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Dear Sir David

Exposure Draft ED 2 Share-based Payment

We are responding to your invitation to comment on the above exposure draft on behalf of the worldwide organisation and Global IAS Board of PricewaterhouseCoopers.

We agree that there is an economic cost to shareholders where rights to shares are granted in exchange for goods and services. Current accounting and presentation fails to give sufficient transparency to this effect, thus we support including a cost in the income statement to reflect the value of the goods and services which the entity has received.

Support for a new IFRS on share-based payment

A standard on share-based payment is needed urgently. We strongly support the fact that the Board has proposed a principles-based standard with a reasonable degree of clarity in its requirements. However, we are concerned that in proposing different methods for awards to employees and separately to third parties the standard contains an unwarranted level of complexity. The two methods should be conformed.

Grant date measurement for equity settled transactions

We agree with the principle of using fair value to measure the rights to shares issued in exchange for goods and services, and believe that grant-date measurement combined with service date recognition is a pragmatic and practicable approach to reflecting the underlying economics of equity settled transactions. However, we have concerns about whether existing valuation techniques such as option pricing models have the ability to measure the fair value of certain types of awards with a high degree of reliability. We also have concerns over the application of the units-of-service method to awards other than to a large group of homogenous individuals.

Option pricing models

The valuation technique to be used should be the one that is robust and best reflects the economics of the transactions. Individual option pricing models should not be specified as these valuation techniques will be refined as experience is gained in applying this standard, and such developments should not be restrained. We understand from discussions with valuation experts that the more complex an award's vesting terms, the more difficult the valuation issues and the wider the range of values that might be assigned by different valuation practitioners. That is, under certain circumstances such information may not currently be sufficiently reliable and comparable amongst entities.

We have significant concerns about the ability of some existing valuation techniques such as Black-Scholes to measure reliably the fair value of complex awards at the date of grant. This is because the entity will need to estimate the fair value of the award taking into account whether specific performance objectives will be achieved, and the performance conditions are often interrelated. For example, an award might link a personal performance hurdle, the listing of the entity within a specified period, and the achievement of a specific market share. There will be considerable subjectivity in forming those estimates.

The standard should be enhanced by further implementation guidance and examples, particularly in the area of assumptions to be included in option pricing models and the effects of a range of scheme modifications and scheme performance conditions that arise in practice. We will forward to you a list of scheme modifications and scheme performance conditions that we have observed in practice.

Working with partner standard setters

We urge the IASB and other standard setters to resolve any differences in the recognition and measurement methodology and to dialogue with valuation specialists on option pricing models so that consistent conclusions are reached on a global basis. In this respect we welcome the positive action of the FASB in inviting comments on adding a project on stock-based awards to its agenda. We have encouraged the FASB to do so as an urgent priority, given the two Boards' stated goal of achieving greater convergence. We urge the two Boards to release final standards on share-based payment in close proximity to each other and with similar effective dates, in order to achieve a level playing field across the world's largest capital markets.

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?

Answer

Yes, we agree with the scope. However, the Board needs to ensure that the requirements for wholly cash-settled transactions are consistent with IAS 39.93 to avoid any inconsistency between the cost of services and the cost of finance.

We encourage the Board to consider including shares issued as part of a business combination when it is in a position to conclude on their treatment in Phase II of the business combinations project. In paragraph 3, IAS 28 and IAS 31 should also be referred to when considering transactions that are in the scope of another IFRS. The Board should also include a consequential amendment to SIC 12.6 to delete the reference to " equity compensation plans", since we believe that the majority of ESOP and similar trusts should be consolidated in the sponsoring entity's financial statements.

We support the development of standards that are based upon principles that reflect the underlying economics and that contain few, if any exceptions. We therefore support paragraph 1 of the proposed FRS that contains no exceptions for certain types of plans. Employee share option plans (ESOP), employee share purchase plans (ESPP) and save as you earn plans (SAYE) are all examples of programmes that form part of the overall benefits enjoyed by employees in return for their services. We therefore agree that such programmes should be accounted for in a manner consistent with other share-based plans.

