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CL 111

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International Accounting Standards Board
30 Cannon Street
London
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Re: Exposure Draft 2, Share-based Payment

Ladies and Gentlemen:

Citigroup appreciates the opportunity to respond to Exposure Draft 2, *Share-based Payment* (Exposure Draft). Overall, we support using a fair value method to recognize stock-based compensation expense and believe that it provides greater transparency to financial statement users regarding a company's use of stock-based awards.

As you may be aware, Citigroup is one of a growing number of companies that has recently adopted FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FAS 123) for financial reporting under US GAAP. Notwithstanding our decision to adopt FAS 123 for recognition purposes, we share the concern voiced by many companies that FAS 123's valuation approach overvalues stock-based compensation. We believe this shortcoming is a major impediment that is preventing more companies from adopting fair value accounting for stock-based compensation under US GAAP. While we have accepted the argument that "zero cannot be the right answer," we are concerned that a fair value methodology that overvalues stock-based compensation may foster behavior among companies that is contrary to its intention. Proponents of fair value accounting for stock options frequently state that recognizing compensation expense will help companies better manage and allocate their equity-based compensation awards. However, we are concerned that it may instead force companies to curtail the use of a highly motivational compensation tool, based on a measure that companies themselves believe to be overstated. While we do not agree with all aspects of the Exposure Draft, we strongly support its more general, principles-based approach to option valuation as opposed to FAS 123's more prescriptive approach. We provide additional comments below on how the measurement guidance in the Exposure Draft could be improved.

Our comments on specific questions and requests for additional guidance are provided below.

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?

As part of redeliberations of the Exposure Draft, we request that the IASB resolve the scope issues related to the Exposure Draft and IAS 32, as described in the Basis for Conclusions (paragraphs BC21-BC24 and BC105-BC119). The scope of the Exposure Draft appears to include *all* contracts

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to acquire goods or services other than those contracts to acquire commodities that will be settled net and that meet the definition of a derivative (that is, those contracts that do not meet the normal purchase/normal sale exception in IAS 32 and IAS 39). As stated in paragraph BC112, this would create a difference between the guidance in IAS 32 (under its proposed amendments) and the IFRS on share-based payment:

- Under IAS 32, an entity would be required to recognize a liability related to contracts to acquire goods or services where "the number of an entity's own shares or other own equity instruments required to settle an obligation varies with changes in their fair value so that the total fair value of the entity's own equity instruments to be delivered always equals the amount of the contractual obligation."
- Under the Exposure Draft, an entity would not recognize a liability related to *any* contracts to acquire goods or services that will be settled in its own shares or other own equity instruments, regardless of whether the number of shares or other equity instruments to be issued is fixed or variable.

We do not believe that contracts to acquire goods or services that will be settled by (a) a fixed number of shares or (b) a variable number of shares depending on the entity's share price are fundamentally different. As such, we believe that the accounting result (whether or not to recognize a liability on the balance sheet) should be consistent.

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 appropriate?

As stated above, we support using a fair value method to recognize stock-based compensation expense. Furthermore, we agree with the general principle in paragraphs 4-6 that an expense should be recognized when goods or services received or acquired are consumed. However, we do not agree with all of the detailed proposals in the Exposure Draft, specifically the 'units of service' methodology. See Question 9 for additional comments.

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 measure share-based payment transactions at fair value. For example, there are no exemptions for unlisted entities. Is this measurement principal appropriate? If not, why not, or in which circumstances is it not appropriate?

We agree with the general principle that equity-settled share-based payment transactions should be measured at the fair value of the goods or services received or the equity instruments granted, whichever is more readily determinable. However, we believe that unlisted entities should be allowed to use the minimum value method to measure the value of equity instruments granted to employees. As noted in FAS 123, and from a cost/benefit standpoint, it is clearly not feasible to estimate volatility for a stock that does not publicly trade. We do not agree with the position in the Exposure Draft that an unlisted entity's use of a very subjective estimate of volatility yields a more appropriate measurement than does the minimum value method. In addition, we would expect much less comparability between financial statements of unlisted entities if they were required to make such subjective estimates.

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?

