February 18, 2003

Kimberley Crook
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CommentLetters@iasb.org.uk

Re: Exposure Draft 2 – Share-based Payment

Dear Ms. Crook:

Thank you for the opportunity to comment on the International Accounting Standards Board's (IASB) proposed IFRS, *Share-based Payment*.

We appreciate that developing accounting guidance for share-based payments transactions is extremely difficult, given the myriad of ways in which these transactions can be structured. We commend the IASB for taking on this project, and for devoting substantial resources towards developing an accounting model. We also commend the IASB for preparing a substantive and well-written "Basis for Conclusions" document, which accompanies the proposed IFRS.

Nevertheless, our organization has deep philosophical differences with the conclusions reached in the proposed IFRS. As a result, we have a vastly disparate view as to how shared-based payment transactions should be measured and recorded in the financial statements.

The purpose of this letter is to outline our views as to the appropriate accounting model for share-based payment transactions. We will begin this letter by describing these views, as well as our basis for conclusions. Following this discussion, we directly respond to the specific questions posed for comment on pages 5-14 of the draft IFRS.

If you have any questions or require further information regarding the views expressed in this letter, please contact Scott Ehrlich, President and Managing Director, at 1-773-732-0654 or by e-mail at sehrlich@mindthegaap.com.

Overview

We agree that all forms of share-based awards, whether issued to employees or others, are a form of compensation and should be recorded in the income statement. We, however, disagree with the conclusions of the draft IFRS as to how such expense should be measured, and over what period such expense should be recognized.

Our views as to the accounting for share-based payment transactions can be summarized as follows (our basis for conclusions is described in the following section):

1. All share-based payment transactions, regardless of whether such transactions will be settled in cash or equity, should be accounted for in the same manner.
2. The initial recognition of a share-based payment transaction should be performed at the date of grant.
3. Until settlement, whether by cash or by issuance of equity, all share-based payment transactions should be accounted for as liabilities.
4. The liability for a share-based payment transaction should initially be measured at intrinsic value on the date of grant. Subsequent to the date of grant, all outstanding share-based payment transactions – that is, share-based payment transactions that have not been settled – should be remeasured at intrinsic value at the end of each reporting period. Changes in intrinsic value should be recorded in the income statement.
5. If the goods or service underlying the share-based payment transaction are not delivered and, accordingly, the entity is not required to settle the share-based payment transaction, the related liability, if any, should be de-recognized, with an offsetting credit to the statement of income.

The following example demonstrates the application of our views:

On January 1, 20X1, an entity enters into the following share-based payment transactions:

A. Grants 100 options to employees, at an exercise price of $20 per share. The options will vest only upon achievement of certain performance targets, which were met on January 1, 20X4. The options will expire five years from the date of grant.

B. Awards 200 stock-appreciation rights (SARs) to key executive officers. The "exercise price" in each SAR is $30 per share. The SARs become exercisable three years from the date of grant, and will expire December 31, 20X5.

C. Grants 1,000 shares of restricted stock to the entity's CEO. Under the terms of the award, the CEO is not permitted to sell the stock for a period of two years. Note that the CEO <u>need not</u> return the stock in the event the CEO ceases to be employed by the company, for any reason, during the restricted period.

D. Agrees to issue 500 warrants to investment bank in exchange for arranging venture capital financing. The warrants will only be issued upon closing of the financing transaction, and will have an exercise price equal to the market price of the entity's common stock on the date that the financing transaction closes. The warrants will be exercisable immediately and will expire three years from the closing of the financing transaction. Assume that the financing transaction closes on January 1, 20X2.

The following matrix describes the application of the five accounting guidelines described at the beginning of this section:

	Award A	**Award B**	**Award C**	**Award D**
Date of initial recognition:	January 1, 20X1	January 1, 20X1	January 1, 20X1	January 1, 20X1[1]
Initial Measurement:				
Market value of entity's common stock on date of initial recognition (assumption)	$ 25.00	$ 25.00	$ 25.00	$ 25.00
Exercise price of award	20.00	30.00	0.00	25.00[2]
Intrinsic value	$ 5.00	$ 0.00	$ 25.00	$ 0.00
Outstanding award balance	100	200	1,000	500
Initial liability (debit to expense)	$ 500	$ -	$25,000	$ -
Settlement of Liability – Jan 1 20X1				
Dr. Liability			$25,000[3]	
Cr. Common stock/APIC			$25,000[3]	
Subsequent Measurement:				
Market value of entity's common stock at **Jan 1 20X2** (assumption)	$ 35.00	$ 35.00		$ 35.00
Exercise price of award	20.00	30.00		35.00
Intrinsic value	$ 15.00	$ 5.00		$ 0.00
Outstanding award balance				
Initial grant	100	200		500
Less: forfeitures (assumption)	(10)	-		-
	90	200		500
Remeasured liability	$ 1,350	$ 1,000		$ -
Liability at end of previous period	500	-		-
Incremental expense (income)	$ 850	$ 1,000		$ -

	Award A	Award B	Award C	Award D
Market value of entity's common stock at **Jan 1 20X3** (assumption)	$ 30.00	$ 30.00		$ 30.00
Exercise price of award	20.00	30.00		35.00
Intrinsic value	$ 10.00	$ 0.00		$ 0.00
Outstanding award balance				
End of previous period	90	200		500
Less: forfeitures (assumption)	(20)	(30)		-
	70	170		500
Remeasured liability	$ 700	$ -		$ -
Liability at end of previous period	1,350	1,000		-
Incremental expense (income)	$ (650)	$ (1,000)		$ -