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?

Answer

Yes, they are appropriate. The Board needs to undertake a project to consider more widely the model that should apply to other transactions between entities and shareholders, and between entities and fellow subsidiaries. The Board should then revisit and update the Framework so that consistent conclusions will be drawn in other circumstances.

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?

Answer

Yes, the measurement principle is appropriate. We believe that requiring similar measurement methodologies – that is, at fair value - for both public and non-public companies is consistent with a principles-based approach. We agree that all entities should be required to apply the requirements of the standard.

As set out in our covering letter, we have significant concerns about the reliability of the fair value measurement of some options, particularly those that that have complex and interrelated performance criteria and those issued by start-up entities. Further, we anticipate that the range of values that will be arrived at by valuation practitioners will be significant, particularly in relation to entities that are dependent upon a single product that is at an early phase of development.

The basis for conclusions should indicate why the Board chose to use the term “more readily available” rather than “more reliable”. The text needs to be clear that reliability considerations should not be ignored.

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?

Answer

No. We do not agree that this is the appropriate date at which to *measure* the fair value of the goods or services received. We believe that they should be measured at the grant (contract) date and recognised upon delivery. This treatment is consistent with the proposed principle for employee options where the *measurement* of employee awards is the grant date. This will remove conflicting principles from the standard.

Grant date should be the date of an irrevocable agreement between the entity and the counterparty. This is when the entity and the counterparty have an agreed understanding of the terms and conditions of the arrangement, and the agreement is unconditional on the approval of other parties. For example, this might be the date that a purchase order is accepted or a contract is signed, that identifies the detailed terms and conditions of the shares to be issued.

Such a transaction should then be *recognised* in accordance with the relevant IFRS when the goods or services are delivered, being treated as an executory contract in the interval.

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?

Answer

Yes, we agree. We consider that the grant date measure is a pragmatic and practical surrogate for the fair value of the goods and services received.

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?

Answer

No, we do not agree.

The Board should simplify the draft IFRS by making the requirement in paragraph 7 apply equally to employee and non-employee transactions and by including a rebuttable presumption that the fair value of the equity instrument is more reliable than the fair value of the goods or services received. Guidance should be given that the presumption could be overcome where there are frequent cash market transactions for the goods.

Where the grant of the equity instruments is to parties other than employees, there may be no restrictions (such as a vesting period). For example, a listed company may pay for goods or services by issuing immediately tradeable shares to the supplier. In these circumstances the fair value of the equity instruments granted is more readily determinable. Whilst we have experience of shares being used for tangible fixed assets that can be bought " off the shelf ", transactions that are not uncommon include shares exchanged for retail distribution commissions for a new and untested product, legal services for start-up businesses and for advertising and warrants issued for joint product development. Thus there are many instances where the fair value of the services being received is not more reliably determinable than the fair value of the equity instrument.

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?

Answer

Yes, except that we recommend that the Board consolidate the employee and non-employee related text in the standard. Thus employee share awards would also be covered by guidance on the circumstances when reliable measurement of the services would be possible (see question 6

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?

Answer

Yes, we agree. Whilst we can see considerable merit in attempting to allocate a greater proportion of the cost to a performance period, we have been not been able to determine a robust basis for allocation. Accordingly, so long as an employee must continue to provide service to earn an award, we believe it is appropriate to attribute a time-based portion of the total compensation cost to the periods in which that service is provided.

We have concerns over the practical application of this approach where an award only vests upon the occurrence of a specified event, for which additional guidance would be helpful. For example, it is not uncommon for employers in development stage companies to incentivise employees with rights to shares that will crystallise only on an initial public offering and for which they will have to agree not to sell their shares for a period thereafter. This gives rise to a variable vesting period and a consequential variable date at which the employee can obtain cash in the market.

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?