For equity-settled share-based payment transactions with employees, paragraph 11 of the Exposure Draft would require the entity to measure fair value by reference to the fair value of the equity instruments granted. As such, we note that this question only addresses the measurement date for transactions with non-employees. Based on discussions with the IASB staff, we understand that:

- If the fair value of the goods or services is measured directly, the entity would measure fair value at the *delivery date.*
- If the fair value of the goods or services is measured by reference to the equity instruments granted, the entity would measure the fair value of the equity instruments at the *grant date.*

We are confused by the proposed guidance as it relates to the measurement date for transactions with non-employees entered into as <u>firm commitments</u>, as defined in paragraph 10 of IAS 39. We believe that the guidance leads to inconsistent and inappropriate accounting results depending on whether (a) the transaction is share-based versus cash-based and (b) for share-based transactions, whether the fair value of the goods or services is more readily determinable than the fair value of the equity instruments granted. Overall, we believe that the measurement date should be consistent for *all* transactions with non-employees.

Share-based versus cash-based transactions

Assume that an entity enters into a firm commitment to acquire goods (for example, equipment). Delivery will occur six months after the date the entity enters into the firm commitment. The fair value of the goods is readily determinable. We note the following:

- Under current IAS and US GAAP, if the entity pays cash for the equipment, it would record the equipment at the delivery date at historical cost measured *at the date the entity entered into the firm commitment.* The equipment would be recorded at the same amount if the entity pays with gold, oil, etc.
- Under the proposed guidance in the Exposure Draft, if the entity pays for the equipment with shares or other of its own equity instruments, it would record the equipment at its fair value measured *at the delivery date* (six months after the date the entity enters into the firm commitment).

We question why the accounting entries and measurement dates should be different depending on the method of payment. For equity-settled share-based payment transactions, the proposed guidance would result in (a) measuring changes in fair value of the equipment after the date the entity enters into the firm commitment and (b) recording those changes in fair value directly in equity. Both of those results are inconsistent with existing accounting principles. If that is the

Board's intention, we believe the basis for those inconsistencies should be fully developed in the Basis for Conclusions. In addition, the impact on other IAS that address the accounting for firm commitments should be assessed.

Share-based transactions depending on which amount is more readily determinable

Assume that an entity enters into a firm commitment to acquire goods (for example, equipment). The entity will grant 10,000 stock options to the supplier. Delivery will occur six months after the date the entity enters into the firm commitment. We note the following:

- If the fair value of the equipment is more readily determinable, the entity would record the equipment at its fair value measured *at the delivery date* (six months after the date the entity enters into the firm commitment).
- If the fair value of the stock options is more readily determinable, fair value would be measured *at the grant date.* Based on the definition in the Glossary, we believe that the grant date would be the date the entity enters into the firm commitment.

Again, we question why the accounting entries and measurement dates should be different depending on which fair value amount is more readily determinable. Economically, we believe that the entity and the supplier set the price for a transaction at fair value at the date of the firm commitment. We believe that the transaction should be recorded based on the price set at that date.

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 the grant date (paragraph 8). Do you agree that this is the appropriate date at which to measure the fair value of the equity instruments granted? If not, at which date should the fair value of the equity instruments granted be measured? Why?

We agree with the proposed requirements. In addition, we strongly support the Exposure Draft's proposal that employee and non-employee stock-based compensation transactions should be accounted for similarly. Under US GAAP, many companies find that EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" (EITF 96-18), has been extremely difficult to apply in practice. We understand that even public accounting firms that specialize in such accounting issues view EITF 96-18 as a beguiling array of rules that are impossible to apply consistently. The Exposure Draft presents a much more practicable methodology by using the grant date as the measurement date for non-employee transactions where the fair value of goods or services is not readily determinable. Further, we do not believe that the EITF adequately justified its rationale for using a different model for non-employees. In our view, a consistent methodology will increase comparability and transparency in the financial statements, and eliminate an approach that has frustrated many preparers and auditors since it was first issued as an EITF consensus.

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 believe that the rebuttable presumption provides useful guidance. Instead, we believe that the general principle to measure 'whichever is more readily determinable' is sufficient and more consistent with the IASB's principles-based approach to standard setting. For example, we believe that the more readily determinable fair value for consulting, legal and similar services should be determined on a case-by-case basis.

