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7 March 2003

Dear Sir David

Exposure Draft of Share-based Payment

We appreciate the opportunity to respond to the International Accounting Standards Board's exposure draft of its proposed IFRS *Share-based Payment*. This letter expresses the views of KPMG International.

Currently IFRS has no recognition or measurement guidance for share-based payments to employees, and, setting aside business combinations, diversity in practice has developed regarding share-based payment for transactions with non-employees. Therefore, we support the IASB's conclusion that a standard addressing share-based payment is an important priority for the Board in order to address this gap. We strongly believe that accounting for share-based payment transactions requires a global solution.

Summary of KPMG conclusions

The discussion on accounting for share-based payments has not been without controversy and different views are held on the subject across the spectrum of possible answers, ranging from not recognising an expense to full remeasurement until vesting date.

However, after considering these differing views and alternatives, on balance KPMG supports the approach proposed in ED 2 to require grant-date measurement of the estimated fair value of compensation offered for employee services and to expense this compensation over the vesting period, as defined.

However, it is important for the final standard to acknowledge that fair value is an estimate subject to significant variability based on a valid range of possible assumptions. The approach that the Board proposed in ED 2 is an inter-dependent package of assumptions and conventions that requires a significant degree of judgement, especially when the measurement of goods or services is made indirectly by estimating the fair value of the share-based payment. Application of this approach will require estimation of a number of variables, which means that the measurement of similar transactions may vary considerably from entity to entity, based on differences in judgements about future performance of both the entity and of the individual being compensated. The ED 2 approach also results in original estimates not being adjusted to reflect actual outcomes. This may appear counter-intuitive to some especially for transactions where share-based payments are "all or nothing" rather than vesting on a pro rata basis.

Although recognising these weaknesses in the 'fair value at grant date' model, we concur with the Board's conclusion that this approach represents the best balance of alternatives that is consistent with the Board's objective of focusing on measurement of goods and services received. This measurement will, as the Board note, often require measurement based on the *estimated* value of the consideration. The assumption that the value of the goods or services, and the consideration, are equal is most appropriately made at the grant date; therefore, we support the Board's proposal to use grant-date measurement for goods and services received that are measured indirectly. However, we consider it to be very important for the Board to identify and articulate clearly for both preparers and users of financial statements the judgements, assumptions, conventions and potential anomalies the ED 2 measurement model introduces, and for all stakeholders, including regulators, to understand these limitations. This is necessary in order to avoid creating an expectation gap from an over-simplified understanding of the accounting, for example by inferring that equity- and cash-settled employee share options are accounted for in the same way.

Within the context of our overall conclusion above, the balance of this letter summarises our major comments on the Board's decisions and on the proposed structure and wording of the draft standard.

1. The use of grant-date measurement involves a significant degree of judgement and estimation. We believe the Board should:

- Articulate more clearly the basic principles involved; based on our understanding, these would be the following:
  - *"Share-based payment transactions result in the acquisition of resources; some may be assets and some may be resources that are consumed immediately and result in an expense.*
  - *The transaction is recognised as and when goods are obtained or services received; consistent with the executory contract principles, this includes recognition over the vesting period (as defined).*
  - *Where goods or services obtained or received cannot be measured directly, the share-based payment is measured at grant date at estimated fair value and not re-measured subsequently (indirect method).*

- *If the indirect method is used, and cash settlement is an option, the liability is re-measured.*
- *The indirect method must be used for employee services because the fair value of the financial instrument is more reliably measurable."*

■ Articulate the degree of judgment involved in the indirect method of determining estimated fair value: in order to measure the transaction at its estimated fair value, there must be an estimate of expected performance, which means similar packages may be measured at different values because of different estimates which are fixed at grant date. A reader working through the text and examples ultimately should grasp the Board's intended measurement approach and its implications. However, we believe it would be most helpful for the Board to spell out both its objectives and the implications. For example, *" ... when goods and services received are measured indirectly by valuing the compensation offered, the fair value at grant date is measured at its estimated value at that date. This estimated fair value is allocated across the actual service period using a units-of-service approach. This means that estimates must be made of both the value of the share-based payment promised, including any conditions, and of the expected quantity of goods and services to be obtained or received. If the quantity of goods and services obtained differs from that expected the cost recognised would differ from the originally estimated total purchase value. However, the estimate is not otherwise adjusted for differences arising from subsequent forfeitures or changes in value of the share-based payment."*

■ Emphasise the impact of different judgements: users of financial statements need to understand that differences in estimates, for example volatility of share price or of expected service from an employee, can result in different measures for otherwise similar share-based compensation packages.

■ Emphasise that grant-date measurement without subsequent truing up of assumptions means that the cost recognised for cash- and share-based payment for the same services may differ. As an illustration consider a multinational with key employees in differing jurisdictions. For tax or legal reasons, employees in some countries are given share options and in other countries equivalent employees are given cash-settled share appreciation rights on identical terms. The share options would be measured at grant date and not adjusted for forfeiture or increases in value; in contrast, the liability for share appreciation rights would be adjusted until the amount payable is fixed, for both forfeiture and changes in value of the shares. It is important that there be an understanding that ED 2 does not eliminate all differences between cash and equity-settled transactions.

■ Emphasise that the potential difference in measurement date for goods and services measured directly and those measured indirectly means there is some inconsistency within the proposals of ED 2. Although we do not see a conceptual basis for the method of measurement (direct or indirect) driving the measurement date, on practical grounds we support the proposal of measuring the share-based payment at delivery or service date where the fair value of the goods or services is measured directly. This is because we do not see a reason to change current recognition practice. While we believe that the compromises involved in consistent application of the grant-date model are justified by the arguments noted in BC 191 to 207, we prefer that this model be limited to share-based payments for services received from employees, and for goods and services from non-employees only when the fair value of those goods and services is not measurable directly.

We note that other IFRS literature uses different measurement models for share-based compensation (for example, IAS 22, *Business Combinations*). While generally we encourage the IASB to attain the highest possible degree of consistency across its standards, we encourage a cautious approach to the wider application of the model proposed in ED 2 beyond the limited set of circumstances described in its scope. Therefore we encourage the Board to make a statement comparable to that in IAS 19 *Employee Benefits* that the model is not to be applied to other arrangements by analogy.

2. Other major comments

a) We have a significant concern with the proposed requirement for the application of the units-of-service allocation method strictly on a time-based approach. In our view the unit-of-service method should be principles-based rather than rules-based. The existing method could be retained as an illustrative example of one method, but entities should be permitted to use other methods, for example one that takes into account other measures of service, such as units delivered, provided that reflects more fairly the services received.

b) We support using option pricing models to determine the fair value of options granted and not prescribing the models to be used. However, we are concerned that it will be difficult in practice to determine appropriate inputs and adjustments to an option-pricing model, particularly where market data are not available. We strongly recommend that the IASB undertake an extensive study or participate in such a study to attempt to develop more appropriate option pricing models to cope with the many variables that must be addressed in the use of grant date measurement. Until that study is completed and properly vetted, the Board should not mandate the use of any one option-pricing model to determine fair value of options and similar arrangements.

c) ED 2 excludes share-based payments from the scope of IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. Instead an approach to accounting for equity and liabilities is proposed that appears to differ somewhat from the approach in those standards.

Specifying in ED 2 the subsequent measurement for the instruments issued raises a possibility of inconsistencies between ED 2 and the accounting that would be required if IAS 32 and IAS 39 were applied. It is not clear from either the text of the proposed standard or the Basis for conclusions what the Board's intention or reasoning is for this.

On the one hand applying IAS 32/39 for subsequent accounting would avoid inconsistencies and the possibility of accounting arbitrage depending upon which standard applies; avoiding issue-specific accounting models also seems more consistent with principles-based standards. Under this approach financial instruments with similar features would be accounted for the same whether or not they fell within the scope of ED 2.

On the other hand, the proposed inconsistency may be intentional, perhaps to avoid the further complexity that may ensue in cases where share-based payments create derivatives on own shares. We have identified a few special cases, mainly those involving instruments that are settled in shares but where the number of shares varies depending upon share price, in which the accounting appears to differ (IAS 32/39 would treat the arrangement as a liability, but ED 2 appears to treat it as equity). The merit of the approach in ED 2 is that a basic principle of ED 2 – one time grant-date measurement of share-based payments – is not compromised by any subsequent remeasurement. Some would argue that applying the approach in IAS 32/39, and therefore in some cases remeasuring a share-settled liability subsequent to grant date, compromises the grant date measurement principle.

It is not clear which approach the Board intended to take. We strongly recommend that the differences are either identified and explained, or eliminated.

d) The disclosures proposed in ED 2 are too detailed. Although we appreciate the Board's desire to require disclosures that help users of financial statements to understand this complex accounting area, the level of required disclosures should depend on the relative materiality of the amounts recognised in the financial statements and the option-pricing model selected. We would support an approach to disclosure similar to that in IAS 36 *Impairment of Assets*, whereby the level of disclosure varies based on the materiality of the amounts involved. In addition, we note that the level of disclosure detail proposed in ED 2 is far greater than the level of detail required in IAS 19, which deals with similar accounting issues.

Detailed comments on the exposure draft

The remainder of our comments are organised as four appendices to this main letter:

Appendix		***Page***
A	Responses to invitation to comment questions 1-25	1
B	Financial instruments	34
C	Comments on Implementation Guidance	39
D	Drafting comments	39

Please contact Mark Vaessen at 020 7694 8089 or Joanna Osborne at 020 7694 8659 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG

KPMG

Appendix A

Responses to invitation to comment questions 1-25

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?

We generally agree that there should be no exemptions beyond those for transactions within the scope of another IFRS.

We support a scope exclusion for share-based payments in business combinations. While generally we encourage the IASB to attain the highest possible degree of consistency across its standards, we encourage a cautious approach to the wider application of the model proposed in ED 2 beyond the limited set of circumstances described in its scope. Therefore we encourage the Board to go further and make a statement comparable to that in IAS 19 that the ED 2 model is not to be applied by analogy to other arrangements outside the scope of the final standard.

There may be circumstances in which a share-based payment transaction occurs in connection with the acquisition of an investment in an associate or a joint venture. Because IAS 28.17 refers to IAS 22 we assume that the Board's intention is for such acquisitions to be excluded from the scope of ED 2, but this is not addressed explicitly. We suggest that the exemption for business combinations should be extended to acquisitions of joint ventures and associates.

Contracts to issue shares – whether entered into with employees, other providers of goods and services or others – are financial instruments. The Board have excluded financial instruments that arise from share-based payments from the scope of IAS 32 and 39. The proposed approach to accounting for these instruments under ED 2 may be inconsistent with the requirements in IAS 32 and 39 in some cases (we have summarised the differences that we have identified in Appendix B).