	Award A	Award B	Award C	Award D
Market value of entity's common stock at **Jan 1 20X4** (assumption)	$ 50.00	$ 50.00		$ 50.00
Exercise price of award	20.00	30.00		35.00
Intrinsic value	$ 30.00	$ 20.00		$ 15.00
Outstanding award balance				
End of previous period	70	170		500
Less: forfeitures (assumption)	(10)	(20)		-
	60	150		500
Remeasured liability (a)	$ 1,800	$ 3,000		$ 7,500
Liability at end of previous period	700	-		-
Incremental expense (income)	$ 1,100	$ 3,000		$ 7,500
Exercised on **Jan 2 20X4** (assumption)	30	100		500
Intrinsic value per award	$30.00	$20.00		$15.00
Value of settled liability (b)	$ 900	$ 2,000		$ 7,500
Remaining liability (a) – (b)	$ 900	$ 1,000		$ -
Settlement of Liability – Jan 2 20X4				
Dr. Liability	$ 900	$ 2,000		$ 7,500
Cr. Common stock/APIC	900	-		7,500
Cr. Cash	-	2,000		-

	Award A	Award B	Award C	Award D
Market value of entity's common stock at **Jan 1 20X5** (assumption)	$ 45.00	$ 45.00		
Exercise price of award	20.00	30.00		
Intrinsic value	$ 25.00	$ 15.00		
Outstanding award balance (net of exercised options on Jan 2 20X4)	30	50		
Remeasured liability (a)	$ 750	$ 750		
Liability at end of previous period	900	1,000		
Incremental expense (income)	$ (150)	$ (250)		
Exercised on **Jan 2 20X5** (assumption)	30	20		
Intrinsic value per award	$25.00	$15.00		
Value of settled liability (b)	$ 750	$ 300		
Remaining liability (a) – (b)	$ -	$ 450		
Settlement of Liability – Jan 2 20X4				
Dr. Liability	$ 750	$ 300		
Cr. Common stock/APIC	750			
Cr. Cash		300		
Market value of entity's common stock at **Dec 31 20X5** (assumption)		$ 31.00		
Exercise price of award		30.00		
Intrinsic value		$ 1.00		
Outstanding award balance (net of exercised options on Jan 2 20X5)		30		
Remeasured liability		$ 30		
Liability at end of previous period		450		
Incremental expense (income)		$ (420)		
No awards exercised – remaining portion expire				
Expiration of Awards – Jan 1 20X6				
Dr. Liability		$ 30		
Cr. APIC[4]		30		

[1] In accordance with the definition of "grant date" in the glossary to the draft IFRS, we believe the award to be granted as of January 1, 20X1. This is the "date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the counterparty have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the counterparty the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met."

[2] At the initial measurement date, the exercise price has not been determined. However, the exercise price will equal the market price of the entity's common stock on the date that the financing transaction closes. Accordingly, prior to establishment of the

formal award terms, the exercise price has been set to equal the current market price of the entity's common stock at January 1, 20X1. consistent with the intent of the award.

[3] The award is considered to be settled as of January 1, 20X1. This is because the CEO has full possession of the common stock used to settle the award, and there are no situations that will obligate the CEO to return such shares to the company. Note that if the shares contained any types of forfeiture provisions – for instance, the shares vested based on the passage of time – the award would not be considered settled at January 1, 20X1. Under the accounting model proposed herein, this award would continue to be remeasured at intrinsic value until settlement, which in this case, would be on the date the award became fully vested.

[4] This entry eliminates remaining obligation at the expiration of award. The resulting credit is to equity, since the award was vested but lapsed unexercised. See "Other Matters" discussion below for reasoning as to this accounting outcome.

Basis for Conclusions

Our accounting model for share-based payment transactions is founded on three principles. These three principles are:

1. All forms of share-based payment transactions are economically equivalent and, thus, should be accounted for in the same way.
2. All share-based payment transactions actually contain two elements – the initial acquisition of goods or services, and the subsequent "financing" of such acquisition through the issuance of share-based payment (in lieu of a more typical cash payment).
3. The intrinsic value model is *operationally* superior to other paradigms for measuring value.

These principles drive our views as to the appropriate accounting for share-based payment transactions. Each of these principles is now described in more detail.

NOTE: For simplicity, the remainder of this letter will refer to the measurement approach we support as the "Intrinsic Value Remeasurement Model". By using this term, we are defining an approach in which an obligation for a share-based payment transaction is:

- ***Initially recognized based on its intrinsic value at the date of grant, <u>and</u>***
- ***Is subsequently remeasured based on intrinsic value at the end of each reporting period until such obligation is settled, whether in cash or by equity.***

<u>1. All Forms of Share-based Payments are Economically Equivalent</u>

We note that the draft IFRS requires equity-settled share-based payment transactions to be characterized as a form of equity, whereas cash-settled share-based payment transactions are deemed to be a liability of an entity.

Simply, we do not subscribe to this view. Instead, we believe that any form of share-based payment transaction is an obligation to the issuing entity. Specifically, it should make no difference whether a share-based payment transaction will be settled through the issuance of equity in an entity or in cash. The mere fact that the transaction has to be "settled" indicates to us that such transaction gives rise to a liability.

To support our opinion, we refer to paragraph 60 of the IAS Framework, which states "an essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement."

We believe that all share-based payment transactions have such characteristics, even if the transactions are required to be settled through the issuance of equity. For example, a grantor of a warrant is *presently obligated* to issue common shares upon fulfillment of the *contractual requirements* by the warrant holder (which may be as simple as payment of the exercise price underlying the warrant arrangement).

