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Sir David Tweedie
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Zurich, 7 March 2003

Comments on Exposure Draft ED 2:
Share-Based Payment

Dear Sir David,

We welcome the opportunity to comment on the above Exposure Draft. Please find enclosed both our response to each question asked in the ED and our additional comments.

Yours sincerely,

Swiss Institute of Certified Accountants and Tax Consultants
Accounting and Auditing Practices Committee

Urs Moser   Philipp Hallauer

Comments on questions

Question 1

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

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

We agree with the proposed scope of the Standard, except that we believe that the financial instrument that arises from a share-based payment transaction should be within the scope of IAS 32 and 39 once its initial recognition and measurement have been established.

We understand the rationale for the proposed exemption for share-based payments issued in connection with a business combination. We believe, however, that the Board should ensure a consistent treatment for share-based payments related to business combinations, joint ventures and associates.

Question 2

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

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

We agree that an expense should be recognised in respect of share-based payment transactions when the related goods or services are consumed.

Share-based payment transactions are executory contracts, therefore the goods or services and the related financial instrument (equity or a liability) should be recognised when there is performance under the terms of the contract. For employee services this is over the vesting or performance period. For other services it is when the services are received. For assets it is when the risks and rewards of ownership of the asset transfer. Although we believe that this is the Board's intended result, we think that the drafting of the Exposure Draft may be interpreted differently. The Exposure Draft states that goods and services should be recognised when the goods are obtained or the services are received. This implies that there are "special" recognition requirements for goods and services acquired in a share based payment transaction. This is not appropriate. The timing of recognition of the goods or services should depend on the relevant requirements of other Standards.

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Question 3

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

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

We agree that, for initial recognition purposes, a share based payment transaction should be measured at fair value. We also agree that there should not be an exemption from this principle: an entity that enters into a transaction with a third party must, in our view, be able to value the transaction when it occurs.

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?

We disagree with measuring transactions that are measured directly on the dates the goods or services are received. The proposal is inconsistent with grant date measurement for transactions that are measured by reference to the fair value of the equity instruments granted. We see no persuasive reason why the basis of measurement (goods or services versus equity instruments) should affect the measurement date. We believe that all share-based payment transactions should be measured at the date the equity instruments are granted.

In our view transactions should be measured at date the parties agree on the amount of consideration. For share-based payments this is the grant date. The same arguments that support grant date measurement for employee services, apply for other share-based payments.

Question 5

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

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

We agree with grant date measurement.

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?

We agree that for transactions with non-employees it will normally be easier to measure the value of the goods and services than the equity instruments. Therefore we support the proposed approach of having a rebuttable presumption that in a share-based payment transaction with parties other than employees the transaction should be measured by reference to the fair value of the goods or services received.

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?

We agree that transactions with employees should be measured by reference to the fair value of the equity instruments granted. We are not aware of any circumstances in which measuring the fair value of the employee services is likely to give a more reliable measure.

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?

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We agree that if the counterparty is required to complete a specified period of service before the equity instruments vest that it is reasonable to assume that the services are received over the vesting period, which based on the definition, includes also any period in which there are outstanding performance conditions.

We recommend that the Board provide guidance on situations where the vesting date is not fixed, for example if options vest at the date when certain performance criteria are met.

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 methods do you propose?

We do not support the units of service approach proposed in the Exposure Draft. We would prefer a simplified approach whereby the fair value of the equity instruments granted is spread on a straight-line basis over the vesting period, unless another method, more appropriately reflects the vesting conditions. This may be the case where vesting is subject to non-time based performance criteria.

The unit of service method is complex and we do not believe it gives a result that is conceptually superior to a straight-line spreading over the vesting period.

Question 10

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

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

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We agree that share based payments that will be settled by issuing a fixed number of shares should be recognised as equity and that the equity should not be remeasured subsequently.

We further believe that the credit entry to equity should be presented within additional paid-in capital (share premium) rather than retained earnings, and recommend that this be clarified.

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?