If the Board intended different principles to be applied in determining whether the financial instrument is equity or a liability and different subsequent accounting treatment of the resulting financial instrument, this intention, and the reasons for it, is not clear from ED 2 or the Basis for Conclusions.

In particular, we do not follow the arguments in the Basis for Conclusions (BC21-BC22) regarding the interaction of the scope of ED 2 and IAS 32 and 39. The paragraphs refer to the debit side of the entry, but fail to address whether IAS 32 and IAS 39 should apply once the measurement of the debit side has been established. BC27 states, *"… the entity has engaged in a transaction that is in essence the same as any other issue of equity instruments*".

On the one hand, applying IAS 32/39 for subsequent accounting would avoid inconsistencies and the possibility of accounting arbitrage depending upon which standard applies. We think that avoiding issue-specific accounting models is more consistent with principles-based standards. Under this approach financial instruments with similar features would be accounted for in the same way whether or not they fell within ED 2.

On the other hand, the proposed inconsistency may be intentional, perhaps to avoid the complexity of accounting for share-based payment transactions involving derivatives on own shares or because the Board consider that special rules should apply to a financial instrument in which the counterparty can control or influence the value at vesting date. We have identified a few instruments, principally those that are settled in shares but where the number of shares varies depending on the share price, which ED 2 appears to treat as equity but IAS 32 and 39 would treat as a liability. (See Appendix B) The merit of the approach in ED 2 is that a basic principle of ED 2 – one time grant-date measurement of share-based payments – is not compromised by any subsequent remeasurement. Some would argue that applying the approach in IAS 32/39, and there in some cases remeasuring a share-settled liability subsequent to grant date, compromised the grant date measurement principle.

It is not clear which approach the Board intended to take. We strongly recommend that the Board either identify and explain the differences or eliminate them.

If the Board decide to retain a different treatment for the credit side of the entry for share-based payments, it is important that the scope between IAS 32 and 39 and the share-based payment standard is delineated clearly. We believe that in some cases it is not clear whether IAS 32 (proposed revised) or the share-based payment standard would be applicable. For example, if a normal purchase transaction is entered into, and later, before settlement of the resulting payable, it is decided to settle the liability by issuing own equity, which standard should apply?

Paragraph 2 of ED 2 addresses the situation where shares of another entity in the group are transferred to the counterparty. It does not seem that this paragraph includes cash-settled share-based payment transactions in its scope. We suspect that the intention was to include all share-based payment transactions and, if so, suggest that this paragraph is reworded to clarify this. If the Board intend not to include all share-based payment transactions in this paragraph, it would be helpful to include an explanation of why.

Clarification is needed regarding whether paragraph 2 of ED 2 also is intended to apply when shares of an associate or joint venture are transferred to a counterparty or shares are transferred to a counterparty on behalf of an associate or joint venture. We believe that ED 2 should apply to these transactions.

We also believe that scope issues may arise when share-based payments are made to a shareholder who also is an employee. In these cases, if the share-based payments are in consideration for goods and services presumably they would fall within the scope of ED 2, whereas in other cases, for example in the context of a financing arrangement, they would fall within the scope of IAS 32 and 39. Clarification would be welcome.

Question 2

Paragraphs 4-6 of the draft IFRS propose requirements for the recognition of share-based payment transactions, including the recognition of an expense when the goods or services received or acquired are consumed.

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

We support the Board's reasoning and conclusion. Although it might be argued that share-based payment transactions do not fit perfectly within the definition of an expense, because it is arguable whether an asset ever existed, we are convinced by the arguments in the Basis for Conclusions that the importance of goods and services being recognised as they are consumed outweighs the argument that an asset never existed.

In certain circumstances under IFRS, expenses that otherwise normally would be recognised in the income statement may be recognised directly in equity. An example is transaction costs of issuing an equity instrument (SIC–17 and IAS 32 proposed amendments) and these may occur in connection with a share-based payment transaction. Two cases occur to us: firstly, there may be transaction costs of issuing share options to employees and secondly, a third party such as a lawyer or merchant banker may receive shares as a bonus in connection with a new issue of shares. In the case of the latter, we assume that paragraph 5 is not intended to override consistency with the treatment of such expenses if they are cash settled (i.e. recognised directly in equity as reductions of proceeds). The former case is more difficult. We cannot see an argument to follow a different principle, yet the resulting recognition of the transaction cost of employee share-based payment transactions in equity is counter-intuitive and inconsistent with expensing the service itself.

ED 2 states in paragraph 4 that the goods or services should be recognised when the entity "…obtains the goods or receives the services". In relation to non-employee transactions, we are not convinced that recognition of the transaction always should occur when the goods are obtained. Physical ownership appears to be implied by the phrase "..are obtained…", which seems inconsistent with other IFRS that have detailed requirements as to when goods or services should be recognised. Under existing IFRS the timing of recognition may differ from the date the goods are obtained or the services are received. For example, if goods were shipped free on board they would be recognised at the date they pass the ship's rail; a building or film under development would be recognised as the work is performed. Therefore we recommend that this paragraph refer to other standards with respect to the timing of recognition of goods or services to avoid possible misunderstanding.

Furthermore, there is general guidance in IAS 37.3 dealing with the circumstances in which a contract should be regarded as executory and when it should begin to be recognised. We can see no reason to follow other guidance in applying the share-based payment proposals. Accordingly, we suggest the following wording for the first sentence of paragraph 4:

"...received or acquired in a share-based payment transaction from the date that the counterparty begins to perform its obligations under the contract or in accordance with the specific recognition requirements of the relevant IFRS."

In order to deal with any uncertainty that might arise in relation to how this should be interpreted for employee transactions, we suggest the Board insert an explicit requirement for employees that performance under the contract is over the vesting period (which may be time and/or performance based). We have commented further in Question 8 on vesting period.

The Basis for Conclusions related to the credit side of the entry addresses only the measurement date, not the recognition date. In terms of IAS 39.27 a financial instrument is recognised when the entity becomes a party to the contractual provisions of the contract. IAS 39.29(b) explains that when a financial instrument arises from a transaction that gives rise to a firm commitment to purchase or sell goods or services, the financial instrument is not recognised until at least one of the parties has performed under the contract. For example, if an entity places a firm order to purchase an asset, the liability arising from the purchase is not recognised until the ordered goods are delivered. Given that the contract is an executory contract, the entity is obligated by the terms of the contract only when the other party performs under the contract. We believe these principles apply equally to share-based payment transactions, regardless of the manner of settlement i.e. the contract is an executory contract and therefore the resulting financial instrument comes into existence only when there is performance under the contract. We comment further in Question 8 on the practical application of this principle.

It is not stated clearly in ED 2 when the credit to equity or a liability should be recognised. By using the word *corresponding* in paragraphs 4 and 16, it seems that ED 2 envisages that the credit to equity or a liability will be made incrementally as the service cost is recorded. For the reasons mentioned above, we agree with this, but we believe it is important that this be stated clearly in the body of the standard and that the principle be explained, possibly in the Basis for Conclusions.

Question 3

For an equity-settled share-based payment transaction, the draft IFRS proposes that, in principle, the entity should measure the goods or services received, and the corresponding increase in equity, either directly, at the fair value of the goods or services received, or indirectly, by reference to the fair value of the equity instruments granted, whichever fair value is more readily determinable (paragraph 7). There are no exemptions to the requirement to measure share-based payment transactions at fair value. For example, there are no exemptions for unlisted entities.

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

We agree with the Board's conclusion. Fair value measurement at inception is consistent with the principles in other IFRS (e.g. IAS 22, IAS 32 and IAS 39, IAS 40 *Investment Property*, IAS 41 *Agriculture*). If share-based compensation is seen as expenditure made by the entity then fair value seems to have more conceptual merit than intrinsic, minimum or historical value.

We also agree that there should not be an exemption from initial measurement at fair value, even if the shares used as payment are not listed. In the absence of evidence to the contrary from field-tests, we believe that an entity, which enters into a transaction in its own shares, should be able to value the transaction at grant date.

We suggest that the Board consider whether guidance is necessary, similar to that in IAS 39.67, for situations where a share-based payment transaction does not take place at arm's length.

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?

Although we do not see a conceptual basis for the method of measurement (direct or indirect) driving the measurement date, on practical grounds we support the proposal of measuring the share-based payment at delivery or service date where the fair value of the goods or services is measured directly. This is because we do not see a reason to change current practice in this area. While we believe the compromises involved in consistent application of the grant-date model are justified by the arguments noted in BC 191 to 207, we prefer that this model be limited to share-based payments for services received from employees, and for goods and services from non-employees only when the fair value of those goods and services is not measurable directly.

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?

Although recognising certain weaknesses which we explain more fully in the covering letter, we concur with the Board's conclusion that grant date represents the best balance of alternatives, that is consistent with the Board's objective of focusing on measurement of goods and services received.

The use of grant-date measurement involves a significant degree of judgement and estimation. We believe the Board should articulate more clearly the basic principles involved. Based on our understanding these would be the following:

- *"Share-based payment transactions result in the acquisition of resources; some may be assets and some may be resources that are consumed immediately and result in an expense.*

- *The transaction is recognised as and when goods are obtained or services received; consistent with the executory contract principles, this includes recognition over a period of time.*

- *Where goods or services obtained or received cannot be measured directly, the share-based payment is measured at grant date at estimated fair value and not re-measured subsequently (indirect method).*

- *If the indirect method is used, and cash settlement is an option, the liability is re-measured*

- *The indirect method must be used for employee services because the fair value of the financial instrument is more reliably measured."*

We note that the proposed definition of grant date refers to a shared understanding between the entity and the counterparty of the terms and conditions of the arrangement. We do not agree that this date could be earlier than the date when an agreement is reached formally, and this appears consistent with the last sentence of the definition in the Glossary, which discusses approval. We suggest that "a shared understanding of" be deleted from the definition, to be replaced by "agreed formally on".

In certain legal environments, formal approval of an option grant may be necessary and this may occur only some time after it is agreed that the option will be granted. Alternatively there may be a constructive obligation to issue shares or options to employees, in respect of past services, for example as a performance bonus, but the commitment may only be made sometime after the reporting date. We think that the normal requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or IAS 19 should be applied in determining if the constructive obligation should be recognised in the financial statements and suggest that the Board address the issue. If the cost is accrued it is not clear whether the corresponding credit should be to equity or a liability, but we presume it should be a liability in particular if the number of shares to be issued were still to be determined. We are uncertain how the formal grant of the equity instrument should be accounted for because paragraph 13 of ED 2 does not seem to address these circumstances.