Moreover, the Framework explicitly provides for the settlement of a liability through a variety of means, including "conversion of the obligation to equity."[1] This provision again supports our view that all share-based payment transactions should be classified as a liability, since a liability is permitted to be equity-settled (or settled in cash) as per the Framework.

In summary, we believe that any form of share-based payment transaction is an obligation to the issuing entity. Accordingly, we do not believe that different accounting models should be employed related to share-based payment transactions that will be settled in cash, versus those that will be settled in equity. These views form the basis of two of our proposed accounting guidelines, namely that:

- All share-based payments, regardless of whether such payments will be settled in cash and equity, should be accounted for in the same manner.
- Until settlement, whether by cash or by issuance of equity, all share-based payment transactions should be accounted for as liabilities.

2. Two Components to a Share-Based Payment Transaction

We believe that when an entity enters into a share-based payment transaction, it has actually consummated two distinct transactions. First, the entity has acquired goods or services. Separately, the entity has decided to "finance" the payment of such goods

[1] Paragraph 62(e) of the Framework.

and services through the issuance of a share-based award, in lieu of purchasing the services or goods with cash.

Accordingly, we feel that it is appropriate to give recognition to this "financing" aspect of the transaction. For that reason, the Intrinsic Value Remeasurement Model – which requires remeasurement of the obligation each reporting period until settlement – is the best approach for reporting the share-based payment transaction.

This approach is consistent with other IAS pronouncements, particularly IAS 21 which requires that monetary assets and liabilities arising from foreign currency transactions be remeasured each reporting period. Similar to share-based payment transactions, a foreign currency transaction actually contains two elements – the initial purchase/sale transaction, and the separate and mutually exclusive decision to finance the settlement of the purchase/sale in other than an entity's functional currency.

Under IAS 21, the remeasurement of monetary assets and liabilities is performed based on the spot rate in effect as of the balance sheet date, with changes in value recorded in the statement of income. This approach is similar to the approach we recommend herein for share-based payment transactions, in that:

- Remeasurement of share-based payment liabilities would be calculated based on factors existing as of the balance sheet date (the market value of the entity's common stock, and the exercise price of the award), and
- Changes in value would be recorded to the statement of income.

Moreover, under IAS 21, remeasurement of monetary assets and liabilities ceases when the related foreign currency transaction is settled. This is the same principle underlying the Intrinsic Value Remeasurement Model.

3. Operational Superiority of the Intrinsic Value Remeasurement Model

We believe that the Intrinsic Value Remeasurement Model provides relevant and reliable information regarding an entity's share-based payment transactions, and is operationally superior to the fair value approach prescribed by the draft IFRS.

We recognize that the IASB debated various models that can be used to measure the value of a share-based award. As articulated in the Basis for Conclusions that accompanies this draft IFRS, most of these models have some advantages as well as some disadvantages.

Unlike the draft IFRS, however, we believe that the advantages of the Intrinsic Value Remeasurement Model outweigh its disadvantages. Specifically, requiring use of the Intrinsic Value Remeasurement Model would provide the following benefits:

(a) Avoidance of option pricing models, which we believe have numerous flaws and whose limitations outweigh the benefits achieved from using such models.

As the IASB acknowledges in its Basis for Conclusions, option pricing models were never designed to value many types of awards that would fall under the scope of the draft IFRS, such as stock options granted to employees. Specifically, option pricing models like the Black-Scholes model, the Binomial model and others assume that options are freely tradable, are not subject to vesting provisions, and have relatively short terms. On the contrary, most employee options do not share these characteristics, meaning that option pricing models can produce erroneous measurements when valuing such awards.[2]

Moreover, studies indicate that option pricing models produce "biased results" when options are either issued deep in or out of the money, or when the market price for a company's shares are highly or minimally volatile.[3]

Finally, option pricing models like Black-Scholes model produce results that often are not intuitive. As an example, assume that a company issues "at-the-money" options when its stock price has been trading at near all-time highs. In this circumstance, the Black-Scholes model will generate an option value that is significantly higher than that which would be calculated had the option been issued when the stock was trading at a lower price. This outcome appears to be counterintuitive, since a lower stock price presumably would permit greater opportunity for appreciation, thus delivering more value to the option holder.

It should also be noted that significant judgment must be made regarding the inputs to any option pricing model, further diminishing the benefits of using such a model to value share-based payment transactions. This limitation will be discussed further under (c) below.

(b) The Intrinsic Value Remeasurement Model provides a vastly simpler method of computing the value of share-based payment transactions than other approaches considered by the IASB, including the fair value model.

Intrinsic value represents the difference between the market price of an entity's common stock and the exercise price of the share-based award at a given point

[2] Numerous academic studies and other papers support these conclusions. See Resources Consulting Group newsletter found at http://www.insidetheboardroom.com/blackscholes.html for a representative article.
[3] Again, numerous academic studies and other papers support these conclusions. See Harter and Harikumar, Journal of Business Finance and Accounting, September/October 2002 for a representative article.

in time. Since both of these factors are often readily determinable, application of the intrinsic value method is substantially easier for practitioners than applying other option pricing models, especially the fair value method.

We acknowledge that determination of the "market price" of an entity's common stock may be challenging if an entity's securities are not publicly traded. Nevertheless, we believe that judgments necessary for private companies to make an estimate of market price are much less demanding than those required to estimate the value of a share-based award using an option pricing model. For example, we believe that it is much easier for a non-public entity to estimate its market value than it would be for such entity to estimate the volatility of its common shares, an appropriate risk-free interest rate, expected dividend yield, and other factors prescribed by the draft IFRS.