Answer

Yes, we support the unit of service approach although it does introduce significant additional complexity. Furthermore, it produces counterintuitive results in cases where the vesting period is contingent on events outside the control of the entity.

We agree with the general principle contained in the proposed IFRS that compensation cost is recognized as an expense over the period in which the counterparty provides service to the entity. We favour the proposed model in which the entity recognizes the value of service rendered in exchange for the award rather than a model that is predicated upon whether or not an award vests. Accordingly, we believe that the proposed IFRS provides a method that is reasonably representative of the economics of the share-based transaction, because it reflects the value of goods or services received by the entity, independent of whether or not the award ultimately vests.

The examples of the application of the unit of service method included in the Proposed IFRS are based upon awards to a large group of homogenous individuals. We have concerns about how entities are expected to apply the unit of service method to a grant to a single employee and where an award vests only upon achievement of a performance condition. Additional examples would be helpful to illustrate how the model should be applied in such situations.

Guidance would also be helpful in relation to an award to one employee that is individually material. It should address what should be considered in assessing the probability of the individual remaining in office until the end of the vesting period.

Guidance on variable vesting periods would also be useful. For example, where an award is made to a CFO that vests only upon an IPO. In order to apply the unit of service approach, the entity will estimate *when* the IPO will occur. If the period until an IPO is initially assessed as three years, when year four and five arrive without the IPO occurring the proposed IFRS requires that compensation cost continue to be recognised each year, until the rights are cancelled or the IPO takes place.

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?

Answer

We agree with the proposed requirement subject to the concerns expressed in our response to question 9. This is consistent with the principle of recognising a cost in each period related to the performance of services by the employees and the receipt of services by the entity. We agree that if the grant date approach is used and the adjustment for lapses and forfeiture are taken into account in the option pricing model to ascertain a fair value, then the treatment proposed in paragraph 16 is appropriate.

It would be helpful if the implementation guidance could address transfers within equity. In our view it would be useful for an option reserve to be credited when services are received for options granted. When the shares are issued, the entity should transfer the related amounts from that option reserve to paid in capital. When the rights are forfeited, the equity should transfer the related amounts from that option reserve to another reserve such as retained earnings.

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?

Answer

Yes, we agree that an option pricing model should be used. One of the key issues regarding share-based payment is the need to derive a service charge that is reliable. For most employee options there will not be a ready market for these options or similar options that are being traded and hence we agree that an option pricing model is the most appropriate method of determining a fair value.

Currently, the draft IFRS does not prescribe the option pricing model that should be used, and we support that approach. However, different fair value models could produce very different results for comparable transactions. The objective should be an option pricing model that is robust and best reflects transactions that would take place in the market.

We have significant concerns about the ability of some existing valuation techniques such as Black-Scholes to measure reliably the fair value of complex awards at the date of grant. This is because the entity will need to estimate the fair value of the award taking into account whether specific performance objectives will be achieved, and the conditions are often interrelated. For example, an award might link a personal performance hurdle, the listing of the entity within a specified period, and the achievement of a specific market share. There will be considerable subjectivity in forming those estimates. In our experience it may be necessary to develop binomial models or undertake Monte-Carlo simulations to arrive at reliable option valuations – the use of such modelling techniques create additional costs.

The final standard should give in the implementation guidance examples of application of the models so that preparers of financial statements can compare the results. Examples could include the situation where leavers maintain their options, where there are variable or accelerated vesting conditions, or where employees agree to cancel their options without leaving the company (eg where in a SAYE scheme an employee chooses to withdraw his contributions and not take up the purchase of shares).

The Board should undertake field-testing and use the practical experience obtained to enhance the guidance on the use of models.

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?

Answer

Yes, we agree that the expected life should be used. We understand the reasons for replacing the contracted life with expected life when applying an option pricing model, and in principle agree that it is an appropriate means of adjusting the option's fair value for the effects of non-transferability.