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

As discussed under Question 6, we support the Board's principles-based approach to standard setting. However, because stock options are generally part of an employee's overall compensation package, we do not believe that the fair value of employee services received is more readily determinable than the fair value of equity instruments granted. Therefore, we agree with the proposed requirements and note that the guidance is consistent with US GAAP.

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?

Overall, we agree with the proposed requirements and note that the guidance is consistent with US GAAP. As stated in the Basis for Conclusions (paragraph BC192), some argue that employee awards that contain future vesting requirements are granted, in part, for past services. We agree with that statement; however, we believe that there is no reasonable or practicable method to determine the portion of the award that relates to past services. We do not believe it is reasonable to assert that employee awards with future vesting requirements are granted *entirely* for past services. As such, we believe that the proposed requirements are reasonable and appropriate.

We recommend that a final IFRS address situations in which the vesting period specified in an award is different from the required service period (awards that 'vest' due solely to the passage of time). For example, assume that a counterparty must provide one year of services in order to vest in an award. However, the terms of the award state that the counterparty cannot exercise the award for five years. We believe that, in substance, the counterparty vests in the award after year one; the terms of the award merely contain delayed exercise provisions. The fair value of the award should be recognized as an expense over the one year that the counterparty provides services.

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 believe that compensation expense should be recognized only for awards that ultimately vest. This principle is consistent with the guidance in US GAAP under FAS 123 for all awards, and the treatment under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, for awards that result in compensation expense. We strongly disagree with the Exposure Draft's proposed treatment of forfeitures whereby the expense already recognized for equity instruments ultimately forfeited is not reversed. Although we acknowledge that services have been received prior to the forfeiture, the fact that the employee forfeited the awards indicates that the services were not provided as consideration for the awards. As such, we believe that the measurement and recognition model in FAS 123 (as it relates to vesting conditions and forfeitures) is superior to that in the Exposure Draft from a conceptual standpoint.

We note that the proposed 'units of service' methodology requires estimates of the *number* and *timing* of expected forfeitures. Entities may not have sufficient historical information to make reliable estimates upon adoption of a final IFRS. Additionally, the fair value per option will often be over- or understated under the Exposure Draft's methodology because forfeitures estimated at the grant date are not subsequently adjusted to actual experience. The differences between estimated and actual results accumulate over time, resulting in recognition of expense that is not truly reflective of actual experience. We do not understand how this result is any improvement over the FAS 123 approach. As such, we believe that the measurement and recognition model in FAS 123 (as it relates to vesting conditions and forfeitures) is superior to that in the Exposure Draft from an operational and practical standpoint. Under the FAS 123 model, the cumulative compensation expense recognized accurately reflects the number of awards that ultimately vest.

We also note that if a cash bonus is being accrued for an employee and that employee terminates his employment prior to receiving his bonus, that accrued amount is reversed to income. While we acknowledge that a cash bonus is a liability rather than equity—and that some may argue that a different accounting treatment is therefore necessary—we believe that a forfeited employee option is so similar to an unearned cash bonus that a similar accounting result should be expected. In our view, justifying different treatment based on a technical accounting argument produces the kind of counterintuitive accounting result that perplexes financial statement users.

Question 10: In an equity-settled share-based payment transaction, the draft IFRS proposes that having recognized 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 recognizing a transfer within equity, i.e. a transfer from one component of equity to another. Do you agree with this proposed requirement? If not, in what circumstances should an adjustment be made to total equity and why?

See comments under Question 9 above.

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 discussed under Question 3, we believe that unlisted entities should be allowed to use the minimum value method to measure the value of equity instruments granted to employees.

Question 12: If an option is non-transferable, the draft IFRS proposes that the expected life of an option rather than its contracted life should be used in applying an option pricing model (paragraph 21). The draft IFRS also proposes requirements for options that are subject to vesting conditions and therefore cannot be exercised during the vesting period (paragraph 22). Do you agree that replacing an option's contracted life with its expected life when applying an option pricing model is an appropriate means of adjusting the option's fair value for the effects of non-transferability? If not, do you have an alternative suggestion? Is the proposed requirement for taking into account the inability to exercise an option during the vesting period appropriate?