(c) The intrinsic value method, as described herein, provides greater accuracy in the measurement of the true value of the share-based award over its term.

In our view, the measurement approach prescribed in the draft IFRS has a fatal flaw. Simply, the expense recognized in the statement of income for equity-settled share-based payment transactions will never represent the ultimate value of the share-based award. Said more bluntly, the expense measured under the draft IFRS will be wrong nearly 100% of the time.

To demonstrate, assume that an entity awards a stock option to an employee. This stock option has an exercise price of $10 per share and will cliff vest in three years. The entity uses an option pricing model and supportable assumptions to determine that the value of the option is $4. Assuming that the employee performs as expected, the draft IFRS would require the recognition of $4 in expense over the service period.

However, unless the employee exercises the award when the entity's common stock is trading at $14 per share, the expense recognized in the financial statements will not equal the ultimate (and true) value of the option. For instance, if the employee exercises the option when the entity's stock is trading at any value greater than $14 – for instance, $20 per share – the expense reported in the financial statements will be understated.

This result occurs because the fair value of the award, as determined at the grant date under the draft IFRS, is never "trued-up" to the ultimate benefit that the award recipient receives upon exercise of the option. This principle is troubling because:

- It is contrary to all other GAAP. To our knowledge, all other IAS pronouncements in which significant judgments and estimates are made at initial recognition are subsequently "trued-up" to the actual cost (or benefit) realized. We note, for example, that this accounting is mandated in IAS standards on pensions, provisions (contingencies), foreign currency transactions and income taxes, among others.
- It is inconsistent with the accounting for cash-settled share-based payment transactions within the draft IFRS. To reiterate our earlier views, we believe that all share-based payment transactions, whether settled in equity or cash, are obligations and should be accounted for in an identical manner. Therefore, we are concerned that the proposed IFRS mandates cash-settled share-based payment transactions be "trued-up" after the service is performed, but the same accounting is not prescribed for equity-settled payment transactions. We not only believe that this difference is inappropriate, but we further believe that it unfairly burdens non-public entities, who often have to settle share-based payment transactions in cash because of the illiquidity of their equity instruments.

Under the Intrinsic Value Remeasurement Model that we support, the aggregate expense reported in the financial statements for any share-based payment transaction will equal the ultimate value realized by the award holder upon exercise. For this reason alone, we believe that the Intrinsic Value Remeasurement Model produces more *relevant* information than the fair value approach outlined in the draft IFRS to long-term investors and creditors of an entity. Moreover, we believe that the intrinsic value approach is the more *reliable* measure of compensation expense, since:

- it is calculated based on objectively determinable elements – that is, the market value of entity's common stock and the exercise price of the share-based award,
- it does not contain the inherent biases contained in option pricing models, as discussed in (a) above, and
- it does not require subjective estimates and assumptions, such as expected dividend yields, risk-free interest rates and volatility, which as, an aside, can be easily "massaged" to significantly alter the end result of an option pricing model.

Summary

In summary, our views as to the accounting for share-based payment transactions are as follows:

1. All share-based payment transactions, regardless of whether such transactions will be settled in cash and equity, should be accounted for in the same manner.
2. The initial recognition of a share-based payment transaction should be performed at the date of grant.
3. Until settlement, whether by cash or by issuance of equity, all share-based payment transactions should be accounted for as liabilities.
4. The liability for a share-based payment transaction should initially be measured at intrinsic value on the date of grant. Subsequent to the date of grant, all outstanding share-based payment transactions – that is, share-based payment transactions that have not been settled – should be remeasured at intrinsic value at the end of each reporting period. Changes in intrinsic value should be recorded in the income statement.
5. If the goods or service underlying the share-based payment transaction are not delivered and, accordingly, the entity is not required to settle the share-based payment transaction, the related liability, if any, should be de-recognized, with an offsetting credit to the statement of income.

We acknowledge that the above approach is not without its limitations – for instance, the intrinsic value approach does not consider the time value of money and some would argue that it produces results that may appear unreasonable in the early stages of an award's life.

Nevertheless, we believe that the Intrinsic Value Remeasurement Model produces relevant and reliable measurement of an entity's share-based payment transactions, particularly over the long-term life of the share-based award. We further believe that this approach has a number of advantages over the approach proposed in the draft IFRS, including:

- Consistency of application among share-based payment transactions that will be settled in cash or equity,
- Avoidance of potentially biased pricing models and highly judgmental assumptions that are potentially subject to manipulation, and
- Operational simplicity.

We recognize that the IASB considered an intrinsic value approach to measure the value of share-based payment transactions, but rejected such approach for the reasons sited in BC92 – BC 97 of the Basis for Conclusions. We urge the Board to reconsider this model, as adapted by the remeasurement provisions proposed in this letter.

Other Matters

- As mentioned previously in this letter, some would argue that the Intrinsic Value Remeasurement Model produces results that may appear unreasonable in the early stages of an award's life.

  To potentially mitigate the concerns of these individuals, we suggest requiring that companies disclose the effects of both a hypothetical 10% and 25% increase in the market price of their common stock. In this manner, readers of the financial statements can be alerted to potential future effects on an entity's results of operations, stemming from the variability of a company's share price. We observe that similar "sensitivity" disclosures are required in other standards, most notably in regards to postretirement benefit obligations under FASB Statement 106.

