CL 70

March 7, 2003

Kenichiro YOKOWO
Manager, Economic Law Group,
Economic Policy Bureau,
Nippon Keidanren (Japan Business Federation)

Comments on the Exposure Draft of ED 2 Share-based Payment

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 are consumed.

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

[Answer]

These recognition requirements are not appropriate for the following reasons:

1) share-based payment transactions are transfers of welfare between new shareholders and existing shareholders and do not cause any reduction of assets of the entity,

2) in many cases there is no market price to measure the fair market value of equity instruments granted. On the other hand, the option pricing model is not sufficiently reliable and the estimated value would misrepresent the value of the instruments. In the case of unlisted (non-public) equities, the probability of misrepresentation would be much higher,

3) even in the U.S. where share-based payment is widely prevailed, the U.S. GAAP does not require the recognition of an expense,

4) the proposed recognition of an expense causes to jeopardize the growth of venture companies which are most likely to use the share based payment, thereby impeding the developments of new industries.

*As we mentioned the above, we believe that the recognition requirements are not appropriate. Therefore, the following answers are just for the case that the IASB would not withdraw the proposal of recognition requirements. Answering the following questions does **not** mean that we accept the recognition requirements.*

Question 3

For an equity-settled share-based transaction, the draft IFRS proposed 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 transaction at fair value. Fore example, there are no exemptions for unlisted

entities.

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

[Answer]

The measurement principle is not appropriate. The entity should measure the goods or services received only directly at the fair value of the goods or services received but not indirectly by the reference to the fair value of the equity instruments granted for the following reasons:

(1) the value of the equity instruments fluctuates with factors unrelated to the value of the goods or services received by the entity of the equity instruments;

(2) also, the measurement date affects on the value.

As to be discussed later, the corresponding account on the credit side should be classified into a liability

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 (paragraph 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?

[Answer]

We believe that the goods or services received should be measured at their fair value whether their fair value is more readily determinable than that of the equity instruments granted or not.

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 (paragraph 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?

[Answer]

We believe that the goods or services received should be measured at the fair value whether their fair value is more readily determinable than that of the equity instruments granted or not.

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, ie a transfer from one competent 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?

[Answer]

We do not agree to the proposed requirement. If the equity instruments granted do not vest or, in the case of options, the options are not exercised, the entity should make subsequent adjustments to total equity because the unadjusted equity causes creditors to misunderstand the financial conditions of the entity. The adjustment should be made in all circumstances.

We also do not agree to the idea of the equity-classification on which Question 10 is premised. When the share-based payment is recognized, the corresponding account on the credit should be classified as a liability since there is a possibility that the equity instruments granted do not vest or, in the case of options, the options are not exercised. If the corresponding account on the credit side were classified as equity, the presentation would mislead creditors. Therefore, the corresponding increase is tentatively credited to a liability until the options are exercised.

Question 18

If an entity cancels a share of 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 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?

[Answer]

The proposed requirements are not appropriate. If an entity cancels a share of option grant during the vesting period, the entity subsequently should de-recognize the canceled share of option grant because the presentation would mislead investors and other relevant persons.

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.

[Answer]

The proposed requirements are not appropriate. The notion that the entity should remeasure the fair value of the liability at each reporting date, with any changes in value recognised in the income statement is not compatible with existing IFRSs which adopt the historical cost method to liabilities.

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.

[Answer]

The proposed requirements are not appropriate. The IFRS should apply only to share based payment that is granted after the effective date of the 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 numberof 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 recognized 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.)

[Answer]

(a) we support the policy of SFAS 123 allowing entities to apply instead the intrinsic value measurement method.

(b) As discussed in the answer to the Question 10, we do not support both SFAS 123 and the draft IFRS.

****