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Dear Sir

IASB EXPOSURE DRAFT 2 SHARE-BASED PAYMENT

The Institute's Accounting Standards Committee has considered the above Exposure Draft and I am pleased to set out its comments below.

The Committee fully supports the objective of the proposed standard to recognise an expense when the goods or services received or acquired under a share-based payment transaction are consumed. In general, the Committee was happy with the content of the draft standard but has mentioned in its responses below, any areas where its discussions identified points which it believes should be given further consideration by the Board.

Responses to detailed questions

Our responses to the detailed questions in the exposure draft are set out below:

(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 believe that transactions that do not result in the entity having an expense should be excluded from the scope of the standard.

(2) Paragraphs 4-6 of the draft IFRS propose requirements for the recognition of share-based payment transactions, including the recognition of an expense when the goods or services received or acquired are consumed.
Are these recognition requirements appropriate? If not, why not, or in which circumstances are the recognition requirements inappropriate?

We agree with the proposed recognition requirements. However, please refer to our response to question 10 below.

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(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?

The Committee agrees that fair value is the most appropriate measurement basis to apply. However, we believe that fair value should be with reference to equity instruments issued and the standard should focus on this emphasis. Furthermore, please refer to our response to question 6 below.

(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 believe that the standard should be using the fair value of the equity instruments issued and therefore the relevant date is the date of grant or issue.

(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 that the grant date is the appropriate measurement date.

(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?

It may well be true that the fair value of the equity instruments granted is more readily determinable than the fair value of the employee services received. However, conceptually, such an approach could lead to misleading results. The financial statements need to reflect the true cost to the company of using equity instruments to pay for goods and services. In general, it would be preferable to calculate this cost directly.

(7) *For equity-settled transactions with employees, the draft IFRS proposes that the entity should measure the fair value of the employee services received by reference to the fair value of the equity instruments granted, because the latter fair value is more readily determinable (paragraphs 11 and 12).*
Do you agree that the fair value of the equity instruments granted is more readily determinable than the fair value of the employee services received? Are there any circumstances in which this not so?

The Committee does not believe that employees should be treated differently from goods and services. Again, it may be true that the fair value of the equity instruments granted is more readily determinable than the fair value of the employee services received. However, the main reason for using fair value of equity instruments granted is that this reflects the actual cost to the company.

(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 general, this presumption seems reasonable. In practice, it will be necessary to analyse these situations on a case by case basis to determine what is the most appropriate accounting treatment. Specific agreements with the counterparty could call the presumption into 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, but we do not believe that this is a surrogate measure We believe the use of fair values of equity instruments should be the principal focus of the standard. Please refer also to our response to question 10 below.

(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?

We disagree with the proposal. If ultimately the equity instruments granted do not vest or options are not exercised, then we do not believe it is possible to state that there has been a cost to the company. Whilst we have read the arguments at BC204-207, we feel this analysis is obscure and will not easily be understood by readers of accounts. If equity instruments do not vest or options are not exercised, nothing has happened in an economic sense. In this situation, it is not obvious why the entity should continue to reflect an increase in equity, or indeed a charge to profit and loss. We believe that the UITF abstract 17 provisions on truing up should also be incorporated here to adjust expectations of cost. We further believe that the assumptions used should be reviewed over time. This would affect all the assumptions used in calculating the allocation of the initial fair value. While we do not believe that fair values should be amended for changes in share prices, we do believe that if options are cancelled then there should be no cost to the entity. In summary, we consider that the profit and loss account should reflect the fair value at date of grant of all options ultimately exercised.

(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?

We agree that an option-pricing model should be used. However, there will frequently be cases in practice where simple application of the Black-Scholes model would be inappropriate. For example:

- Where shares are only exchanged in an internal market (ie are not generally traded), it would normally be inappropriate to apply a risk-free rate when performing a Black-Scholes valuation of any share options. A valuation method sometimes adopted in the banking sector is to determine what would be the cost of hedging the risk position. However, where shares are not traded, it is impossible to undertake such a hedge and there is significant risk attached to this type of share option.
- Senior executive share option schemes frequently embody non-standard features. For example, exercise may be contingent, amongst other things, on relative performance compared to peer group companies. In such cases, the standard Black-Scholes model is likely to overstate the fair value of such options, possibly materially.

In summary, we are concerned that in certain cases there will be severe practical difficulties in implementing the fair value requirement. In practice, it is likely that an unmodified Black-Scholes model will be inappropriate to use in many situations and there will be a need to individually model some share option schemes as a result. The difficulty of doing this should not be underestimated and it will therefore be essential for companies to provide appropriate disclosure in this area.

(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 with the suggestions in the draft IFRS.

(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 with the suggestions in the draft IFRS.

(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 agree with the suggestions in the draft IFRS.