- For awards in which vesting is contingent upon achievement of performance or other targets, we considered, but ultimately rejected, an approach in which recognition of the award would only be required in the event that the guidance on "provisions" (in IAS 37) were met. We believe that it would be counterintuitive for companies to assert that the probability of an award vesting is less than "more likely than not". Such an assertion would send an inconsistent message to the recipient of the award, suggesting that the company does not believe that the service provider will perform under the terms of the arrangement or other performance conditions will not be met (for instance, successful completion of an initial public offering). Since the granting of share-based awards involves significant monetary and other costs (including in some cases, a shareholder vote), we believe that companies would not go to the trouble of granting the awards unless they believed exercise of the awards was at least probable, as defined in IAS 37.

- We believe that if goods or service underlying the transaction are delivered, but the related share-based payment expires unexercised, any remaining obligation at expiration should be de-recognized, with an offsetting credit to equity. We considered, but rejected an approach in which the de-recognition of the obligation would be reported as income. Under the Intrinsic Value Remeasurement Model outlined in this letter, an obligation would only be recognized when an unsettled share-based award is "in-the-money". We believe that a reasonable person would exercise a vested and in-the-money share-based award prior to expiry, even if the award only generated a nominal benefit. Accordingly, we view the lack of exercise of such an award to be akin to a capital contribution or donation, and accordingly, should be reflected as such.

- Finally, please note that we have other peripheral comments regarding the draft IFRS, specifically related to the proposed amendments to IAS 12 (Income Taxes) and IAS 33 (Earnings Per Share). Our comments can be found in the response to question 25 at the end of this letter.

Thank you once again for the opportunity to comment on the proposed IFRS. Please find below our responses to the specific questions posed therein.

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?

In general, we support the proposed scope of the IFRS.

However, we are confused by the language in paragraph 3(b). Specifically, we recognize that certain transactions involving share-based awards should be accounted for under the proposed IFRS, while others should be accounted for under IAS 32 and 39, if specified conditions are met.

Perhaps we are mistaken, but we read the scope exception in 3(b) to require that stock options granted to employees (and external service providers) that will be settled in cash be accounted for in accordance with IAS 32/39, and not in accordance with the draft IFRS.

If this is indeed the intent of the IASB, we are confused as to why guidance is necessary in the draft IFRS for the accounting for cash-settled share-based payment transactions. In other words, it would seem to us that all cash-settled awards would be scoped out the draft IFRS and would be accounted for under the provisions of IAS 32/29. Therefore, any guidance contained in the draft IFRS related to such awards would be irrelevant.

Accordingly, we are assuming that this was not the intent of the IASB in drafting this paragraph.

As a suggestion, perhaps 3(b) can be deleted, and a new paragraph inserted between existing items (2) and (3). This paragraph can merely state that "certain share-based payment transactions may meet the definition of a derivative in paragraphs 10 and 13-16 in IAS 39 [Revised 200X]. Such share-based payment transactions should apply the provisions of IAS 32 and 39."

Moreover, to demonstrate when a share-based payment transaction should be accounted for under the final standard, or when it should be accounted for as a derivative financial instrument under IAS 32 and 39, the examples provided in BC22-BC23 (in the basis for conclusions) should be incorporated into the final IFRS following this inserted text described above.

We are supportive of the proposed amendments to IAS 32 and 39, found in Appendix E to the draft IFRS, as currently written.

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 do not agree with requiring recognition of a share-based payment transaction when the related goods and services are acquired or received. As stated earlier this letter, we believe that the share-based payment transaction should be recognized at the date of grant, as currently defined in the draft IFRS.

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 do not agree with many of the measurement principles in the draft IFRS. As stated throughout this letter, we believe that the most reliable measurement of the value of a share-based payment transaction is the value of the award issued. Furthermore, we believe that measurement of the share-based payment transaction should continue until settlement of the related award, and not stop once the goods or services have been received. Please see our response to question 8 for further information as to our views.

We do support, however, the principle that no exemptions be permitted related to the recognition of share-based payment transactions, even for unlisted entities.

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 believe that the appropriate date on which to *initially* measure the value of the share-based payment transaction is the date the related share-based award is granted. We believe that the value of such award should continue to be remeasured, using the intrinsic value method, until settlement.

Please also refer to our responses to Questions 2 and 3 above.

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?

As stated in our response to Question 4 above, we believe that the date of grant is the appropriate date on which to *initially* measure the value of all share-based payment transactions, regardless of whether the related awards will be settled in equity or cash.

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 do not agree with this presumption. Specifically, we are concerned that estimating the fair value of goods or services provided is not as reliable as valuing the share-based awards granted.

In our experience, we do not see many share-based payment transactions in which the goods or services provided have a readily-determinable market value, such as exchanging equity instruments for making copies at Kinko's or purchasing a commodity like fuel. Instead, share-based awards are often issued in exchange for services, such as a finder's fee for negotiating financing or in exchange for legal services. We believe that determining the value of such services is highly judgmental, and much less reliable than valuing the share-based awards themselves (particularly using the Intrinsic Value Remeasurement Model we support in this letter).

This is especially true in situations in which start-up companies enter into share-based payment transaction in exchange for services. In these situations, it could be argued that a service provider would discount its normal and customary fees, hoping that the start-up company would prosper and the service provider could recover its investment through future work. On the other hand, it could be argued that a service provider may actually charge higher than customary fees, given the risk associated with the start-up entity. Accordingly, we are confused as to which measure represents "fair value" – the "customary fees", the discounted price, or the risk-adjusted price.

Because of the judgment involved in determining fair value of services, we do not believe that this presumption is desirable or operational.

<u>Question 7</u>

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?

