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Direct dial	:	Tel.: (+31) 20 301 0391 / Fax: (+31) 20 301 0279
Date	:	Amsterdam, 3 March 2003
Re	:	Exposure Draft 2 Share-based Payment

Dear Sirs,

The Netherlands Council for Annual Reporting (CAR) appreciates the opportunity to respond to your questions raised in the *"Exposure Draft 2 Share-based Payment"* (further referred to as ED 2).

The CAR also supports the objective to recognise an expense when goods or (employee)services received or acquired under a share-based payment transaction are consumed. In addition to the questions raised, we would like to comment on some other issues which we would like to bring to your attention.

We refer to our comments in the attached document, where we have provided responses to the questions raised by you in ED 2.

In addition to our responses on the questions asked, we would like to make the following comments.

Level playing field
We are of the opinion that a worldwide level playing field for the ED 2-proposals of the IASB is necessary, in order to avoid significant differences between IFRS-based results and US GAAP-based results. Such level playing field is not applicable as long as it is not required to expense the fair value of granted share based payments to employees in the profit and loss account under US GAAP.
The IASB and the FASB have started its Convergence Project, however, Accounting for Share based Payment has not been scheduled for discussion. We strongly support that this is to be put on the agenda, where the IASB should promote the concepts of ED 2. We consider that the timing of the implementation of ED 2 should be in line with any amended accounting treatment under US GAAP based on ED 2.

Framework
When reviewing ED 2, we identified that definitions and principles in the Framework are not always appropriate or applicable in this proposed Standard. We stipulate that the Framework should be updated to properly cover all relevant principles required to apply in the existing and future Standards.

Q1. Paragraphs 1-3 of the draft IFRS set out the proposed scope of the IFRS. There are no proposed exemptions, apart from for transactions within the scope of another IFRS.

Is the proposed scope appropriate? If not, which transactions should be excluded and why?

Response

Yes, we agree with the IASB proposal.

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

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

Response

Yes, we agree with the IASB proposal. However, the definition of an expense in the Framework should be clarified based on reference to IASB pronouncements. We refer to our general comment on the update of the Framework.

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

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

Response

Yes, we agree with the IASB proposal.

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

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

Response

No, we do not agree with the IASB proposal. The grant date should be the only date when the measurement takes place, since this is the date when both parties can identify the economic substance of the transaction concluded.

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

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

Response

Yes, we agree with the IASB proposal.

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

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

Response

Yes, we agree with the IASB proposal.

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

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

Response

No, we do not agree with the IASB proposal.

The requirement for transactions with employees "to measure the fair value of the employee services received by reference to the fair value of the equity instruments granted" is <u>too restrictive</u>.
We recommend to modify para 11 and 12 such that they propose a rebuttable presumption that, for equity settled transactions with employees, the fair value of the equity instruments granted is more readily determinable than the fair value of the employee services received.

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

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

Response

No, we do not agree with the IASB proposal. We consider the allocation of cost over the performance period more appropriate. However, such allocation over the pre- and vesting period should only be applied if the employee service can be allocated reliably to past and future periods. We expect this only applicable in rare circumstances. If such allocation of cost cannot be determined reliably, the IASB method should be applied.
Therefore, we propose to include a rebuttable assumption that the allocation of cost is based on the vesting period, unless the employee services can be allocated and measured reliably otherwise.

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

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

Response

No, we do not agree with the IASB proposal.
We do agree that the amount to attribute to each unit should be calculated, however without taking into account the expected rate of employees leaving. We consider that such variable should be included in the fair value of the option granted itself. Accordingly, a much more simple model will be applicable.

Under the principles as applied, it has the following advantages:

- The calculation is less biased by a subjective element as the expected leave rate;
- The calculation can be applied for one employee as well (eg. the CEO responsible for the compilation of the financial statements);
- Our proposal focuses on the P&L charge since the starting point of ED 2 is the P&L charge in respect of the consumption of employee services rather than the recognition and measurement of the instrument;
- No truing up is required; we do not support a truing up principle as this results in reversing previous P&L charges for employees having left the entity in subsequent years. Once the services of employees have been consumed, these charges should not be reversed, as is proposed via the truing up principle.

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

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

Response

Yes, we agree with the IASB proposal

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

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

Response

Yes, we agree with the IASB proposal. However, we question whether the use of an option pricing model is possible where no past performance is available (e.g. unlisted companies or start-up companies). (See also Question 24)

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

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

Response

Yes, we agree with the IASB proposal. We consider that more guidance might be given on the determination of the 'expected life'.

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

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

Response

Yes, we do agree with the IASB proposal that vesting conditions should be taken into account. Whether this is included within the option pricing model itself or separately adjusted should not matter, as long as the assumptions are properly disclosed. Since we excluded the expected leave rate in Question 9, we propose to include such leave rate as part of the vesting conditions in calculating the fair value of the option granted.

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

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

Response

The concept and definition of a 'reload feature' and the proposed workings of such feature are not clear. This should be explained clearer.

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

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

Response

No, we have not identified any other features for which the IFRS should specify requirements.

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

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

Response

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

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

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

Response

Yes, we agree that if an entity reprices a share option, or otherwise modifies the terms or conditions on which equity instruments were granted, it should measure the incremental value granted upon repricing and include that incremental value when measuring the services received during the remainder of the vesting periods. We consider that the alternative method better serves the allocation of services received over the remaining years until vesting date. We refer to our proposal in Question 9 for calculating the applicable value of units of service.

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

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

Response

No, we dot not agree with the IASB proposal since there should be no income statement charge once the contractual arrangements have been cancelled. Any compensation for the cancellation should be recognised immediately.

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

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

Response

Yes, we agree with the IASB proposal.

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

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

Response

Yes, we agree with the IASB proposal.

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

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

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

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

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

Response

No, we do not agree with the disclosure requirements, because the majority of the disclosure requirements in para 48 and 52(b) are excessive. These disclosure requirements should be incorporated into Appendix D, provided that this Appendix D is not an integral part of the Standard.

The disclosure requirements in paras. 46, 48a(i), 48b(i) and 52(a) should remain, given the useful information also to assess future expected cost and the possible dilution of earnings per share. We do not see the usefulness of the disclosure requirements of para 52(b).

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

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

Response

No, we do not agree with the IASB proposal. The application of ED 2 should not commence before the issuance of the final Standard, as the due process of the preparation of the Standard has not been completed. The requirements should apply as from the publication date of the final IFRS and also in line with the requirements of (when published) IFRS 1, First Time Application.

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

Are the proposed requirements appropriate?

Response

Yes, we agree with the IASB proposal.

Q24. 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.

<u>Response</u>

We agree with the IASB proposals except for the following points:

(a) third bullet: we consider that this should be permitted: we refer to our response in Question 11.

(b) first bullet: we refer to our response in Question 9;

(c) we concur with SFAS 123 as long as there are no other vesting conditions to be fulfilled.

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

<u>CAR Other comments</u>

Defined terms and Glossary

We propose that the Glossary should be more prominent in the final IFRS. We do not see the usefulness of the distinction between Appendix A (Defined terms) and a Glossary. We suggest to include the Glossary in Appendix A.

SIC 16

Based on the proposals of ED 2 it is unclear whether SIC 16 Share Capital – Reacquired Own Equity Instruments (Treasury Shares) will be applicable to employee share option and share purchase payment plans, or not.

Yours sincerely,

Prof. dr. Martin Hoogendoorn RA
(Chairman CAR)