Both FAS 123 and the Exposure Draft require that the option pricing models use expected life, rather than contractual life, to reflect the nontransferability of the option. In fact, this is the only prescriptive discount required by the Exposure Draft. We question why this particular discount is the only one that the IASB has chosen to specifically mandate. In our view, companies should be given latitude to determine whether the use of expected life is, in fact, the most appropriate way to adjust the fair value per option to reflect nontransferability. While use of expected life as opposed to contractual term does reduce the value of an option, and therefore is directionally correct, we are not aware of any empirical studies that would suggest the resulting discount is adequate, nor that it is the only way to value non-transferability.

In general, we note that there is little or no guidance under US GAAP or IAS in valuing other subjective items such as derivatives, financial guarantees, and intangible assets. We believe that companies should be afforded the same judgment in valuing employee stock options as they are in valuing other material accounting items. We do not object to general guidelines, however, of parameters or variables that companies should consider in the valuation. Overall, we support a

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principles-based approach to valuing stock options and recommend that the requirement to use expected life be removed from a final IFRS on share-based payment.

Question 13: If a grant of shares or options is conditional upon satisfying specified vesting conditions, the draft IFRS proposes that these conditions should be taken into account when an entity measures the fair value of the shares or options granted. In the case of options, vesting conditions should be taken into account either by incorporating them into the application of an option pricing model or by making an appropriate adjustment to the value produced by such a model (paragraph 24). Do you agree that vesting conditions should be taken into account when estimating the fair value of options or shares granted. If not, why not? Do you have any suggestions for how vesting conditions should be taken into account when estimating the fair value of shares or options granted?

We agree with the proposal in the Exposure Draft to take vesting conditions into account by incorporating them into the application of an option pricing model or by making appropriate adjustments to the value produced by such a model. In addition, we believe that compensation expense should be recognized only for awards that ultimately vest (see comments under Question 9). By incorporating vesting conditions into the valuation of stock options, and only recognizing compensation expense for awards that actually vest, we believe that cumulative compensation expense will be more accurately reflected in the income statement.

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 support the proposal that the fair value of options with reload features should be measured at grant date, as opposed to the FAS 123 approach where each reload is valued as a separate grant. We understand that option pricing techniques have sufficiently evolved since the issuance of FAS 123, such that reload features may be measured as part of the original option valuation. This results in an expense amount that truly reflects the premium value of an original option grant with a reload feature, which we believe is consistent with a grant date valuation objective.

We request additional guidance on the periods over which the fair value of the reload option should be recognized. Specifically, should the fair value measured at the grant date be recognized (a) entirely over the vesting period of the initial grant or (b) split between the vesting periods of the initial grant and each reload grant? If the IASB believes that (b) is the appropriate answer, we request additional guidance on how to allocate the total fair value to each vesting period.

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?

As stated above, we support a principles-based approach and believe that companies should be afforded judgment in valuing employee stock options. We do not object to general guidelines of parameters or variables that companies should consider in the valuation. However, we do not believe that a final IFRS should specify *any* requirements for taking into account various features common to employee share options. In particular, we believe that companies should be given latitude to determine whether the use of expected life is, in fact, the most appropriate way to adjust the fair value per option to reflect nontransferability. See additional comments under Questions 11,12 and 13 above.

Question 16: The draft IFRS does not contain prescriptive guidance on the estimation of the fair value of options, consistent 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?

As discussed above, we strongly support the principles-based approach to valuing stock options. See specific comments under Questions 11, 12, 13 and 15 above.

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 recognize additional amounts for services received during the remainder of the vesting period, i.e. additional to the amounts recognized 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 with the requirements for measuring the incremental value granted upon modifying a stock option. However, as discussed in Question 9, we do not support the 'units of service' methodology or the requirement to recognize compensation expense for awards that do not ultimately vest. As such, we believe that the incremental value should be recognized over the remaining vesting period consistent with the guidance in FAS 123.

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 recognize the services rendered by that 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 agree with the requirement to measure additional compensation expense if an award is settled at greater than fair value at the settlement date. We do not agree with the proposed requirement to continue to recognize compensation expense for services rendered by the grantee in the remainder of the vesting period. In practice, we believe that there are limited circumstances in which an entity could unilaterally cancel a share or option without providing some form of remuneration. Accordingly, we believe that absent evidence that a replacement award or other remuneration was granted, previously recognized compensation expense for a cancelled award should be reversed, and no additional compensation expense should be recognized. The appropriate accounting can only be determined on a case-by-case basis.