The Glossary defines both 'equity instrument' and 'equity instrument granted'. The definition of an equity instrument is consistent with the definition in the Framework and in IAS 32 and IAS 39. There is no definition of an "equity instrument granted" in other IFRS and we believe that it is sufficient to define grant date. Therefore we propose that the definition of "equity instrument granted" be deleted.

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 agree with the Board's assumption that in most cases it will be easier to obtain the fair value of goods and/or services received. It seems reasonable to expect that quoted prices for cash sales, or prices for similar recent transactions, will be readily available.

However, we believe that reliability of measurement is more important than ease of calculation. In cases where market inputs to the option valuation model are not available we support measurement by reference to the fair value of the goods and services because we believe that in these cases the value of the goods or services is likely to be more ***reliably*** measurable. However, in cases where market data is available, the fair value measurements of the equity instruments and the fair value of the goods and services are likely to be equally reliably measurable. In cases where both the equity and the goods and services are equally reliably measurable, we support measurement by reference to the value of the goods or services, as this is likely to be more readily determinable. Therefore we believe that the rebuttable presumption should be that the fair value of the goods or services received is more ***reliably*** measurable than the fair value of the equity instruments granted, unless both are equally reliably measurable, in which case the presumption should be whichever is more readily determinable.

Share-based payment transactions with non-employees may contain elements that are reliably measurable and elements that are not. For example, the payments to the supplier mentioned in paragraph 10 of ED 2 might have been wholly in equity instruments, rather than just the bonus element. In the circumstances in which the fair value of the entire payment to the supplier is not readily determinable because of the bonus element, ED 2 would seem to require the indirect method of valuation for the entire grant. However, an alternative method might be to split the transaction into its components, which we suggest should be permitted provided that the equity instruments that relate to the measurable and un-measurable elements can be reasonably identified.

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?

On balance we support measuring the fair value of employee services by reference to the fair value of the equity instruments granted on the basis that this is likely to be the more ***reliable*** measure, although not necessarily more ***readily determinable***.

We suggest that the final standard should restrict the use of the term “readily determinable” (or, as suggested in our answer to question 6, “reliably measurable”) to goods and services and indicate clearly the mandatory treatment for employees.

We assume that the Board have chosen to make the indirect method mandatory because of the strength of their concern regarding potential inconsistency and inaccuracy if the direct method was permitted for employee services. We have been able to identify only one circumstance described below in which the indirect measurement would give a less reliable or more inconsistent answer than the direct method for employees. Since we think this is rare, we support the Board’s conclusion that a fair bargain is struck at grant date.

Although we support mandatory treatment, the Board may wish to consider making an exception in the circumstances where direct measurement of the employee services is reliably measurable by reference to a cash alternative.

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?

We agree with the proposal to recognise share-based payments in full on grant date if no further conditions have to be fulfilled, and to spread the expense over the vesting period if certain conditions during the vesting period have to be fulfilled. This approach is broadly consistent with the recognition of employee benefits in IAS 19 and makes sense in particular in relation to employee services. However, we doubt if the principle also should be applied to goods and services from non-employees where the instruments may vest upon delivery.

Vesting period is defined in the Glossary as ending on the date when service conditions, including the completion of a specified period of service, and performance conditions are satisfied. In some jurisdictions, there may be a legal notion of 'vesting' that differs from the definition in the Glossary, and which may occur at a different time from the ED 2 definition. For example, an arrangement may state that shares have legally 'vested', when a period of service must still be completed and be subject to forfeiture if service or performance conditions are not satisfied. We think that the Board intend substance to take precedence over form in determining vesting period. We believe it would be helpful for the Board to clarify, perhaps in the Basis for Conclusions, that its use of the word 'vesting' is based on completion of all service and performance criteria rather than legally based. The Board also may wish to include an example of determining vesting date in the Implementation Guidance.

We have considered under what circumstances there might be *"...evidence to the contrary..."* if a share-based payment vests immediately. In all the cases we have thought of we believe that performance conditions or any requirement to return, refund or forfeit the shares, would contradict immediate vesting and would be taken into account in the measurement of the equity instrument.

However, we are concerned that recognition may be unclear in relation to shares issued at the beginning of an agreement. Consider an example of an employee who is issued with 100 shares to be earned after four years of service; if the employee fails to provide the service, then some or all of the shares must be forfeited and returned to the issuer. From the date the shares are issued, they have ordinary voting and dividend rights.

Presumably the shares must be shown as outstanding from the date of issue; however, the question is what amount should be recorded in equity on initial recognition of the shares. The requirements of IAS 1 *Presentation of Financial Statements*, and the executory contract recognition requirements in IAS 39 discussed in Question 2, would seem to require the full value of the shares to be recognised in equity at initial issuance because the shareholder has the full rights attaching to the shares. However, ED 2 paragraph 13 appears to indicate that, because of the forfeiture conditions, there is evidence to the contrary of immediate vesting and therefore the accounting should follow the requirements of ED 2 to recognise equity over the vesting period.

However, this is not addressed directly, and ED 2 did not include a consequential amendment to IAS 1.74 or 1.86, which could be viewed as not wholly consistent with this view. The Board should address this issue in the final IFRS or Implementation Guidance.

If there is evidence that the services have not yet been received, either partly or wholly, we believe that ED 2 requires an entity to follow the general principle in paragraph 4. This would mean that the recognition of the expense for services and equity would be delayed until the services are received. We assume any reasonable method of allocation of the expense between the services delivered and not yet delivered should be used and we propose that this be stated.

We also have considered a more complicated transaction in which there is a mixture of vested and unvested equity instruments and a mixture of services delivered and to be delivered. Using contingent fee cash transactions as a model, we have considered an example in which an advisor assists an entity in relation to a complicated legal matter and where the payment is in equity instruments, some of which are vested at the beginning and some at the end. We summarise below the case we have used.

Four individuals own an enterprise equally and contract with a professional services provider for services in connection with the resolution of a complicated legal matter.

- *A share-based payment contract is agreed.*
- *The contract stipulates that the advisor will receive shares from each individual representing 20% in total of the entity's shares.*
- *Half the shares vest immediately and half on the successful resolution of the legal matter (expected to be in two years' time). The shares, in total, are worth 1,000, which is equal to the fair value of the services at the grant date.*
- *The services comprise:*

		Fair value
1	*The past services at the grant date*	*100*
2	*The delivery of a new, fully operational software programme at a date to be agreed to assist in legal compliance in the future*	*200*
3	*Advisory services throughout the period. These are not expected to be incurred evenly because they will increase in frequency and intensity towards the resolution date*	*300*

4	*A success bonus on resolution of the legal matter*	*400*

What does ED 2 require in the two alternative situations where the fair value of the bonus can be determined or cannot be determined?

We would assume that the transaction should be split into its elements, if this can be done on some reasonable basis. If not, it should be accounted for wholly under the indirect method. The issue then would be to determine what should be recognised when the initial equity transaction vests, and we assume that this should be the fair value of those shares. However, there may be evidence to show that the fair value of those shares is substantially at variance with the value of the services received at that date. In this case we assume that any reasonable method of allocation of the expense between the services delivered and not yet delivered should be used.

While we are reluctant to suggest increasing the length of the proposed standard or Implementation Guidance, we wonder if some discussion of how to interpret paragraph 13 is appropriate.

Equity instruments that do not vest immediately are addressed by paragraph 14. Paragraph 15 sets out specific requirements in relation to the unit-of-service method where the indirect method is used. If the transaction is in relation to non-employees and the indirect method is required, it seems unclear whether the general requirements of the last sentence of paragraph 14 should be followed or the more rigorous requirements of paragraph 15. The indirect method is required where the services cannot be measured, but this does not necessarily mean that the date when the services are rendered cannot be established. Nor does it mean that the third party services will be accounted for most appropriately under a unit-of-service method of recognition. For non-employee services that are accounted for under the indirect method we suggest that paragraph 14 should state that paragraph 15 should be followed only when the entity cannot find a method of accounting for the services as they are rendered, using any reasonable method of allocation.

Paragraph 14 requires an entity to presume that services are received during the vesting period. For non-employees, the goods or services may not be received until after the shares have vested. We believe that this situation should be addressed.

The proposals do not address the situation where the vesting date is not fixed. This may arise, for example, if the share-based payment vests when and if certain performance criteria are met. Although it may not be common, we imagine that this situation may occur and we suggest that this issue be addressed.

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 methods do you propose?

Generally we support the Board's decision to allocate the determined fair value of share-based payment transactions over a specified period of time in the manner suggested. We also agree with the method of calculation. But a time-based allocation may not always be appropriate, in particular for non-employee services, or in cases where there are performance as well as time-based vesting conditions. For example, where employees are awarded equity instruments as rewards for specific events such as the car salesman who receives commission of 10 shares for every car sold, there is no reason in such cases for the unit of service to be time-based. Therefore, we believe that the unit-of-service method should not be rules-based, but rather principles-based. The existing method could be retained as an illustrative example of one method, but entities should be permitted to use another method, for example one that takes into account other measures of service, such as units delivered, if that reflects more fairly the services received.

In practice multiple, non-concurrent vesting conditions occur, for example:

- the employee could be required to stay for a service period and achieve a certain growth in sales in part of the service period; or

- a customer could be required to achieve a certain volume of purchases during an initial period to qualify, and then to remain a customer for a longer period.

In these cases, it seems to us that a good proportion of the value received in exchange for the equity instrument relates to the performance criteria rather than the value being received equally over time.

It appears inappropriate not to take into account this "performance effect", which should lead to a different timing of recognition of the expense than that proposed. We believe that ED 2 does not address performance conditions sufficiently. We suggest that the notion that there might be more valuable and less valuable periods of service could be accommodated within the existing expense recognition model by some form of weighting of the units of service. This could be dealt with by providing more guidance on what constitutes units of service and including guidance on circumstances when it may be appropriate to attach a weighting to the units. Also example 2 in Appendix B could be expanded to give examples of interaction between vesting and performance criteria.

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?

We agree that the credit should be to equity and the amount recorded in equity should not be remeasured subsequently. These proposals are consistent with the treatment in the proposed amendments to IAS 32 for instruments that will be settled by issuing a fixed number of shares in exchange for a fixed amount of cash or other assets.

Although in most share-based payment transactions the number of shares to be issued will be fixed, there may be cases where a variable number of shares will be issued. Where the variability relates to performance conditions, the variability will be considered in the valuation of the instrument and we do not believe that this variability compromises equity classification of the instrument. The variability may, however, be inherent in the terms of the equity instrument itself, rather than related to performance conditions. For example:

- shares to a fixed value may be issued if the counterparty fulfils certain vesting conditions;

- the exercise price under the option may be variable, for example it may be based on the share price at the exercise date, less a promised margin; or

- share appreciation rights might be settled net in shares.