Some valuation techniques will require the use of additional factors beyond those used in current option-pricing models. Some of the factors more frequently cited are the impact of vesting provisions, non-transferability provisions, or the ability to "early exercise" an award. We encourage the Board to discuss this further with subject matter experts in order to gain first hand knowledge of the types of techniques that might yield reliable fair value measures.

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?

Answer

Yes, we agree that vesting conditions should be considered when estimating the fair value of options or shares granted.

We believe that insufficient consideration has been given to the fact that performance condition and the value of an option are often related. For example, assume there is an option which has a Black-Scholes value of say $50 before considering any vesting condition and there is a performance condition which has a 50% chance of being met. The 'fair value' of the option will not be $25 because many of the outcomes where the performance condition is not met would be where the option had little or no value at exercise (eg the option is underwater).

All vesting conditions should be incorporated as an integral part of the application of an option pricing model. This needs to be more robust than simply permitting an adjustment to the value obtained by a model as suggested in the last sentence of paragraph 24. This latter approach could lead to a significant error in estimating fair value.

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?

Answer

No. We do not agree and believe this needs a rethink. The text seems to establish a rule for a specific circumstance rather than a principle, and where possible those principles should be simple to apply. Which is the principle that is being addressed here?

The proposed requirements in relation to reload features are over complicated and there is no explanation as to the need for these requirements. Of concern to us is that the features of a reload option have some similarities to annual schemes. A not uncommon arrangement is that companies match employee deposits with an additional promise to issue a matching number of additional shares if the employee uses these funds to subscribe for company shares at a date in the future. Is the principle behind the reload feature the fact that there is an automatic award, or that the award only arises when the employee takes an action, or that the award is priced at the date of the employee action ?

Based upon discussion with valuation experts, we are not convinced that valuation techniques have evolved sufficiently to value reliably a reload option at the date of employment or on introduction of a scheme. Accordingly we believe that rolling awards including reload features should be treated as new grants on the date that additional options are awarded if that is more reliably measurable. The disclosure in Appendix D under "Share options - Arrangement 2" relating to the reload feature appears to support our view.

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?

Answer

We believe that the standard would be enhanced by additional guidance in certain areas. To assist you in this process we will forward to you a list of scheme modifications and scheme performance conditions that we have observed in practice.

As explained in our response to question 14 we consider that the principles should not be over complicated when considering the application to specific examples. Indeed we consider that if guidance is given for specific variants to share-based payment transactions, new variants will be introduced which are not addressed in the standard and therefore the principles may be subject to abuse. Therefore the text should make clear that these are examples of applying the principles.

Examples of circumstances that need to be taken into account include:

(a) restrictions over the ability of an employee to transfer or hedge shares post-vesting (such as an IPO lockup period);

(b) variations in vesting date and roll over arrangements triggered by performance targets (regularly retested targets) or by external events outside the control of the entity, such as an IPO, take over or merger;

(c) the effect of an employee paying income tax on exercise of an option; and

(d) annual schemes that the employer can in principle withdraw at any time but have become informal practices giving rise to a constructive obligation.

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?

Answer

Yes. We agree with the approach of setting principles-based standards. However, as detailed in our response to question 11, we have concerns over the comparability of similar option grants. Therefore, we would recommend that in the final standard there are examples in the implementation guidance of how to apply the different valuation techniques for different share or option grants.

As noted in our response to question 11, we would also welcome the results of field-testing to support the different valuation models.

Question 17

If an entity re-prices 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?

Answer

Yes, we agree with the incremental value approach. However, we have a different view of the appropriate treatment of any amounts that would be charged to future periods – see question 18.

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.

Answer

We agree with the proposal that a contractual repricing of an existing option should continue to result in the original charge being spread forwards. However, where there is no direct contractual linkage we support a different approach. As a matter of principle there should not be an accounting expense for a contractual arrangement that is no longer in place between the employer and employee (unless there is a constructive obligation). We believe that cancellation by an entity will arise only in the circumstances that alternative compensation is being awarded by other means. Consequently the entity should not continue to charge for cancelled share-based payments, but instead the amount that would have been charged against future periods should be charged immediately together with the incremental fair value, as addressed in question 17.