While we are not experts on option valuation techniques, we agree in principle that the fair value of options should be estimated using an option pricing model. Given the lack of market information and therefore the degree of financial knowledge that will be required to determine the inputs to an option pricing model, as well as the complexity of the adjustments that are likely to be required to the model, expert assistance will often be required in performing the valuation. We do not believe that the guidance in the Standard itself could (or should) ever be a substitute for a proper understanding of financial modelling techniques and, accordingly, recommend to limit the guidance to the absolutely necessary.

Question 12

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

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

We agree that a lack of transferability affects the value of an option and should therefore be taken into account in the valuation process. Using the expected rather than contractual life of the option seems to be a reasonable way of making this adjustment. We note that it may be difficult to estimate the expected life of an option in practice, particularly for new option schemes.

We further support the proposed requirement to take into account the inability to exercise an option during the vesting period.

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?

We agree that vesting conditions affect the value of an option and should therefore be taken into consideration. The proposed approach seems reasonable.

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?

The proposals in respect of reload features seem reasonable but we would prefer all reload features to be treated in a similar way rather than allowing a choice.

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?

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We believe that instruments with a variable exercise price, or under which a variable number of shares will be issued should be given further consideration. Although these instruments will be settled in own equity, IAS 32 and IAS 39 would require them to be recognised as a liability in most cases. We recommend that this issue be considered in the context of share-based payments. We think that a consistent approach to accounting for all similar instruments is important.

We also believe more guidance is needed on options that have performance conditions or that do not vest evenly over time.

Question 16

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

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

We support having principle-based Standards and therefore agree that the option valuation methodology should not be prescribed. Significant judgement will be involved in performing the calculation, particularly for unlisted and newly listed entities where there is uncertainty in the determination of the input parameters of the option model. Therefore, the models and any significant assumptions applied, as well as any significant adjustments made to the inputs to the models, should be disclosed.

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 re-pricing should be dealt with? Of the two methods illustrated in Example 3, which is more appropriate? Why?

We disagree with the proposed "incremental value" approach whereby the allocation period is only re-estimated in respect of the incremental value. In our view this partial remeasurement is inconsistent and unnecessarily complicated.

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We believe a repricing should be treated as a new option grant. A modification of the terms of an option is a transaction between the parties that should be accounted for. This effectively results in a new agreement between the parties and therefore it should be accounted for as a new option grant. Therefore the valuation of the option and the period over which the fair value is recognised (i.e. the units of service) should be re-estimated at the date of the modification. The new fair value should be recognised based on the revised estimate of the units of service.

We agree that amounts previously recognised should not be adjusted.

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 do not agree with the proposed approach to continue to recognise an expense in respect of cancelled options.

A cancellation is an agreement between the parties to cancel the agreement. This is a transaction that should be accounted for. Therefore we believe that when an option is cancelled the recognition of an expense should cease from that date onwards.

We agree that amounts previously recognised as an expense should not be reversed.

Question 19

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

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

We agree that cash-settled transactions give rise to a liability. The amount of the liability varies based on the entity's own share price, and therefore in our opinion the liability is a derivative instrument. We agree therefore that the liability should be remeasured to take into account changes in its fair value and that these changes should be recognised in the income statement. This is consistent with the treatment of derivative instruments in IAS 32 and IAS 39.

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We disagree with the proposed treatment of the remeasurement of the liability as a remeasurement of the underlying share-based payment transaction. This is inconsistent with the Board's basic principle (with which we agree) that the transaction is measured at the grant date and is not remeasured. The proposed approach results in an inconsistent measurement of the cost of a share-based payment transaction depending on how the transaction will be settled, an inconsistency without any conceptual justification.

We believe that the measurement of the asset or service cost should be frozen at the date the share-based payment is granted. Any gains or losses arising from subsequent differences in the measurement of the financial instrument should be considered separately and recognised <u>immediately</u> as financial income or expense in line with IAS 32 and IAS 39.

We suggest that rather than repeating rules on accounting for similar instruments in two separate standards, the Board refer to IAS 32 and 39 for the liability/equity classification and subsequent measurement of net cash- and net share-settled instruments as well as instruments that will be settled by issuing a variable number of shares.

Question 20

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

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

We agree that a liability should be recognised in all cases where an entity has incurred an obligation. This is consistent with the definition of a liability and with IAS 32 and IAS 39.