In these and similar cases, where the variability is an inherent part of the equity instrument and does not relate to performance or vesting conditions, the revisions to IAS 32 and 39 would require liability treatment for these instruments.

ED 2 does not address these situations specifically, but given that in each case settlement is in equity instruments, it seems that the intention of ED 2 is that these instruments should be treated as equity. Although equity treatment has the advantage of not requiring remeasurement in these cases, we strongly recommend that the Board establish a clear principle that either justifies and explains the reason for the inconsistency with IAS 32 in the Basis for Conclusions or eliminates the inconsistency.

The Board may intend there to be a different treatment for those instruments that arise from a share-based payment from the subsequent measurement that IAS 39 would require. If this is the case, it is important that ED 2 states clearly that it should be applied only in respect of instruments arising from share-based payments and not to any similar transactions by analogy.

If the Board do not intend there to be a different treatment for these types of instruments we propose that reference be made to IAS 32 and 39 for the classification and subsequent treatment of the financial instruments rather than having repetition.

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?

We support using option pricing models to determine the fair value of options granted. However, we are concerned that it will be difficult in practice to determine appropriate inputs and adjustments to an option-pricing model, particularly in cases where market data are not available. We suggest that before issuing a final standard, the IASB performs field-testing to assess the reliability of various models and to determine whether entities have suitable expertise to determine a reliable estimate of fair value.

We also recommend that the IASB undertake a study or participate in such a study to support developing more appropriate option pricing models to cope with the many variables that must be addressed in the use of grant date measurement.

Also, given our concerns about the level of expertise in applying option valuation techniques in practice, in particular in making adjustments to these models as would be required under ED 2, we believe that many entities will need to use a valuation specialist to perform the valuation. We recommend that the Implementation Guidance should encourage entities to use a specialist to perform the valuation. If a recognised professional body of option valuation experts emerges, of similar stature to actuaries or property valuation specialists, we suggest that the IASB should go further and follow a disclosure approach similar to that adopted in IAS 19 and IAS 40. We do not think this is appropriate currently, but recommend that the IASB keep the matter under review.

We have noted that many options within the scope of IAS 39 that are not traded have similar terms and conditions to those of options issued in share-based payment transactions. We would prefer any guidance on the valuation of derivatives to be provided only once, or at a minimum to be consistent. We believe any such guidance should apply to all options with similar terms and conditions. To the extent the Board prefer to include detailed guidance on the valuation of options in the share-based payment standard because of the specific features of options issued in share based payment transactions, we believe a reference to this guidance should be included in IAS 39.

Where subsequent measurement of the financial instrument at fair value is relevant (for liabilities), the possible lack of a reliable measure of fair value for unlisted equity instruments should be addressed. It would be our preference to address this issue by reference to the IAS 39.93 subsequent measurement exemption.

We believe that the guidance in ED 2 on performing the valuation is helpful and necessary to ensure a consistent approach to the valuation. In our view the level of detail of the proposed guidance is sufficient, and we would be against extending the guidance in an attempt for the standard to be used as a financial text book forming the basis for the calculations. ED 2 is an accounting standard and not a finance text book or a valuation standard. Therefore, although we agree that the Board should set out basic valuation principles to ensure a consistent approach, we do not believe that the guidance in respect of valuations could ever be an adequate substitute for a proper understanding of the valuation principles.

However, we found paragraphs 23 and IG 24-29 difficult to follow, even with a reasonable working knowledge of option modelling. We suggest that the final standard restricts itself to the requirement to consider expected dividends and to ensure that the dividend entitlement and the model inputs are consistent. If considered necessary the Implementation Guidance could be expanded to explain why the adjustment is needed and how dividend payments influence option values and a simple example could be included. However, as stated above, we would rather valuation/pricing theory was not addressed in an accounting standard.

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?

We agree that it is necessary to adjust the value of employee share options for their lack of transferability. Using the expected rather than contractual life seems to be a reasonable method of making this adjustment.

The proposed requirement for taking into account the inability to exercise an option during the vesting period also seems appropriate.

Because of the lack of market data in this regard we believe that in both cases the adjustments will be somewhat arbitrary regardless of how they are determined. We recommend that the IASB include this aspect in any field-tests to see whether the proposed approach gives a sensible result in practice. We also believe that the nature of the adjustments required highlights the need to use someone with an adequate understanding of financial principles as well as expected employee service trends to perform the valuations.

It may be difficult to establish the expected life of options for newly listed entities with new share option schemes. We think that guidance similar to that in IG 19 on volatility could be provided.

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?

After considering the alternatives weighed up by the Board, on balance we support the approach proposed in ED 2 to adjust the value of shares or options for specific vesting conditions. As we have already stated, we support the Board's proposal to use grant-date measurement for goods and services received that are measured indirectly and we consider that an appropriate estimate of fair value can be struck only if vesting conditions are taken into account fully. However, it is important for the final standard to acknowledge that fair value is an estimate subject to significant variability based on a valid range of possible assumptions.

The approach that the Board proposed in ED 2 is an inter-dependent package of assumptions and conventions that requires a significant degree of judgement. Application of this approach will require estimation of a number of variables, which means that the measurement of similar transactions may vary considerably from entity to entity, based on differences in judgements about future performance of both the entity and of the individual being compensated. The approach also results in original estimates not being adjusted to reflect actual outcomes, especially for transactions where share-based payments are "all or nothing" rather than vesting on a pro rata basis. This may appear counter-intuitive to some.

We strongly recommend that the Board articulate in the Basis for Conclusions the degree of judgement involved in the indirect method. We think it is important for the Basis for Conclusions to identify clearly for both preparers and users of financial statements the judgements, assumptions, conventions and potential anomalies the measurement approach introduces, and for all stakeholders, including regulators, to acknowledge these limitations.

In order to measure the transaction at its estimated fair value, there must be an estimate of expected performance, and essentially the transaction is measured based on its estimated fair value. A reader working through the text and examples ultimately should grasp the Board's intended measurement approach and its implications. However, we believe that it would be most helpful for the Board to spell out both their objectives and the implications. For example, *" ... when goods and services received are measured indirectly by valuing the compensation offered, the fair value at grant date is measured at its estimated value at that date. This estimated value is allocated across the actual service period using a units-of-service approach.*

This means that estimates must be made of both the value of the share-based payment promised, including any conditions, and of the expected quantity of goods and services to be obtained or received. If the quantity of goods and services obtained differ from that expected the cost recognised would differ from the originally estimated total value. However, the estimate is not otherwise adjusted for differences arising from subsequent forfeitures or changes in value of the share-based payment."

In practice it will be very difficult to make the adjustments and they are likely to be somewhat arbitrary because of the lack of market data in this regard. This is another area where we believe the Board should consider by field-testing whether the proposals are likely to get a reliable result.

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 note that the proposals give an inconsistent result depending on whether the reload feature is taken into consideration in valuing the option or not. In practice we believe that it will be extremely difficult to adjust the value of options for the effects of reload features, even if a knowledgeable specialist performs the valuation.

Our earlier comments regarding specialists and field-testing apply. If the results of field-testing show that it seldom is possible to adjust the valuation for the impact of reload features, we would prefer a consistent approach whereby all reload features are accounted for as new options.

Question 15

The draft IFRS proposes requirements for taking into account various features common to employee share options, such as non-transferability, inability to exercise the option during the vesting period, and vesting conditions (paragraphs 21-25).

Are there other common features of employee share options for which the IFRS should specify requirements?

We believe that the following features also should be considered:

- performance features and vesting conditions that are not spread evenly over time; and
- options with a variable exercise price or where the number of shares to be issued is not fixed (see our comments in this regard in our answer to question 10).

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?

We support having principle-based standards and therefore agree that the option valuation methodology should not be prescribed.

We also favour an approach of making appropriate adjustments to an option valuation model. Notwithstanding our general concern in relation to the levels of disclosure discussed in our answer to question 21, we believe that it is important that the models and any significant assumptions used, as well as any significant adjustments made to the inputs to the models, be disclosed to enable a user of the financial statements to understand the amounts recognised.

We are concerned about the level of expertise in performing option valuations in practice. Please see our earlier suggestions on field-testing and the use of specialists.

Also, we believe that it is important that some principles be included about the consistency of the models that are used. For example, once an entity uses a particular model to value options, under what circumstances could it use a different model in subsequent periods?

Particular difficulty will be experienced in performing the valuation for newly listed entities and new option schemes where there is more uncertainty in the determination of the input parameters of the option model.

It may be helpful for the Board to participate in a study to develop more appropriate option pricing models to address the many variables that must be addressed in the use of grant-date measurement. Until that study is completed and properly vetted, the Board should not mandate the use of any one option-pricing model to determine fair value of options and similar arrangements. In the interim, disclosure about the method used to determine fair value, as proposed in paragraph 47 of ED 2, should be required.

Question 17

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

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

In our view, in re-pricing the options the entity and the counterparty have entered into a variation to the original agreement. This effectively results in a new agreement between the parties. On this basis we believe that it should be treated as a new option grant. Therefore we consider it appropriate to revisit the original valuation and period over which the fair value is recognised. Our reasoning is that this represents a new arrangement, rather than a different outcome to the original arrangement. Therefore we would prefer an approach where the units of service and the fair value of the revised option are both re-estimated at the repricing date, and the revised fair value (instead of the residual original value plus incremental value) is recognised over the estimated remaining units of service. We agree that no adjustments should be made to amounts previously recognised but do not support continuing to recognise expense in relation to cancelled agreements.

This would give the following result to Example 3:

- The fair value of the options at the date of re-pricing is CU 8.
- The total fair value of the options at the re-pricing is: CU8 * 410 * 100 = CU 328 000.
- The new fair value of CU 328 000 is recognised over the revised estimated units of service of 800.
- This will mean if the units of service are as anticipated, the total expense recognised after the date of re-pricing is CU 328 000.

This method of accounting for a repricing of options is consistent with the treatment that is applied to new options.

If, however, the Board retain the incremental value approach, we would prefer the alternative method of averaging the repricing in example 3. We would not support allowing entities a choice of approach in recognising the incremental value. We do not support the Board’s approach to only re-estimate the units of service in respect of the incremental value.

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.

Although we understand the basis for the Board's conclusions, it does not seem right to continue to recognise an expense in respect of options that have been cancelled. We believe that when an option is cancelled, this results in the contractual arrangement between the entity and the counterparty being revised (cancelled). Therefore we believe that from this date the recognition of an expense should cease. We agree that amounts previously recognised should not be restated.