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 (paragraphs 31-34).

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

Answer

Yes, we agree with the proposal. As noted in our response to Question 1, the Board needs to ensure that the requirements for wholly cash-settled transactions are consistent with IAS 39.93 to avoid any inconsistency between the cost of services and the cost of finance.

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.

Answer

We agree that when the counterparty has the choice an entity should account for cash-settled share-based payment transactions as a liability.

However, where the entity has the choice of settlement in cash or shares, the transaction should be treated as a share-settled transaction only where it is highly probable that the entity will exercise the option to use shares. A history of settling in shares should not determine the treatment but it should influence the assessment of the probability of the manner of settlement.

The approach in paragraph 44(c) needs to be clarified. If the entity had accounted for a transaction as equity-settled (say 100) and this has a higher value than the cash alternative (say 80), the entity has already accounted for the 100 and there is nothing further to record. Conversely if the entity accounted for the transaction as cash-settled (80) but then settles in shares (100), there is nothing in paragraph 44(c) to catch the extra value in the income statement. Paragraph 44(c) appears to apply to both paragraph 43 and 44 and therefore it should be a separate main paragraph.

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)?

Answer

Certain disclosures appear particularly onerous and seem to address anti-avoidance issues rather than disclosures that enable the users of the financial statements to understand the impact of the share-based payment transactions in force.

We support the disclosures of the model used and of the model's inputs (paragraph 48(a)(i)). However, the requirements of para 48(a)(ii) to (iv), in particular the historical comparisons of volatility, appear unnecessarily onerous.

Paragraph 46(c) will require information to be collated on a person by person basis and there could be many different exercise dates during the year. The Board should clarify whether for each separate exercise date the weighted average share price is required or whether it is a composite weighted average share price for all options exercised during the period.

Under paragraph 48(a) if the fair values disclosed are weighted averages, then the assumptions disclosed should be weighted or should be a range. Otherwise the requirements are very onerous for entities that issue a large number of grants during the year.

Paragraph 48(e) needs clarifying: what is the "or would have vested, if the specified performance conditions had been satisfied"? Is this just the number outstanding that have not vested in earlier years?

We do not support the requirement in paragraph 52(b) to split out the cash and equity component of the expense. We do not believe that " would have been " disclosures are necessary. Further, in situations where there are a large number of forfeitures the cash component may be negative, whereas the equity component cannot be negative. If the Board retains this requirement it should be articulated more clearly perhaps by using the text in BC237 in the Basis for Conclusions.

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

No, we do not agree. The transitional provisions for equity-settled share-based payment transactions propose that the draft IFRS should be applied to all grants of shares or options after 7 November 2002 that have not vested at the effective date. We do not agree with the proposed partial retrospective approach. In addition we urge the Board to seek an agreement with the FASB to arrive at consistent first time application dates of the new standard and believe that an alternative compromise will need to be found.

We understand that this proposal has been set as an anti-avoidance/abuse measure. However, we believe that there are other controls such as shareholder approval and market scrutiny that would result in restraining entities from granting higher than normal levels of equity instruments prior to the proposals being implemented.

We believe that in order for entities to determine the effect that the standard has on their overall incentive policy, and the information that they will need to collate to comply with the standard, they should be permitted to apply the requirements of the new standard to grants awarded on or after the start of the first reporting period in which the standard will apply.

However, in order to avoid a stepped charge some entities may wish to apply the requirements fully retrospectively and should be permitted to do so if they wish. Such entities should however apply the requirements consistently to all share-based plans in the reporting group and apply IAS 8.

If, however, the 7 November cut-off is retained, the standard needs to clarify whether it applies to awards granted before 7 November 2002 but which were modified after that date.

