, as this would mean double-counting the entity's part of the transaction (impairment of the unrecorded intangible asset plus the cash payment).

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.

Yes, the requirements proposed for the treatment of cash-settled share-based payment transactions are appropriate.

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.

Yes, we agree with the proposed approach.

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)?

Yes, we consider the disclosure requirements proposed in the draft standard to be 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 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.

Yes, we agree with the proposed transitional requirements. However, the following issue has been raised.
Assume an entity has granted share options prior to the publication date of this exposure draft (which we assume is 7 Nov 2002) and therefore is not required to recognise the plan in its financial statements. If the entity modifies the plan subsequently, i.e. after 7 Nov 2002, we wonder whether the entity should only recognise the modification or also the underlying plan. We therefore propose to the board to clarify this.

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 agree that all tax effects of share-based payment transactions should be recognised in the income statement.
We are concerned, however, that problems may arise with regard to the approach as illustrated in Appendix E example 5:

The example illustrates only one specific case of possible tax treatments. As taxation of share-based payments differs between jurisdictions, it may well be that the example does not give sufficient guidance for users as it is not principle based.

Secondly, we are of the opinion, that it is not sufficient to only add an example into IAS 12. We strongly suggest inserting a new paragraph in IAS 12 explaining the principles that make share-based payment transactions subject to deferred taxation.

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.

(Respondents may wish to note that further details of the differences between the draft IFRS and SFAS 123 are given in the FASB's Invitation to Comment.)

We agree with the proposed treatments in ED 2 to the extent set out in our answers to questions 1 through 23. We acknowledge that in several instances our agreement with the proposed treatment in ED 2 implies disagreement with the treatment required in SFAS 123 and other FASB statements related to share-based payments. In other instances, however, neither treatment is supported.

Question 25

Do you have any other comments on the Exposure Draft?

We have the following additional comments on the Exposure Draft:

1. Share option grants that vest in instalments

In paragraph B3 of Appendix B the treatment of share option grants that vest in instalments is outlined. ED 2 requires that each instalment should be dealt with as a separate option grant.

This treatment implicitly assumes that the combined option grant consisting of all instalments requires the employee to render N times (with N being the number of instalments) the number of service units in the first year as in the last year. This is due to the fact that in the first year compensation expenses from all N plans are recorded while in subsequent years compensation expenses are only recorded for the instalments that remain unvested.

In our view, this implicit assumption may not in all cases reflect the economic substance of share options grants that vest in instalments. When treating all

instalments as one combined agreement between the entity and the employee, it may be argued that the number of service units rendered by the employee is identical in each year. If this is actually the case, the treatment proposed would implicitly assume that the service units in the first year are valued significantly higher than the service units in the last year covered by the combined grant consisting of all instalments.
A different treatment that may be considered by the Board is to determine the fair value of the combined grant and divide this value by the number of service units expected to be received during the entire time (i.e. the service period of the last instalment). This would lead to an evenly spread compensation expense over the entire service period of the stock option grant.

2. Changing vesting conditions when an employee leaves the entity

We wonder how the following transaction should be accounted for under ED 2.
An employee holding unvested share options is leaving the entity at the end of the first year of a two-year service period, thereby forfeiting the options. However, as part of a severance agreement vesting conditions are changed so that the employee may keep his share options without rendering any further services.
As the entity does not receive services upon the dismissal no further compensation expenses should be recognised in the second year. However, the entity clearly transfers extra value to the employee by changing the vesting condition. In fact the options would otherwise be valueless and therefore the additional value transferred is equal to the fair value of the options at the time the employee leaves the entity. In our view this should lead to the recognition of an additional expense at the end of the first year. We are unsure, however, if this view complies with the requirements of ED 2.

3. Separating compensation and other expenses

Under the requirements of ED 2 changes in value of shares or share options are not accounted for in the financial statements while any changes in value of phantom shares or share appreciation rights lead to a profit or loss for the entity. Because these latter changes in value are recognised as additional compensation expense or reversals of compensation expense, the use of equity-settled and cash-settled share-based payment transactions may lead to different levels of compensation expense. To avoid these discrepancies we suggest that the expenses due to cash-settled share-based payment transactions are separated in compensation expenses and other expenses. The compensation expense should be accounted for in accordance with the rules set out for equity-settled share-based payment transactions. Any additional profit or loss due to changes in value of phantom shares or share appreciation rights should be recorded as other expenses.

4. Terms and Conditions of share-based payment arrangements

We understand that the current exposure draft is silent about exchanges of share-based payment transactions or changes to their terms in conjunction with business combinations, spinoffs, squeeze out or other equity restructurings. We therefore propose to the board to consider the need of a clarification regarding the treatment of such changes.