If cancelled options were no longer accounted for, all new options, whether or not they were identified as replacement options, would be treated in the same way. We think this has the merit of greater consistency and simplicity. Under the current proposal the treatment of a new option depends on whether it is identified as a replacement option – in which case only the incremental fair value is recognised and re-measured – or treated as a new option, in which case the fair value and units of service are estimated when it is issued. We do not think that this accounting faithfully represents the economic substance of the transactions.

Question 19

For cash-settled share-based payment transactions, the draft IFRS proposes that the entity should measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity should remeasure the fair value of the liability at each reporting date, with any changes in value recognised in the income statement.

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

We agree with the principle that cash-settled share-based payment transactions give rise to a liability. The amount of the liability varies based on the entity's own share price, and therefore in our opinion the liability is a derivative instrument. Therefore we agree that the liability should be remeasured to take into account changes in its fair value. This is consistent with the measurement of derivative instruments in IAS 32 and IAS 39.

The proposals in ED 2 seem to characterise the remeasurement of the liability as a remeasurement of the underlying share-based payment transaction. This is inconsistent with the Board's basic principle (with which we agree) that the transaction is measured at the grant date and is not remeasured. The proposed approach results in an inconsistent measurement of the cost of a share-based payment transaction depending on how the transaction will be settled. An alternative approach would be to separate the accounting for the credit side of the entry (the financial instrument) from the accounting for the debit side of the entry (the underlying transaction) after initial recognition. Therefore the gain or loss from remeasurement of the financial instrument would not be recognised as a remeasurement of the underlying share-based payment transaction (such as the employee expense), but rather as a gain or loss on the derivative instrument itself (shown as a gain or loss arising from transactions with potential shareholders).

In these cases, it would be consistent with grant-date measurement for the asset or service cost to be frozen at the date the share-based payment is granted. It would be consistent with IAS 39 for any gains or losses arising from subsequent differences in the measurement of the liability to be considered separately and reported as gains or losses arising from transactions with potential shareholders.

We agree with the proposed approach whereby a liability is not shown for the full fair value of the equity instruments granted at the grant date, but rather the liability is accrued incrementally over the vesting period. The reason we support this approach is that we view the liability as arising from an executory contract and therefore we believe it only comes into existence as the employee performs or as goods or services are received (see further comments in question 2).

As stated earlier, we are unclear regarding the Board's approach in relation to transactions that may be treated differently under ED 2 and IAS 32 and 39. As explained further in our answer to question 10, according to the proposed amendments to IAS 32, net share-settled transactions and transactions that will be settled by issuing a variable number of shares or that have a variable exercise price also give rise to a derivative liability (a written call on own equity). Although share-based payment transactions of this nature will be rare, they may occur. Therefore we believe that they should be addressed. We believe that the Board should clarify whether it is their intention that a treatment consistent with IAS 39 and the guidance in ED 2 on cash-settled share-based payment transactions apply to these types of instruments or whether they should be treated in the same way as equity-settled transactions.

We note that ED 2 requires any changes in the measurement of the liability at each reporting date to be recognised in the income statement. There is no specific guidance on what to do if the underlying transaction was the acquisition of an asset. There also is no specific guidance on the timing of recognition of the amount in the income statement, i.e. should it be recognised immediately or over the remaining vesting period. ED 2 implies that the entire change in value should be reported immediately in the income statement regardless of the nature of the underlying transaction. We agree with this proposal, which supports an argument that any remeasurement of a liability is more akin to a gain or loss on the financial instrument than a remeasurement of the underlying asset or services.

In the example of a cash-settled transaction in appendix C, the cost of the employee services is spread on a straight-line basis over the vesting period (i.e. 1/3 each year), rather than based on the units of service. We believe this is an inconsistency that should be eliminated between the allocation of expense for equity-settled and cash-settled transactions. It introduces an arbitrary method of allocation, which the Board seek to avoid in other IFRS [see BC 107 of ED3]. In our view the total fair value of the SAR at grant date should be recognised over the vesting period based on the units of service in the same way as it is for an equity-settled transaction.

We also note that if the Board decided to disconnect the subsequent measurement of the financial instrument from the accounting for the underlying share-based payment the remeasurement of the liability will not have any impact on the cost recognised in respect of the underlying transaction and therefore the disclosure required by paragraph 52(b) would be unnecessary since the cost recognised in respect of the transaction would be the same, regardless of how it is settled.

Question 20

For share-based payment transactions in which either the entity or the supplier of goods or services may choose whether the entity settles the transaction in cash or by issuing equity instruments, the draft IFRS proposes that the entity should account for the transaction, or the components of that transaction, as a cash-settled share-based payment transaction if the entity has incurred a liability to settle in cash, or as an equity-settled share-based payment transaction *if no such liability has been incurred. The draft IFRS proposes various requirements to apply this principle.*

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

We agree with the proposals in ED 2 for cases where the entity has a choice of settlement. It is unclear to us why the guidance in ED 2 repeats rather than refers to IAS 32 and 39. The Board should consider conforming the drafting of these sections of ED 2 with the drafting of amended IAS 32 in this regard.

We find the proposals in respect to share-based payments in which the counterparty has the choice of settlement to be complex and unclear.

It seems that the sections of ED 2 that deal with alternative means of settlement aim to address two different types of transactions. The first is a transaction in which the counterparty has a choice only in respect of whether the settlement is in cash or shares. The second is a transaction where the counterparty is offered various possibilities as a package and can choose one of the alternatives. The latter is illustrated in the Implementation Guidance. We believe that these two types of transaction are different economically and need to be addressed separately.

In our view where the counterparty simply has a choice of the method of settlement, the transaction does not give rise to a compound financial instrument, but rather a derivative liability. This is consistent with the proposed amended IAS 32. Therefore, if an approach consistent with IAS 32 and 39 were intended, all transactions where the counterparty has an option for cash settlement or net share settlement would be accounted for as derivative liabilities. If the counterparty chooses gross share settlement, the liability recognised would be transferred to equity at the settlement date.

Where a counterparty is given the choice between various alternatives, the transaction gives rise to a number of interdependent instruments. The nature of the package of instruments will depend on the terms and conditions of each of the components. The components may include any combination of: equity instrument, non-derivative liability, derivative liability and possibly even derivative assets. Accounting for these individual instruments is complicated because of the interrelationship between them.

We can see the rationale adopted in the example in the Implementation Guidance for recognising an equity and a liability element in respect of this particular combination of instruments. However, we find the approach extremely complex and we believe that it will be difficult to apply in practice. In particular, we are not clear as to how the liability will be measured subsequent to its initial recognition. Also, given the interrelationship between the instruments, we can see an analogy to SIC-5 and think an argument could be made to treat the entire package as a liability, which would be a far simpler approach.

Also, the approach described by the Board seems to work for the specific fact pattern given in the Implementation Guidance but not all combinations of instruments will give rise to a compound instrument.

Both compound instruments and derivatives on an entity's own equity, including those with multiple settlement and contingent settlement possibilities, are (or will be) dealt with comprehensively in (revised) IAS 32 and IAS 39. Given the complexity of addressing the various scenarios, if the Board intend for a consistent approach for accounting for these types of instruments to that under IAS 32 and 39 (see our earlier comments in this regard), we would suggest a reference to IAS 32 and 39 rather than repeating guidance in ED 2. However, if the Board believe that there should be a different treatment for these instruments if they arise from a share-based payment, we believe that it will need to expand the guidance in this section of ED 2 to cover a range of possible share-based payment transactions with alternative physical, net cash and net share settlement alternatives, at either the entity's or the counterparty's choice. We do not believe that all such transactions are compound instruments.

It is not clear to us from ED 2 whether the remeasurement of the liability that arises from a transaction with a cash alternative at the date of settlement should be recorded in the income statement or directly in equity. We believe that this should be specified.

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)?

We are strongly opposed to extensive disclosures unless they are meaningful. In our view the disclosures proposed in ED 2 are excessive. There seems to be a carry-over of all the IAS 19 disclosure requirements of the detailed terms of share-based payment transactions. We think that it is unnecessary to continue to require entities to disclose the considerable detail in paragraphs 45-48 about the terms of share-based payments in light of the proposals to recognise them in the financial statements.

Although the disclosures about the amounts recognised in the financial statements are meant to give users a clearer picture of fair values and the financial impact of share-based payments, we are concerned that the information may be overwhelming rather than meaningful to the vast majority of users. We believe that the degree of disclosure that is required about the amounts recognised should be proportional to the relative materiality of the amounts recognised in the financial statements in this regard. Therefore we would support an approach similar to that adopted in IAS 36 where disclosures are "graded" according to the significance of the amounts recognised.

There will be challenges involved in complying with the proposed requirements and we doubt if the information will be of sufficient benefit to users of the financial statements to justify the significant cost and effort that will be entailed. In particular, extensive calculations will be required to provide the disclosure required by paragraph 52(b) and we are unconvinced by the arguments in favour of requiring it. As a minimum, we strongly recommend that the IASB reconsider whether the usefulness of the disclosure in paragraph 52(b) is sufficient to justify the effort that will be involved in providing it.

We recommend that the disclosure requirements should be limited to:

- accounting policies;
- terms and conditions;
- identifying the models and significant assumptions used in performing the valuation (retaining paragraph 49);
- amounts recorded in the balance sheet, income statement, cash flow statement and equity; the latter to be separately identified; and
- existing paragraph 50.

There may be circumstances in which a share-based payment transaction is significant in the context of the financial statements as a whole. In those circumstances it may be appropriate to consider also requiring an indication of the financial impact of adjustments made to the values derived from the model, for example, for vesting conditions, lack of transferability and reload features (currently it is not proposed to require disclosure of the amount of any adjustments made to the valuation in respect of reload features).

We think it would be helpful if Appendix D illustrated these requirements, together with an example of disclosure arising from other IFRS, for example:

- equity movements;
- related party disclosures; and
- illustrating the disclosures that would be required if the circumstances of share-based payments fall within paragraphs 108 to 115 of the proposed revised IAS 1.

While we hope that the Board are able to respond to these concerns, if they do not agree, as a minimum we consider that it would be extremely desirable to clarify what level of aggregation of information is acceptable in order to prevent unnecessary and unhelpful levels of disclosure.

If our recommendations are accepted in relation to levels of disclosure, the definition of *share–based payment arrangement* may not be needed.

Paragraph 53 seems to be a duplication of existing requirements in IAS 1 and therefore is redundant.