The standard further needs to address what disclosures are needed for awards granted before whatever date is used in the transitional provisions. Currently paragraph 54 seems to exclude disclosures for options granted before 7 November 2002 but not yet vested at the effective date. Our reading is that for such options there would be no disclosure even under IAS 19, as the scope adjustment to IAS 19.1(b), set out in Appendix E3 of ED 2, does not seem to deal with such awards.

For cash-settled transactions paragraph 55 does not specify if the retrospective adjustment is made to retained earnings at the beginning of the year of implementation or to current year expense for that year. Given that the transitional provisions override the requirements of IAS 8, the Board should clarify that the adjustment should go to opening retained earnings.

Paragraph 55 states that the entity can use intrinsic value on transition but it would appear that this is only for the opening amount and not for subsequent balance sheet dates.The Board should clarify if the transition exemption is intended to apply until those 'grandfathered' SARs are settled.

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?

Answer

No, we do not support the requirement that all tax effects of share-based payment transactions should be recognised in the income statement. We support the general approach that all tax effects are recognised in the income statement except for items that are recognized in equity. The tax effects of items recognised in equity should be reported in equity alongside the items to which they relate.

However, in some jurisdictions entities receive corporate tax relief based on the personal income tax charge levied on employees and those charges are assessed based on share prices at the date of exercise of an option. In times of rising share prices this can lead to tax relief that exceeds the amount charged in the income statement for the employee services. It seems intuitively wrong for an entity to earn income from a share-based award measured at grant date.

Therefore, we recommend that any tax relief that is obtained due to the increase in the share price above the amount charged to income should be reported in equity in accordance with IAS 12.58(a).

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. For each of the 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)

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:

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

Answer

As indicated in our answer to Question 1, we support the development of standards that are based upon principles and that contain few, if any exceptions, to those principles. We therefore support the proposed IFRS that contains no exceptions for certain types of plans. In our view, employee share purchase plans are programmes that are established in order to remunerate employees for service. We therefore agree that such programmes should be accounted for in a manner consistent with other share-based plans.

(2) 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

Answer

We believe that guidance, in which companies may choose between two methods of accounting for share-based awards hinders comparability. We support the fair value method since this will reflect the underlying economics of many share-based transactions with employees, particularly those involving share options and therefore will be the most relevant measure to users of financial statements.

> **(3) 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).**

Answer

We agree that the IASB's proposed approach to calculate the fair value of equity instruments of nonpublic entities will result in a measure that more closely approximates fair value than the result obtained using the minimum value method. We acknowledge that additional effort will be required of private entities to obtain fair value information, particularly as it relates to measures of expected volatility. We believe that requiring similar measurement methodologies – that is, at fair value, – for both public and non-public entities is consistent with a principles-based approach. Because we do not believe that the minimum value method appropriately measures fair value, we do not advocate its inclusion.

(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:

> **(1) 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.**

Answer

We believe that the fair value of the right to receive a share-based award should be measured at the grant date. In order to achieve consistency under such a model, the fair value measured at the grant date would not be subsequently readjusted. We therefore believe that the effect of forfeitures must be taken into account in the measurement of fair value.

We believe the principles that are inherent in a grant date model must be followed consistently. Accordingly, we support a model that incorporates the effect of forfeitures in the initial valuation of the share-based award and recognizes that value as the counterparty renders service. Accordingly, in a scenario where an employee renders service but fails to meet a specified vesting requirement, we believe that all or a portion of the award's value should be recognized for the service received by the entity.

> **(2) 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.**

Answer

We agree with the general principle contained in both SFAS 123 and the Proposed IFRS that compensation cost is recognized as an expense over the period in which the employee provides service to the entity. We favour a model in which the entity recognises the value of service rendered rather than a model that is predicated upon whether or not an award vests. Accordingly, we believe that the Proposed IFRS provides a method that is more representative of the economics of share-based transactions, because it reflects the value of goods or services received by the entity, independent of whether or not the award ultimately vests.