Not withstanding our previously communicated views regarding the use of fair value, we do agree with the conclusions in the draft IFRS that the value of the share-based awards will always be more readily determinable than the value of the employee services provided.

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?

Since we believe that:

- the most reliable measure of the value of the share-based payment transaction value is intrinsic value, and
- the value of an award should continue to be remeasured until settlement,

we cannot respond to this question, as it is not applicable to our preferred measurement approach.

Note that the Intrinsic Value Remeasurement Model values the award underlying a share-based payment transaction, and not the goods or services received. As stated in our response to Question 6 and throughout this letter, we believe that measuring the value of the award will always be more reliable than measuring the value of the goods or services received. Consistent with this principle, we do not find it necessary to then "attribute" the value of the award over some arbitrary service period. Instead, we view the share-based payment transaction as a form of financing and, thus, we support recognition of the entire remeasured value each reporting period until settlement, in the same manner as foreign currency transactions are reported under IAS 21.

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?

We do not agree that it is necessary to estimate units of service, and attribute the calculated value of the services as units are "received". Please see our response to Question 8 above.

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?

As stated throughout this letter, we do not agree with this principle. Instead, we believe that all forms of share-based payment transactions should be accounted for in the same manner. Specifically, all forms of share-based payment transactions, including those that will be settled in equity, should be treated as obligations of the issuing company until settlement. Thus, the value of such share-based award should be subsequently adjusted until settlement.

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?

As stated previously, we do not agree that an option pricing model should be used to estimate the value of options granted, due to the fundamental and pervasive flaws of such models. Instead, we favor the Intrinsic Value Remeasurement Model for initial and subsequent measurement of share-based awards until such awards are settled.

<u>Question 12</u>

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 cannot provide a response to this question. Please refer to our responses to Questions 8 and 11.

<u>Question 13</u>

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 do not believe that vesting conditions should be taken into account when an entity measures the value of share-based awards. As described earlier in this letter, we are of the view that an entity would not issue a share-based award unless it believed that the likelihood such award will be settled is more likely than not. Accordingly, we would find it inconsistent with the guidance of IAS 37 if vesting conditions were somehow considered in valuing the share-based award.

Question 14

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

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

We believe that the reload feature should not be taken into account at the initial measurement of the award. Estimating the value of a reload feature at the time an option is initially granted is subjective and prone to manipulation. Instead, we believe that any "reload" option awards should be initially measured at the time the reload award is granted (and consistent with our views expressed in this letter, subsequently remeasured at intrinsic value until settlement).

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?

We have no comment on this question, as using the Intrinsic Value Remeasurement Model we propose in this letter would negate this concern.

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?

While we are supportive of the concept of principles-based standards, we vehemently disagree with this aspect of the draft IFRS.

As highlighted previously, there are a number of limitations associated with using option pricing models, particularly in regards to valuing options awarded to employees. Many of these limitations have been identified in the draft IFRS, including the inability of option pricing models to consider non-transferability and vesting conditions when calculating a fair value of an option.

Some in academia have spent a substantial amount of time trying to develop models that contemplate the unique characteristics of employee stock option awards when measuring fair value. To the best of our knowledge, no one has been successful in accomplishing this objective to date.

Therefore, we find it disingenuous and, frankly, disturbing that the IASB would "leave it up to practitioners" to solve these comprehensive and challenging problems. We strongly believe that if the IASB desires that options and other share-based awards be measured using fair value, then the Board must prescribe standards and implementation guidance that explicitly illustrate how to adjust the valuations produced by existing models to address these known limitations.

Question 17
If an entity reprices a share option, or otherwise modifies the terms or conditions on which equity instruments were granted, the draft IFRS proposes that the entity should measure the incremental value granted upon repricing, and include that incremental value when measuring the services received. This means that the entity is required to recognise additional amounts for services received during the remainder of the vesting period, ie additional to the amounts recognised in respect of the original option grant. Example 3 in Appendix B illustrates this requirement. As shown in that example, the incremental value granted on repricing is treated as a new option grant, in addition to the original option grant. An alternative approach

is also illustrated, whereby the two grants are averaged and spread over the remainder of the vesting period.

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

In concept, we believe that the incremental value related to any modifications to share-based awards, including repricings, should be reflected in the accounts. However, given our views expressed throughout this letter, we would propose determining the incremental value using the updated intrinsic value of the repriced award at the date of the repricing. Again, the intrinsic value of the repriced award would be remeasured until the award is ultimately settled.

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 believe that outright cancellation of a share-based award (that is, a cancellation that is not linked to the issuance of a replacement award) would be very rare. Accordingly, we don't have any strong views regarding the provisions contained in the draft IFRS.

In regards to grants of replacement options, please see our response to Question 17 (repricings).

As an observation, we note that the Intrinsic Value Remeasurement Model described in this letter is much more operational than the guidance in the draft IFRS in regards to dealing with repricings. In most instances, a repricing occurs when an original option grant is out-of-the-money. Accordingly, under the Intrinsic Value Remeasurement Model, the cumulative value of the original award would be zero. However, once the award is repriced, intrinsic value would be calculated based on the new terms of the award, which presumably would lead to a higher likelihood of compensation expense being recorded.

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 are supportive of this requirement, although we believe that the value of the liability should be determined throughout the life of the award using the intrinsic value method. Specifically, we feel that the costs associated with measuring a cash-settled award at fair value until vesting, and then intrinsic value thereafter, outweigh the minimal benefits of applying this approach.

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 do not agree with these requirements because we believe that all share-based payment transactions should be recorded as a liability until settlement, regardless of whether settlement by cash or equity is elective.

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)?