Question 22

The draft IFRS proposes that an entity should apply the requirements of the IFRS to grants of equity instruments that were granted after the publication date of this Exposure Draft and had not vested at the effective date of the IFRS. It also proposes that an entity should apply retrospectively the requirements of the IFRS to liabilities existing at the effective date of the IFRS, except that the entity is not required to measure vested share appreciation rights (and similar liabilities) at fair value, but instead should measure such liabilities at their settlement amount (ie the amount that would have been paid on settlement of the liability had the counterparty demanded settlement at the date the liability is measured).

Are the proposed requirements appropriate? If not, please provide details of your suggestions for the IFRS's transitional provisions.

We understand that share options often have a long life cycle, sometimes for many years. Based on the transition requirements in paragraph 54, the expense in the first year will reflect just over one year's worth of options and this will be built up over time until the full expense is recognised. Subject to our comments below, we agree with the transitional requirements and with this consequence, but think that it would be helpful if users of the financial statements were made aware of this. We wonder if some discussion in the Basis for Conclusions would assist in this respect.

We generally support the Board's proposal not to allow retrospective application on the basis that we have concerns about the reliability of retrospective estimation of fair value at grant date. Under IAS, or previous GAAP in the case of first-time application, an entity may, however, already have applied principles similar to those proposed in ED 2 in accounting for share-based payments. In these cases we do not believe that the entity should be required to reverse its previous accounting. Alternatively, an entity may have disclosed the grant date fair value of equity instruments granted in the notes to the financial statements. We note that IAS 40.70 (revised 2000) permits retrospective application where an entity previously has disclosed publicly the fair value of its property. We believe a similar approach for share-based payment transactions merits further consideration.

We have concerns about the requirement to calculate fair value of options granted between 7 November 2002 and the effective date of the standard. We think that many entities currently do not calculate the fair value of share-based payment transactions as proposed in ED 2. In practice, given the complexity of the proposals in ED 2, and the uncertainty about the requirements of a final standard, many entities are unlikely to perform the calculations until after a final standard is issued. Accordingly for options granted at dates nearer to 7 November 2002 than 31 December 2004, it will be difficult in the calculations as at grant date to ignore actual subsequent volatility, employee service or option experience, and dividend decisions. For example, in the current economic environment, it might be possible for an entity to grant share options and before its first reporting date for the options to be out-of-the-money with no prospect of recovery before the end of the contract.

We consider that it is appropriate for the final standard to require the calculation at grant date, and state that adjustments for hindsight are inappropriate. However, we think this principle is extremely difficult to enforce on transition without some allowance for hindsight. We do not think any relief would be necessary for financial inputs such as the market price of the entity. For non-financial inputs, we have considered the notion of an adjustment period analogous to fair value adjustments under IAS 22. This adjustment period would permit non-financial inputs to the model to be adjusted to take account of hindsight, up to the date of approval of the first financial statements after grant date. However, we are not in favour of this approach because it only should be necessary for the short term and we would not support it being a long-term position. Therefore we propose instead that the transition date (7 November, 2002) is delayed, perhaps to the effective date of the final standard.

The proposal to apply the requirements retrospectively to liabilities existing at the effective date of the IFRS is consistent with the proposed transitional provisions for liabilities existing at the effective date of the revised IAS 32 and IAS 39. We agree with this proposal, as long as no changes are made to the proposed transition requirements in IAS 32 and 39 in this regard.

Paragraph 55 seems to require vested share appreciation rights to be measured at their settlement amount at the date of measurement (we presume this is the effective date of the IFRS) rather than at fair value. We do not understand this distinction. In our view, the settlement amount and fair value of a vested share appreciation right should be the same.

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?

We agree with the Board's conclusion to include all tax effects of share-based payment transactions in the income statement.

Question 24

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

The main differences include the following.

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

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

- *SFAS 123 encourages, but does not require, entities to apply its fair value measurement method to recognise transactions with employees; entities are permitted to apply instead the intrinsic value measurement method in Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees (paragraphs BC70-BC74 in the Basis for Conclusions give an explanation of intrinsic value); and*

- *unlisted (non-public) entities are permitted to apply the minimum value method when estimating the value of share options, which excludes from the valuation the effects of expected share price volatility (paragraphs BC75-BC78 in the Basis for Conclusions give an explanation of minimum value).*

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

- *under SFAS 123, the estimate of the fair value of an equity instrument at grant date is not reduced for the possibility of forfeiture due to failure to satisfy the vesting conditions, whereas the draft IFRS proposes that the possibility of forfeiture should be taken into account in making such an estimate;*

- *under SFAS 123, the transaction is measured at the fair value of the equity instruments issued. Because equity instruments are not regarded as issued until any specified vesting conditions have been satisfied, the transaction amount is ultimately measured at the number of vested equity instruments multiplied by the fair value of those equity instruments at grant date. Hence, any amounts recognised for employee services received during the vesting period will be subsequently reversed if the equity instruments granted are forfeited. Under the draft IFRS, the transaction is measured at the deemed fair value of the employee services received. The fair value of the equity instruments granted is used as a surrogate measure, to determine the deemed fair value of each unit of employee service received. The transaction amount is ultimately measured at the number of units of service received during the vesting period multiplied by the deemed fair value per unit of service. Hence, any amounts recognised for employee services received are not subsequently reversed, even if the equity instruments granted are forfeited.*

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

(d) SFAS 123 does not specify a measurement date for transactions with parties other than employees that are measured at the fair value of the equity instruments issued. Emerging Issues Task Force Issue 96-18 Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services requires

the fair value of the equity instruments issued to be measured at the earlier of (i) the date a performance commitment is reached or (ii) the date performance is complete. This date might be later than grant date, for example, if there is no performance commitment at grant date. Under the draft IFRS, the fair value of the equity instruments granted is measured at grant date in all cases.

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

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

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

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

We agree with Board's suggested approach on all the points raised except as discussed elsewhere in this letter and below.

Although we find the Board's arguments against the minimum value method set out in the Basis for Conclusions to be convincing, we believe that field-testing is necessary to determine whether or not the application of a fair value model is likely to provide a more reliable measure in practice. If based on such field tests the Board conclude that a fair value model will not result in a reliable measure of fair value, we believe some form of minimum value approach, as mentioned in part (a) of this question, or "reasonability check" on the calculation, warrants further consideration. For example, a minimum value approach may be used to determine a "floor" to the amount recognised in the financial statements to ensure that the various adjustments to reduce the expense do not result in the expense recognised being less than the minimum value.

Question 25

Do you have any other comments on the Exposure Draft?

Business combinations

We have identified a number of aspects relating to the interaction between ED 2 and business combinations, for example:

- Particularly in case of the acquisition of an owner-managed business, the consideration for a business combination may include share-based payment transactions with employees. It is unclear whether the resulting debit entry should be included in goodwill or recognised as an employee expense. In our view the appropriate treatment of these transactions depends on the nature of the transaction. If the share-based payment is given to employees as compensation for services received, for example "stay" bonuses, then the cost should be recognised as an employee expense over the retention period. Whereas if the share-based payment is granted to the shareholder in his or her capacity as an owner, then it is an integral part of the cost of the acquisition and should be treated as such.

- Assets and liabilities acquired as part of a business combination may include assets or liabilities relating to existing share-based payment transactions. We assume that the Board intend these assets and liabilities to be treated in the same way as any other assets or liabilities of the acquiree at acquisition, and for them to be valued in accordance with ED 2. We propose that this is stated, which probably would best be done in the business combinations standard.

- Share-based payment transactions may be provided to existing employees of the acquired entity as a replacement for existing arrangements which have lapsed due to the business combination. For example the shares of an acquired entity may no longer be listed or the shares of the acquirer are regarded as a more appropriate incentive.

- Fees or bonuses may arise in connection with the completion of the transaction, either to new or old employees, or to third parties, which are share-based payment transactions.

- To be consistent with the proposed transitional provisions in ED 2, we think that any equity-settled transactions of an acquiree granted on or before 7 November 2002 should be exempt from valuation under IAS 22. We wonder if a consequential amendment to IAS 22.39 to cross-refer to the final standard would clarify the Board's intention.

We believe that the above issues should be considered, possibly in the Board's deliberations in its project on business combinations (phase 1 or phase 2).

Social charges

In certain countries, for example Sweden and the UK, social charges are payable on share options when those options are exercised based on the difference between the strike price and the market price of the shares at the exercise date. We understand that current practice in Sweden is to accrue for these charges based on the current market price of the shares under option. Under UITF 25, the UK practice is similar except that the charge is spread over the performance period. ED 2 does not address the accounting for such charges and any significant transaction costs in relation to issuing the equity instrument. If nothing were included, then we would assume that IAS 37 would apply, resulting in accrual of the liability over the performance period applying the executory contract approach. In our view the most appropriate treatment would be to recognise an estimate of the expected social charges consistent with the fair value of the option on the same unit of service method set out in ED 2.

Earnings per share

We agree that there are earnings per share ("EPS") issues that should be addressed in the share-based payment standard, but we find the guidance provided in appendix E4 to be incomplete and very confusing.

Normally the amount of the option premium is not considered in determining whether or not an option, warrant or equivalent is dilutive. The Board have not explained why, in Appendix E4, it is proposing that the unpaid option premium be included as an adjustment in computing the amount of dilution. During our attempts to understand the Board's reasoning here, we also identified an additional adjustment that the Board should require for the unearned portion of share grants.

Therefore we suggest that the Board make the following adjustments to the proposed IAS 33 *Earnings Per Share* amendments.

1. Explain the reason for including the unrecognised option premium relating to unearned options in the calculation of dilution.

We believe that the reason for this adjustment is that, under IAS 33, an entity has an asset for a normal option premium from the date the option is granted (e.g., cash paid or receivable for the amount due). However, in the case of an option for a share-based payment where the goods or services have not been provided yet, and therefore no asset is recognised, any dilutive effect of the option contract will be included in the EPS denominator without there being any benefit (income) in the EPS numerator from having that asset (the "option premium" goods or services) available. Rather than adjusting the numerator (e.g., by requiring a computation of return on capital and applying that return to the amount of option premium not yet recognised in respect of share-based payment as an adjustment to the EPS numerator) the Board are proposing that the dilutive effect, if any, of potential ordinary shares is adjusted for the additional amount of equity that is not yet recognised.

The Board should be clear as to why this adjustment is being made, in part so that this example is not inappropriately applied by analogy to other situations.