The value of share-based awards should be recognized as the counterparty renders service, even if the counterparty fails to vest in the award. We believe that the units of service method achieves that objective.

Compensation cost should reflect the value of services provided, independent of the outcome of the specified performance condition. However, such models will require robust measurement techniques. As described above, while we believe that a grant date accounting model is conceptually sound, we are concerned about whether a reliable value can be determined for certain awards, for example, awards that include multiple performance requirements. This will be so particularly for an award with complex vesting provisions based upon numerous performance criteria that are measured over the period of several years. Under the consistent application of a grant date model, fair value estimates made at the grant date would reflect the effect of all restrictions, including the effect of forfeitures. That amount would not be subsequently adjusted, including circumstances where those performance or vesting criteria are not ultimately achieved.

(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.**

Answer

We support the approach for settlements of unvested awards set forth in SFAS 123, wherein the settlement of an unvested award is considered to be a deemed acceleration of that award's vesting and a simultaneous repurchase. We note that the IASB viewed this approach as preferable during its deliberations of the issue. Furthermore, we do not believe this approach is inconsistent with other aspects of a grant date model. Under a grant date model, the subsequent occurrence of events in accordance with the original terms of a share-based award (for example, forfeitures) do not have an accounting consequence. However, we believe that recognition should be given to mutually agreed amendments to the original terms of an award. We would therefore view a settlement transaction as similar to a new grant date, in that the entity and the counterparty reach a new agreement as to the terms of the award. In addition, because further service by the counterparty is not required, continued recognition of compensation expense should likewise not be required.

(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**

(e) **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.**

Answer

We see no conceptual distinction between awards granted to employees and those granted to non-employees. We therefore support a single model that will be applied consistently to both classes of service providers. We note that the terms of an award are negotiated at the inception of an exchange transaction and each party understands that provision of specified services will result in an equity award with specified terms (a certain number of shares or the right to purchase a certain number of shares at an agreed-upon price per share). The fact that the fair value of that equity instrument may later change or that the counterparty may choose not to provide the specified services should not alter the terms of that original exchange. Consider a case in which the issuer's share price declines precipitously following the grant of an option award. In that case, the fair value of that award may decline to near zero, however the services bargained for at the inception of the arrangement and ultimately received by the entity may have significant value (for example, as measured by the price commanded by similar services in the open market). Accordingly, we believe that a model that measures the fair value of the equity instrument granted based upon the initial terms of the award more accurately reflects the economics of the transaction.

(f) **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).**

Answer

Consistent with our support for a principles-based approach, we support valuing all share-based awards, including SARs, at fair value.

(g) 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

(h) 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.

Answer

We do not believe that all tax benefits derived from share-based compensation arrangements should be recognised in income. It would not be appropriate to recognise a tax benefit from the exercise of employee share options – that is, in excess of the deferred tax benefit recognised in the income statement at the time of grant - in the income statement because such tax benefits represent additional proceeds to the entity from the issuance of shares, that is, the benefit arises as a result of a capital transaction.

We are also troubled by the fact that, under the model proposed in the draft IFRS, an entity might recognise income in respect of future tax benefits that exceed the compensation expense associated with the award. It seems intuitively wrong for an entity to earn income from a share-based award measured at grant date.

Question 25

Do you have any other comments on the Exposure Draft?

Answer

(1) Paragraph 4 (debt or equity) should be subject to paragraph 35 (hybrids), otherwise paragraph 4 appears to override the need to consider paragraph 35.

(2) Paragraphs 9 and 11 should be black letter.

(3)"Pay package" is used throughout the document. Perhaps remuneration would be a better expression.

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If you have any questions in relation to this letter please do not hesitate to contact Jochen Pape, Chair of the PwC Global IAS Board (49 211 981 2905), or Ian Wright (44 207 804 3300).

Yours faithfully

PricewaterhouseCoopers