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

We agree with the proposed requirements. Please see our request for additional guidance on hedging stock options and stock appreciation rights below.

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 the 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 believe that the proposed requirements are overly complicated. We support the guidance in FAS 123:

- If the entity has a choice of settlement methods, the award should be accounted for as an equity-settled share-based payment transaction (unless the entity generally settles in cash or settles in cash whenever a grantee requests cash settlement).
- If the grantee has a choice of settlement methods, the award should be accounted for as a cash-settled share-based payment transaction.

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

We agree with the proposed disclosure requirements. We note that the disclosure requirements are consistent with the requirements under US GAAP and provide useful information to the users of financial statements.

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 than 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 (i.e. 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 proposes requirements appropriate? If not, please provide details of your suggestions for the IFRS's transitional provisions.

We support the proposed transition guidance.

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 recognized in the income statement. Are the proposed requirements appropriate?

Under the Exposure Draft, all tax effects related to equity instruments would be recognized in the income statement. This differs from FAS 123, which requires a more complex approach that may result in either an income statement or equity effect, or both. We believe that the FAS 123 requirements are overly complex. The IFRS approach is much more practical and in our view reflects—through income—the effect of real cash flows realized through the income tax benefits associated with employee stock options.

We request that the IASB clarify that income tax benefits received by an entity upon the exercise of stock options should be reflected in the Operating Activities section of the statement of cash flows, consistent with the guidance under US GAAP in EITF Issue No. 00-15, "Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option."

We request that a final IFRS provide guidance on when employer payroll taxes related to employee share-based payment transactions should be recognized. EITF Topic No. D-83, "Accounting for Payroll Taxes Associated with Stock Option Exercises," and EITF Issue No. 00-16, "Recognition and Measurement of Employer Payroll Taxes on Employee Stock-Based Compensation," provide explicit guidance under US GAAP.

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Question 24: Comparison of Exposure Draft to FAS 123

See above for our comments on differences between the Exposure Draft and FAS 123. In summary:

- We support using a fair value method to recognize stock-based compensation expense and believe that it provides greater transparency to financial statement users regarding a company's use of stock-based awards. As such, we would not support a final IFRS that permits entities to measure stock-based compensation expense using the intrinsic value method because we do not believe it provides useful information to the users of financial statements.
- We believe that nonpublic companies should be permitted to use the minimum value method when estimating the value of stock options granted to employees.
- We support the proposal in the Exposure Draft that the fair value of options with reload features should be measured at grant date, as opposed to the FAS 123 approach where each reload is valued as a separate grant.
- We object to the proposed 'units of service' methodology in the Exposure Draft. We prefer the recognition approach in FAS 123 and believe that no expense should be recognized for awards that do not vest.
- We strongly support the Exposure Draft's proposal that employee and non-employee stock-based compensation transactions should be accounted for similarly.
- We support the Exposure Draft's proposal that all tax effects related to equity instruments would be recognized in the income statement.

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

Request for Additional Guidance

We request additional guidance on hedge accounting for stock-based compensation contracts. IAS 39 does not currently address whether and how stock options and other stock-based compensation contracts would qualify for hedge accounting. We request that a final standard (either IAS 39 or the final IFRS on share-based payment) address those issues. Alternatively, we request that the IAS 39 Implementation Guidance Committee address those issues concurrent with the issuance of a final standard on accounting for share based payment.

We note that the Exposure Draft would require share appreciation rights (SARs) that will be settled in cash to be measured at fair value. The entity would accrue the related liability over the vesting period. One reason that entities enter into derivative contracts related to their own shares is to hedge the resulting profit and loss (or cash flow) impact of SARs. It is not clear from the Proposed Amendments to IAS 39 whether such contracts will qualify for hedge accounting under either the fair value or the cash flow model. To the extent that hedge accounting is not permitted, changes in fair value of a purchased call option would not match the changes in fair value of the SARs recognized in earnings. We believe that hedge accounting should be permitted on the basis that a purchased call option would provide an effective economic hedge of the liability under the SARs. We note that FASB Statement 133 Implementation Issue No. G1, "Hedging an SAR Obligation," provides guidance on this issue under US GAAP.

If you have any questions or require more information, we would be pleased to discuss our comments with you in more detail.

Sincerely,

/s/

George C. Schleier
Vice President and Deputy Controller