Although there seem to be a vast number of disclosures proposed under this Exposure Draft, we do believe nearly all are appropriate, presuming that the IASB adopts the measurement provisions outlined in the draft IFRS.

However, the requirement of paragraph 52 (b) is confusing. This item appears to require disclosure of the impact of recognizing vested cash-settled share-based payment transactions using the intrinsic value method, in lieu of measuring such transactions using a fair value approach. We are uncertain as to whether this provision is effectively requiring cash-settled award to be measured under two models – intrinsic value for purposes of financial statement recognition, and fair value for purposes of disclosure. If our understanding is correct, we are uncertain as to the benefit of such a disclosure. If our understanding is incorrect, we would suggest that the intent of the disclosure be better clarified.

Assuming, however, that the IASB adopts the measurement provisions suggested in this letter (i.e., Intrinsic Value Remeasurement Model), we believe that some of the proposed disclosure requirements could be eliminated. For instance, the disclosures required by paragraphs 48 (a)-(c) could be deleted, since relevant information regarding how the value of the share-based awards were determined (the number and weighted-average exercise price of the awards outstanding) is already disclosed pursuant to paragraph 46(b).

As noted earlier in this letter, we acknowledge that the Intrinsic Value Remeasurement Model does not alert financial statement readers to the potential future variability in the value of the share-based awards. This is because the obligation under the intrinsic value approach reflects the difference between the market value of the entity's common stock and the exercise price of an award at a point in time. This approach does not estimate expected future increases (or decreases) in the market value of the entity's common stock. Consequently, we believe that if the intrinsic value approach is adopted for all share-based payments, disclosure of the effects of a hypothetical increase in the value of an entity's equity should be disclosed. For purposes of this disclosure, we would recommend hypothetical increases of (a) 10% and (b) 25%, based on the market value of the entity's common stock at the end of the reporting period.

Finally, regardless of the measurement approach adopted, we believe that the following disclosures would be useful in assessing the financial condition and future commitments of an entity:

- the number of options or other share-based awards available for grant, classified by plans that have been (i) approved and (ii) not approved by shareholders of the entity, and
- the reason(s) why an entity decided to issue share-based awards for goods and services in lieu of more traditional forms of settlement (cash payment).

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 believe that the proposed transition requirements would be unduly onerous and would adversely affect comparability among periods presented. To demonstrate our concerns, we will limit our discussions to equity-settled share-based payments, although our comments also apply to cash-settled share based payments as well.

Requiring companies to record expense for non-vested options in the current period, while not requiring similar accounting in prior periods, causes an inconsistency between reporting periods, affecting comparability of an entity's historical and current results of operations.

Moreover, as companies grant options and other equity-settled share-based payments in future periods, the expense that such companies will report will be higher than that reported in the initial transition period. This is because all share-based payments will be accounted for under this draft IFRS, and not just non-vested awards. This "ramp up" effect does not accurately reflect the trends and economic realities of an entity's share-based payment schemes. In fact, this transition approach has been banned by the FASB in Statement 148, beginning for fiscal periods beginning after December 15, 2003 for similar reasons to those described above.

We do recognize that retrospective application of the measurement standards proposed in the Exposure Draft would be challenging. For instance, when estimating the fair value of an option issued in an earlier period, it is somewhat arbitrary to ask companies to make assumptions about things like expected volatility, estimated option life, etc. using facts that "could have been known" at the time the options were awarded.

Given the disadvantages of both prospective and retrospective adoption, we would propose a transition approach that is a bit of a compromise. Specifically, we would propose that companies adopt the provisions of this draft IFRS retrospectively, however starting only with the period preceding the year of adoption. In other words, presuming that this proposed IFRS would become effective for calendar year companies on January 1, 2004, the provisions of the standard should be applied as though the standard was in effect from January 1, 2003. In this manner, at least two periods of comparative information could be presented, while some of the judgments necessary to determine the value of equity-settled share-based payment transactions issued in prior periods would be mitigated.

Please note that the above discussion assumes that the measurement provisions described in the proposed IFRS are adopted. If, instead, the IASB adopts the measurement provisions recommended in this letter (that is, the Intrinsic Value Remeasurement Model), true retrospective application would indeed be possible and preferable. This would be the case for all share-based payments, including those that would be settled in cash.

We do acknowledge that private entities may have difficulties in applying this retrospective approach, as it would require such companies to make estimates of the fair value of their equity securities at historical periods. Nevertheless, we do not view this requirement to be unduly burdensome, as cost effective techniques exist to estimate the fair value of an entity's common stock at a point in time. One such technique, sometimes suggested by the Securities and Exchange Commission in comment letters to registrants, involves rolling forward or backwards valuations determined in third party transactions involving an entity's equity (for example, stock issuances or stock-for-stock business combinations consummated at interim periods) to earlier or later dates.

If our above recommendations are adopted, we note that the guidance in Paragraph E6, amendments to IFRS [X] First-time Application of International Financial Reporting Standards, should be updated accordingly.

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?

Yes, we believe that the proposed requirements are appropriate. We support the general principle of recognizing all current and deferred tax provisions through the income statement.

Please note that the use of the Intrinsic Value Remeasurement Model leads to an elegant solution to this periphery issue. Specifically, in most taxing regulations, the tax deduction received by a company upon exercise of an award will be the same amount that has been recognized, on a cumulative basis, as expense under the Intrinsic Value Remeasurement Model. Accordingly, any tax benefits associated with an award cannot exceed the expense recognized in the income statement. Thus, the Intrinsic Value Remeasurement Model permits both the expense and the related tax benefits to be recorded in the income statement without the undesirable outcome that may result under the fair value approach (i.e., the income tax benefit recognized in the income statement exceeds the expense recorded).