2. State that the EPS calculation should reflect only expected shares/options to be issued.

We have considered the following example. If an agreement was entered into to grant 500 options that vest pro-rata over five years, but expected service was three years, the fair value of the service would be equivalent to the value of 300 options. The EPS calculation should reflect 300 as the maximum potential ordinary shares. (In line with the requirements of ED 2, the number of potential ordinary shares would be re-estimated for the purposes of the EPS calculation at each subsequent reporting date if actual service differed from that expected.) Similarly, the adjustment to the calculation of diluted EPS illustrated in Appendix E4 to include the unrecognised option premium for options not yet earned should be based on expected options to be earned. Following the example above, it would initially be for the unearned portion of the 300, not the unearned portion of the 500.

3. Provide guidance on the adjustment of EPS relating to grants of shares rather than share options.

Share-based payment arrangements that grant shares, rather than share options, will immediately give rise to potential ordinary shares. Over the life of the agreement, as shares are earned, the unearned shares (again, based on expected shares to be earned) will continue to be potential ordinary shares that should be included in the calculation of diluted EPS. The adjustment to the dilution calculation proposed in Appendix E4 should be applied to these potential ordinary shares, as the grant-date measurement of service to be received represents the amount to be paid for those shares, and is the appropriate benchmark against which to calculate dilution. But we think a further adjustment is needed to state that the shares earned to date should be included in both basic and diluted EPS as outstanding shares, on the basis that they are shares whose issuance is contingent only upon the passage of time.

Also, we believe that the Board should clarify that share grants that are not yet earned are not shares whose issuance is contingent only on the passage of time when the only condition is time-based vesting.

First time application

In the consequential amendments to ED 1, relief is given from applying ED 2 to post-November 2002 equity-settled share-based payment transactions that vest between the effective date of the standard (say 1 January 2004) and the date of transition (for example, 1 January 2006). An entity applying IFRS for the first time may have a subsidiary that applied ED 2 from its effective date. We are unclear if it is the Board's intention that transactions recognised by the subsidiary should be reversed.

As presently drafted, we understand that an entity applying IFRS for the first time in 2011 could be required to go back to options granted on, for example, 8 November 2002 and determine the fair value of all those that are not yet vested. Where previous GAAP does not require similar accounting for share-based payment transactions, the fair value of the transaction at grant date would need to be determined (directly or indirectly) for the first time. This calculation will require consideration of grant date forecasts of future employee service, volatility, dividends and performance measures such as growth in earnings per share (for indirect measurement) and consideration of the historical fair value of goods and services (for direct measurement). This may involve undue cost or effort, in particular in circumstances where options are granted before an entity is aware it will adopt IFRS. Similar arguments to those that supported the first time application exemption for business combinations seem to apply.

Therefore we think that there should be an additional exemption in ED 1. We have identified two alternatives. The exemption could require fair value at transition date with an option to use hindsight in performing the valuation, subject to a requirement to exclude the effect of major changes in circumstances. Alternatively there could be an exemption similar to that for business combinations i.e. retrospective application could be limited to options granted after the date of transition to IFRS or some earlier self-designated date.

Whether or not an exemption is added to ED 1, we think it would be helpful to address the possible impact of hindsight on the estimates required by ED 2. In paragraph 9 of the Implementation Guidance in ED 2, there is a requirement to consider the extent to which future experience will differ from past experience. For first-time adopters we believe that the guidance in paragraph 26 of ED 1 could apply and accordingly hindsight could be used up to the date of approval of the first IFRS financial statements. Conversely, ED 1 requires leases and the distinction between liability and equity, which are determined at inception and not subsequently changed, to be determined without the use of any hindsight. We can see an analogy between leases and debt/equity classification and share-based payment transactions. We propose that a consequential amendment be included to clarify which treatment the IASB consider appropriate for each type of share-based payment.

Valuation date

We are concerned that entities may find the process of calculating share-based payment fair values at grant date difficult and that in practice the actual calculation may be done some time after the event. We believe, to be consistent with the grant date measurement approach, that the valuation should be performed on or near the grant date and not on some arbitrary date during the reporting period. We think that any lack of clarity in this area is undesirable and that the Board should state clearly that the valuation should be on or near the grant date. If the Board consider that this principle may be difficult to apply in practice, we note that IAS 19.56-57 provides guidance regarding actuarial valuations in advance of balance sheet date. While the issue is one of delayed calculation after grant date rather than advanced valuation before balance sheet date, guidance analogous to that in IAS 19.56-57 could be provided for share-based payment valuations.

Modifications and replacements of options

Paragraph 27: The proposals do not address the treatment of a modification of terms that decreases the value of the options. Although we would expect this to be rare we would think it is possible, particularly if the payment is designed as a bonus element.

Paragraph 29: The proposals do not address the circumstances in which the employee or other counterparty terminates or cancels the arrangement.

Paragraph 29(c): The proposals also do not address situations where replacement options are issued that are of lower value than original options. Although this could be rare, it may happen.

Decision grid

We have found it difficult to distinguish clearly all the alternative measurement and recognition aspects of the two categories of counterparty for equity-settled transactions. A decision tree or grid in the Appendix to the standard, similar to the table we have included in Appendix B, would facilitate the determination of the requirements to particular situations in the variety of circumstances that ED 2 covers.

Investment property

Proposed revised IAS 40.21A requires the use of the fair value of the property if it is *more clearly evident* than the value of the equity instrument. We believe that this should be conformed to ED 2 to include a rebuttable presumption that the measurement should be by reference to the value of the property and to use the phrase more reliable rather than more clearly evident.

Transactions where a parent issues shares on behalf of a subsidiary

We believe that additional guidance is necessary to clarify the accounting treatment that should be applied by a parent that issues share options on behalf of a subsidiary in the parent's standalone (unconsolidated) financial statements. We assume that the parent would record a credit to equity. We expect that the corresponding debit should be viewed as a contribution by the parent to the subsidiary and therefore recognised as an increase in the investment in the subsidiary. However it is not clear whether this transaction is within the scope of ED 2 or of IAS 32 and 39. Also, if it is in the scope of ED 2, it is not clear whether the transaction should be measured at: the fair value of the equity instruments issued; the fair value of the implied incremental investment in the subsidiary; or the fair value of the services received by the subsidiary. Each of these measurement methods should give the same result, assuming a fair trade, but we would support consistency with the proposals in ED 2. Therefore if the transaction relates to employee services, we would prefer the measurement to be by reference to the fair value of the equity instruments granted.

Past practice of cash settlement

Paragraph 42: Based on our experience of this issue in the context of financial instruments, we propose that guidance is included, perhaps based on existing guidance on this issue in IAS 32. Further interpretation questions that will be raised include: If this is the first transaction, is it acceptable to consider intention? We believe so but if not, this should be specified. If there is a history of such transactions, would a single transaction that was settled in cash result in "tainting" of the past practice? What if the intention and the actual outcome differ?

Employee share trusts

Treasury shares normally are recorded at cost and not revalued and any gain or loss on subsequent disposal is recorded directly in equity. If the sponsor's shares are held by a plan accounted for under IAS 19 and these shares are qualifying plan assets they are measured at fair value. ED 2 would require that SIC-16 apply to a sponsor's shares, however the interaction of the scope of IAS 19 and ED 2 is not clear in some areas.

We think that there might be circumstances in which employee benefit plans include independent entities such as trusts to provide share-based benefits to employees of an entity. ED 2 addresses the entity's share-based payment transactions only when the trust is either consolidated or a shareholder (as described in paragraph 2).

It is not clear to us whether such entities that are outside the scope of ED 2 will fall within the scope of IAS 19 or not. Perhaps because such shares cannot be held directly, these entities may be used to hold shares of the plan sponsor, for example in the UK, Switzerland and South Africa. Such trusts may fall within the scope of IAS 19, which would require net presentation of the benefit obligation rather than viewing the sponsor's shares as treasury shares and presumably applying SIC-16.

Sometimes entities hold treasury shares, either directly or via a trust, in order to create an economic hedge of the cost of the equity-settled share-based payment. (This often is referred to as hedging against either the dilutive effect or the volatility, although it is recognised that such transactions are outside the scope of IAS 39 and true hedge accounting is not applicable.) The impact of treating own shares held in such a trust as if they are plan assets is that the shares are held at fair value, with adjustments going through the income statement. Depending on whether the 'hedged' item, i.e. the share option or other instrument that gives rise to the employer's obligation, is classified as equity (and not remeasured) or as derivative liability (and remeasured), there may be mismatches in the accounting for the asset and the obligation.

Further, in cases where the employer's only obligation is to issue shares, it is not clear what the liability of the sponsor is, even within ED 2. It also is not clear whether the Board intend the net presentation requirement of IAS 19 to apply to trusts holding shares of the sponsor related to share-based compensation plans. Is it the Board's intention that the scope changes proposed in ED 2 as consequential amendments to IAS 19 scope out of IAS 19 only the obligation aspect of share-based payments, or is it intended to scope out of IAS 19 both the obligation and any related plan assets? We recommend that the Board clarify the intended interaction of IAS 19 and ED 2, and which standard it expects to apply to trusts holding own shares for equity compensation benefits.

We note that IAS 33 does not appear to address shares of the sponsor held in such entities, regardless of whether they fall within IAS 19 or ED 2 (i.e. are they considered outstanding if the trust entity is not consolidated but rather its assets are presented net against the liability?) We suggest that guidance is given on this point in IAS 33.

Additionally, we think that the exemption in SIC–12 for all post-employment and equity compensation plans may create a loophole for entities to avoid the requirements of ED 2. We suggest it might be appropriate as a consequence of the proposed accounting treatment for share-based payment transactions to reconsider the scope exclusion in paragraph 6 of SIC–12. In any case we would encourage the Board to address the issue (e.g. as in the Basis for Conclusions of IAS 19, paragraph 68 D(f)), because we believe that this is of practical relevance.

Appendix B: Financial instruments

Comments on inconsistencies between ED 2 and IAS 32 and 39

We have noted the following key inconsistencies between ED 2 and (proposed amended) IAS 32 and IAS 39:

- The scope of ED 2 extends to transactions in equity of group entities (paragraph 3) whereas the proposed amendments to IAS 32 are silent on the treatment of transactions in equity of other group entities.

- According to the ED 2 proposals (paragraph 4), share-based payment transactions without a cash alternative always result in a credit to equity. Under the proposed amendments to IAS 32, transactions that are settled in a variable number of own shares result in a liability.

- If shares or options are repurchased for an amount that exceeds the fair value of the shares or options at the date of the repurchase, ED 2 proposes that any excess should be recognised as an expense (paragraphs 29(b) and 30). In terms of IAS 32.29A repurchases of own equity should never result in a gain or loss being recognised; IAS 32 seems to assume that all repurchases are at arm's length.