(15) *The draft IFRS proposes requirements for taking into account various features common to employee share options, such as non-transferability, inability to exercise the option during the vesting period, and vesting conditions (paragraphs 21-25).*
Are there other common features of employee share options for which the IFRS should specify requirements?

We consider that, as a principles-based standard, the general wording of paragraphs 17 and 18 is sufficient.

(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. If anything, there is more detail than necessary for a standard based on points of principle. We do not believe that the standard should seek to be a book of prescriptive guidance.

(17) *If an entity reprices a share option, or otherwise modifies the terms or conditions on which equity instruments were granted, the draft IFRS proposes that the entity should measure the incremental value granted upon repricing, and include that incremental value when measuring the services received. This means that the entity is required to recognise additional amounts for services received during the remainder of the vesting period, ie additional to the amounts recognised in respect of the original option grant. Example 3 in Appendix B illustrates this requirement. As shown in that example, the incremental value granted on repricing is treated as a new option grant, in addition to the original option grant. An alternative approach is also illustrated, whereby the two grants are averaged and spread over the remainder of the vesting period.*
Do you agree that the incremental value granted should be taken into account when measuring the services received, resulting in the recognition of additional amounts in the remainder of the vesting period? If not, how do you suggest repricing should be dealt with? Of the two methods illustrated in Example 3, which is more appropriate? Why?

We agree that incremental value should be taken into account, although we believe that if our preferences noted elsewhere in this response were taken into account, this would not be necessary. Of the two methods illustrated in Example 3 of Appendix B, we consider the first method to be more appropriate since it more accurately reflects the fact that year 3 is the final year of the original option grant. In other words, it is more appropriate to recognise a higher expense in year 3, compared to spreading this over both years 3 and 4.

(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 disagree with the proposal. We believe that if the share or option grant has been cancelled, it is not appropriate to state that there is still a cost to the company to recognise. As we similarly noted in our response to question 10, if equity instruments or options are cancelled, nothing has happened in an economic sense. It is therefore not obvious why the entity should continue to reflect a profit and loss charge, including that incurred to date.

(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.

(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 with these proposals, although note that they are likely to be onerous to apply and not readily understood. Again, appropriate disclosure will be required to explain any such material transactions.

(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 note that the disclosure requirements in paragraph 48(e) are concerned with options that would have vested during the period had the vesting conditions been satisfied. Since the vesting conditions have not been satisfied, we believe that this disclosure requirement is purely hypothetical and therefore unnecessary. We also note that paragraph 52(b) requires disclosure for cash-settled share-based payment transactions of the portion of the expense recognised for the period that is attributable to the transaction having been measured as a cash-settled transaction rather than as an equity-settled transaction. To disclose this, it would be necessary to calculate what the equity-settled transaction would have been, which we believe is not relevant in these circumstances. We are also concerned that the disclosures required by paragraph 46(b) are excessive.

(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 disagree with this proposal. We believe that the first day of implementing the standard should not be the publication date of the Exposure Draft as the Exposure Draft may change. The Committee would allow early adoption and while we would permit full retrospective application, we would not require this. We believe that the first day of implementation should not be earlier than the date of issue of the final standard.

(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?

Yes.

(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.

(a) We would prefer to see a fully inclusive approach rather than allowing exemptions. On the grounds of principle, we believe it is difficult to argue for any exemption for unlisted companies, and we would not therefore want to see exemptions. However, as already noted, we are concerned that in certain cases there will be severe practical difficulties in implementing the fair value requirement and that it will therefore be essential for companies to provide appropriate disclosure in this area. We also note a potential inconsistency with IAS 39, which prohibits entities from fair valuing certain unquoted entities. (See especially Q&A 70-2.)

(b) We agree with the draft IFRS that the possibility of forfeiture should be taken into account. However, on the second point we believe that although the draft IFRS is conceptually correct, it goes too far in stating that there should still be a charge even if the option is cancelled. Due to this concern, the Committee favours the SFAS 123 approach.

(c) We prefer the SFAS 123 approach on the basis that if a grant is being bought out, then the cost should be recognised immediately, being the cash less the reversal of the previous charges for equity instruments now never issued.

(d) We agree with the IFRS approach and believe that the fair value should be measured at the grant date in all cases, subject to forfeiture or cancellation.

(e) We prefer the draft IFRS approach as being theoretically correct.

(f) We prefer the draft IFRS approach on the basis that if the expense has been charged to the income statement then it is appropriate that the tax benefit should also be recognised in the profit and loss account.

(25) *Do you have any other comments on the Exposure Draft?*

No.

If you wish to discuss our comments further, please do not hesitate to contact me.

Yours faithfully

RICHARD ANDERSON
Assistant Director, Accounting and Auditing
Secretary to the Accounting Standards Committee