We agree with the proposals for cases where the entity has a choice of settlement. We recommend that, rather than repeating guidance, ED 2 refer to IAS 32 and 39, or at a minimum that the drafting of these sections of ED 2 be conformed with the drafting in the proposed amendments to IAS 32 in this regard.

We disagree with the proposal to treat the financial instrument arising from share-based payments in which the counterparty has the choice of settlement as a compound instrument. In our view the proposed approach is inconsistent with the definition of a liability, the principles in SIC-5 and the proposed amendments to IAS 32. Also we find the proposed approach extremely complex and we believe it will be difficult to apply in practice. In particular, we are not clear as to how the Board intends the liability to be measured subsequent to its initial recognition.

In our view where the counterparty has a choice of the method of settlement, the entity has a potential obligation to settle in cash and therefore a financial liability. We believe that the financial instrument should be shown as a liability in its entirety and that the liability should be remeasured. Consistent with our answer to question 19, we would prefer the remeasurement of the liability to be presented as financial income or expense, rather than as an adjustment to the cost of the goods or services. If the counterparty chooses gross share settlement, the liability recognised should be transferred to equity at the settlement date. To avoid potential inconsistencies, we would prefer a reference to the relevant guidance in IAS 32 and 39 rather than having the guidance repeated in ED 2.

Question 21

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

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

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

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

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

We find the proposed disclosures unnecessarily extensive. We believe the disclosures should focus on the amounts recognised in the financial statements and the key valuation methods and assumptions used to determine these amounts. The proposed detailed disclosures of the nature and extent of share-based payment transactions in paragraphs 45-48 are unnecessary under the proposals to recognise these items in the financial statements.

Also, the level of disclosures should be proportionate to the relative significance of the amounts involved. It is likely that the amounts recognised in respect of share-based payment transactions will not be significant in relation to other items in the financial statements in many cases. The disclosure requirements should be drafted in this context. There may be circumstances in which a share-based payment transaction is significant in the context of the financial statements as a whole, in these cases we accept that more detailed disclosures should be required.

We specifically suggest deleting the disclosure required by paragraph 52(b) due to cost benefit considerations.

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Question 22

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

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

We are not in favour of the proposed transition date of 7 November 2002. We would prefer the new rules to apply only to options granted on or after the effective date of the final standard. Most entities currently do not calculate the fair value of share-based payment transactions as proposed in ED 2. The calculations are complex, will be difficult to perform retrospectively, and will give rise to hindsight issues.

We do not understand the requirement to recognise liabilities arising from cash settled share-based payments at their settlement amount rather than their fair value.

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 the tax consequences of share-based payment transactions should be reported in the income statement.

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.

We believe that US GAAP should not drive IFRS. We therefore do not comment on these differences.

Question 25

Do you have any other comments on the Exposure Draft?

- The Exposure Draft does not address the situation where equity instruments are granted in respect of past services. For example, instead of a cash performance bonus, share or options may be issued to employees, but the equity instrument may only be granted in a subsequent reporting period. Applying IAS 19 principles, it would seem that the employee cost should be accrued in the period in which the services are rendered, i.e. in advance of the equity instruments being granted. But this is not clear from ED 2. Also, if the cost is accrued it is not clear whether the corresponding credit should go to equity or a liability. If the number of shares to be issued were still to be determined the credit would seem to have the nature of a liability. We believe it is important that these issue be addressed.

- We believe that the accounting treatment for share-based payments should apply equally to share-based payments made on an entity's behalf by a trust or similar special purpose entity. We suggest this be specified, particularly given that these entities are specifically excluded from the scope of SIC-12.

- We believe guidance should be given on accounting for social charges related to share-based payments. In our view these charges should be accounted for consistently with the underlying transaction to which they relate.

- We believe that first-time adopters of IFRS should only be required to apply the proposals in respect of share-based payments granted on or after the date of transition to IFRS. The complexity of calculating the fair value, especially retrospectively, and the issue of how to deal with hindsight, mean that in our view retrospective application beyond the date of transition to IFRS would involve undue cost and effort.

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