Please also see our response to Question 25, however, in regards to a concern we have related to the example provided in E5 of the draft IFRS.

Question 24

In developing the Exposure Draft, the Board considered how various issues are dealt with under the US standard SFAS 123 Accounting for Stock-Based Compensation, as explained further in the Basis for Conclusions. Although the draft IFRS is similar to SFAS 123 in many respects, there are some differences. The main differences include the following.

(a) Apart from transactions within the scope of another IFRS, the draft IFRS does not propose any exemptions, either from the requirement to apply the IFRS or from the requirement to measure share-based payment transactions at fair value. SFAS 123 contains the following exemptions, none of which are included in the draft IFRS:

- ***employee share purchase plans are excluded from SFAS 123, provided specified criteria are met, such as the discount given to employees is relatively small;***

- ***SFAS 123 encourages, but does not require, entities to apply its fair value measurement method to recognise transactions with employees; entities are permitted to apply instead the intrinsic value measurement method in Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees (paragraphs BC70-BC74 in the Basis for Conclusions give an explanation of intrinsic value); and***
- ***unlisted (non-public) entities are permitted to apply the minimum value method when estimating the value of share options, which excludes from the valuation the effects of expected share price volatility (paragraphs BC75-BC78 in the Basis for Conclusions give an explanation of minimum value).***

(b) For transactions in which equity instruments are granted to employees, both SFAS 123 and the draft IFRS have a measurement method that is based on the fair value of those equity instruments at grant date. However:

- ***under SFAS 123, the estimate of the fair value of an equity instrument at grant date is not reduced for the possibility of forfeiture due to failure to satisfy the vesting conditions, whereas the draft IFRS proposes that the possibility of forfeiture should be taken into account in making such an estimate.***
- ***under SFAS 123, the transaction is measured at the fair value of the equity instruments issued. Because equity instruments are not regarded as issued until any specified vesting conditions have been satisfied, the transaction amount is ultimately measured at the number of vested equity instruments multiplied by the fair value of those equity instruments at grant date. Hence, any amounts recognised for employee services received during the vesting period will be subsequently reversed if the equity instruments granted are forfeited. Under the draft IFRS, the transaction is measured at the deemed fair value of the employee services received. The fair value of the equity instruments granted is used as a surrogate measure, to determine the deemed fair value of each unit of employee service received. The transaction amount is ultimately measured at the number of units of service received during the vesting period multiplied by the deemed fair value per unit of service. Hence, any amounts recognised for employee services received are not***

subsequently reversed, even if the equity instruments granted are forfeited.

(c) If, during the vesting period, an entity settles in cash a grant of equity instruments, under SFAS 123 those equity instruments are regarded as having immediately vested, and therefore the amount of compensation expense measured at grant date but not yet recognised is recognised immediately at the date of settlement. The draft IFRS does not require immediate recognition of an expense but instead proposes that the entity should continue to recognise the services received (and hence the resulting expense) over the remainder of the vesting period, as if that grant of equity instruments had not been cancelled.

(d) SFAS 123 does not specify a measurement date for transactions with parties other than employees that are measured at the fair value of the equity instruments issued. Emerging Issues Task Force Issue 96-18 Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services requires the fair value of the equity instruments issued to be measured at the earlier of (i) the date a performance commitment is reached or (ii) the date performance is complete. This date might be later than grant date, for example, if there is no performance commitment at grant date. Under the draft IFRS, the fair value of the equity instruments granted is measured at grant date in all cases.

(e) SFAS 123 requires liabilities for cash-settled share appreciation rights (SARs) to be measured using an intrinsic value measurement method. The draft IFRS proposes that such liabilities should be measured using a fair value measurement method, which includes the time value of the SARs, in the same way that options have time value (refer to paragraphs BC70-BC81 of the Basis for Conclusions for a discussion of intrinsic value, time value and fair value).

(f) For a share-based payment transaction in which equity instruments are granted, SFAS 123 requires realised tax benefits to be credited direct to equity as additional paid-in capital, to the extent that those tax benefits exceed the tax benefits on the total amount of compensation expense recognised in respect of that grant of equity instruments. The draft IFRS, in a consequential amendment to IAS 12 (revised 2000) Income Taxes, proposes that all tax effects of

share-based payment transactions should be recognised in profit or loss, as part of tax expense.

For each of the above differences, which treatment is the most appropriate? Why? If you regard neither treatment as appropriate, please provide details of your preferred treatment.

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

We will not address this question, because we do not support many of the provisions of both SFAS 123 and the draft IFRS.

Question 25
Do you have any other comments on the Exposure Draft?

We do not understand the rationale for the proposed modification to IAS 33, as described in E4. The effects of the amendment in E4 would be to lessen the potential dilutive effects of issuing options. We don't understand the benefit (or the theoretical justification) for such amendment.

We are also concerned with the example in E5 of the draft IFRS. Specifically, we do not agree with how the tax basis of the employee services is determined. The tax basis of a share-based award represents the amount that will be deductible from taxable income in future periods. In our experience, this amount equals the intrinsic value of the award in most of the taxing jurisdictions that permit deductions for share-based awards. Taxing regulations generally would not mandate that the intrinsic value of the award be multiplied by a fraction to take into consideration the remaining period of time until vesting of the award.

We would recommend adjusting the example to eliminate this "vesting fraction" or, less desirably, require in IAS 12 that the tax basis of the asset be adjusted to consider the vesting provisions of the award.

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