- Cash-settled share-based payment transactions normally contain written calls on own equity that are net cash settled. Under IAS 32 written calls on own equity that will be net cash settled are treated as derivatives and therefore measured at fair value with all changes in fair value recognised in the income statement. We supported the proposed amendments to IAS 32 (see our comment letter on the IAS 32 proposed amendments for further details). Paragraph 31 of ED 2 requires cash-settled share-based payments to be recognised as a liability and measured at fair value with changes in fair value being recognised in the income statement. However, ED 2 does not refer to these transactions as a derivative, although an option pricing model is used to value the liability in the illustrative example in appendix C.

- Under IAS 39 there is an exemption from the requirement to measure a derivative linked to an unlisted equity investment at fair value subsequent to initial acquisition if the fair value cannot be estimated reliably. No similar exemption from fair value measurement subsequent to initial recognition is proposed in ED 2. We do not believe an exemption from fair value measurement is appropriate for initial measurement purposes (at this date the entity should be deemed to be able to determine a value for the transaction if they have entered into the transaction); but for transactions that give rise to a derivative liability that is required to be remeasured, we believe additional consideration should be given as to whether a reference to the exemption in IAS 39 should be included.

- Under IAS 32 net share-settled derivatives on own equity also are treated as liabilities. ED 2 does not address transactions that are settled net in shares.

- Both IAS 32 and ED 2.35 propose that if there is a cash settlement alternative, a transaction in own equity shall be treated as a liability if it gives rise to a potential obligation to settle in cash. We agree with this principle. However, the guidance for determining whether a share-based payment transaction that may be settled in cash gives rise to a liability in ED 2 differs from the guidance in the proposed amendments to IAS 32, specifically IAS 32.29E and 29F and ED 2.35 and 42. We are not certain whether the Board intended this classification difference, or whether the guidance in ED 2 and IAS 32 in this regard should be conformed.

- ED 2.36 proposes that if the counterparty can choose cash settlement, there is a compound instrument; it then provides some guidance on how to measure the debt and equity components. On the other hand the proposed amendments to IAS 32 require a transaction in own equity to be treated as a derivative if the counterparty has an option for cash settlement. Derivatives on own equity are not considered to be compound instruments under IAS 32 and so IAS 32 does not require a bifurcation of the debt and equity components of derivatives on own equity with cash settlement alternatives.

- ED 2 requires that where a counterparty has the choice of cash settlement the fair value of both the debt and equity components is determined and the compound instrument is measured as the sum of the components. Under the proposed amendments to IAS 32, the fair value of a compound instrument is deemed to be the proceeds received (analogous to the fair value of the compound instrument in ED 2) on the issue of the instrument. No gain or loss is recognised on the initial recognition of such an instrument. The fair value of the liability component is determined first, and the balance of the proceeds received are allocated to the equity component on the basis that equity is a residual. No attempt is made to fair value the equity component. ED 2, BC243 argues that the method proposed is the same as the method proposed in IAS 32. However, measuring a compound instrument at the sum of the fair values of the individual components may not give the same result as measuring the liability component at fair value and allocating the residual amount to the equity component. In that case a difference between ED 2 and IAS 32 would occur.

- ED 2 provides specific rules about how to account for a situation where an entity treats a transaction with a cash settlement alternative as if it will be settled in equity but settles the transaction in cash (ED 2.44). There is no guidance on how to account for such a situation in the proposed amendments to IAS 32 and IAS 39.

- ED 2 does not provide guidance on the remeasurement of derivative liabilities (except at settlement), whereas IAS 39 requires remeasurement at every reporting date.

Table comparing ED 2 and IAS 32 and 39 approaches for specific instruments

	Transaction	ED 2	IAS 32 and IAS 39 (proposed revised)	Difference	Net profit or loss impact?
1	Equity settled transaction with vesting period: option to purchase fixed number of shares for a fixed exercise price or grant of fixed number of shares.	Equity and not remeasured.	Equity and not remeasured.	No differences in principle. Different levels of guidance on recognition and measurement issues.	No
2	Equity settled transaction: fixed number of shares to be issued if performance conditions met.	Equity and not remeasured.	Equity and not remeasured.	No differences in principle. Different levels of guidance on recognition and measurement issues.	No
3	Equity settled transaction: shares having a fixed monetary value will be issued if vesting conditions met.	Equity and not remeasured.	Liability. Remeasurement not applicable as there is a fixed monetary amount.	Yes. Liability versus equity treatment for the credit side.	No
4	Net equity settled transaction: share appreciation rights settled by issuing shares equal in value to the equivalent cash settlement amount.	Equity and not remeasured.	Derivative liability, remeasured through the income statement.	Yes. Derivative liability versus equity treatment of the credit side. Equity is not remeasured. Derivative liabilities are measured at fair value and gains and losses are reported in the income statement.	Yes

	Transaction	ED 2	IAS 32 and IAS 39 (proposed revised)	Difference	Net profit or loss impact?
5	Equity settled transaction where option exercise price is not fixed, for example it is the share price at the exercise date less 20%.	Equity and not remeasured.	Derivative liability, remeasured through the income statement.	Yes. Derivative versus equity treatment for the credit side. Equity is not remeasured, derivative liabilities measured at fair value and gains and losses are reported in the income statement.	Yes
6	Share appreciation rights.	Liability. Remeasured through the income statement as an adjustment to the employee cost.	Derivative liability. Remeasured through financial income or expense.	Yes. Classification of gains and losses in the income statement.	No[1]
7	Counterparty has a choice to receive cash or fixed number of shares.	Compound instrument with liability and equity components. Remeasure liability, presumably through the income statement.	Derivative liability remeasured through financial income or expense.	Yes. Equity/liability classification and income statement classification of gains and losses.	Probably not[2].
8	Entity has a choice to settle in cash or own equity.	Treat as equity if certain conditions are met. Otherwise treat as liability.	Treat as equity if certain conditions are met. Otherwise treat as derivative.	Yes. Conditions for equity or liability classification are similar but not identical. Also, if it is treated as a derivative, classification of gains and losses in the income statement is different.	Probably not[3].

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[1] There will be no bottom line income statement impact assuming under ED 2 the liability is recognised over the service period using a units of service approach consistent with the approach used for equity settled transactions. However, the illustrative example in ED 2 treats the liability as arising on a straight line basis over the vesting period. This method results in different timing of recognition.
[2] The subsequent measurement of the liability element is not clear from ED 2. The valuation could be done on a relative value approach, or the entire instrument (including the equity component) could be measured at fair value with all changes in fair value attributed to the liability component. The former approach would give a different income statement result.
[3] Unless liability/equity classification differs as a result of different levels of guidance.

	Transaction	ED 2	IAS 32 and IAS 39 (proposed revised)	Difference	Net profit or loss impact?
9	"Package" for example counterparty can choose to receive a fixed number of shares or a payment based on increase in share price.	Compound instrument with liability and equity components. Remeasure liability, presumably through the income statement.	Accounting for two interdependent alternatives is not addressed. If apply general principle, classify combination of instruments as a liability and remeasure it.	Yes. Equity/liability classification and income statement classification of gains and losses.	Probably not.[4]

[4] It is not clear from ED 2 how the liability component should be remeasured, in particular whether the valuation should be done on a relative value approach, or whether the entire instrument (including the equity component) should be measured at fair value with all changes in fair value attributed to the liability component. The former approach would give a different income statement result.

Appendix C – Comments on Implementation Guidance

ED 2 states that the requirement to include transfers of equity instruments from group entities does not apply where the transfer is clearly for another purpose. We note that BC19 includes examples and believe it would be more appropriate to include these in the Implementation Guidance.

We note that a footnote to BC1 includes a discussion of what an issue of shares is. The interaction with SIC–16 is an important one and we think that it should be included in the Implementation Guidance.

In IG5 objectives are stated for the valuation of an option using a model and for determining expected lives. These objectives are not included in ED 2 and we believe that would be a more appropriate place for such principles.

There is some additional guidance on valuing options in the Basis for Conclusions. We believe that this guidance is helpful in ensuring consistent application of the requirements of the proposed standard, and we recommend that consideration be given to moving or repeating the paragraphs that contain guidance on valuation issues in the Implementation Guidance.

Appendix D – Drafting comments

Question 1

Leases are not listed in the examples of transactions in the scope of ED 2 in paragraph 3. They also are not specifically excluded. We believe that share-based payment transactions in respect of leases should be included in the scope of the share-based payments standard and we believe that this should be clarified.

Paragraph 2 also restricts itself to entities in the group. We are not sure if "group" has the same meaning as in the existing Glossary, or alternatively if it is intended to include subsidiaries outside the entity, for example under common control, or other related parties, such as pension funds, other employee benefit trusts or associates. We suggest that it should be restricted to entities that are controlled by the parent and included in its consolidation and think that it would be helpful to include the existing definition in the Glossary.

Question 3

We have some comments on the manner in which section 7 is drafted. The general principle, in black type, that it is *"…whichever fair value is more readily determinable…"* is overridden by grey-letter paragraph 11 for employees. We are concerned that there is scope for confusion. We suggest that paragraph 7 stops after *granted.* Incorporating our comments elsewhere on the proposals themselves, a new black-letter paragraph could be inserted to say:

"For transactions with employees, the entity shall measure the fair value of services by reference to the fair value of the equity instruments granted. For other transactions, the entity shall use whichever value is more reliably measured."

Question 4

The definition of fair value in the Glossary does not appear to cover services or, explicitly, goods and we suggest that these are incorporated. If these are meant to be covered by the “momentary asset” discussion in ED 2, this should be addressed specifically. Alternatively, if the Glossary definition is intended to cover every standard, we suggest that a paragraph is included in the standard explaining how this should be interpreted for goods and services in the context of this standard.

There is no definition of an employee in the Glossary. Given that there are differences in treatment for share-based payments with employees and non-employees we recommend that a definition of an employee be included. We suggest a definition consistent with the guidance in this regard in IAS 19.

Question 5

We are unclear of the purpose of the final sentence of paragraph 8. It seems to us that this forms part of the Basis for Conclusions, rather than being a necessary part of the standard.

Question 7

Paragraph 12 and *because* onwards in paragraph 11 are devoted to the argument of what is more readily determinable. We wonder if this would fit more appropriately in the Basis for Conclusions.

Furthermore, paragraphs 11 and 12 do not cover the receipt of goods from employees. An example might be the purchase of a factory building in exchange for an equity instrument from an employee who is also a shareholder. The fair value of the factory probably is more reliably determinable than that of the equity instrument.

Question 8

We suggest that *when* in line 5 of paragraph 14 should be *as* to be consistent with paragraph 4.

We assume that paragraph 13 also applies to goods, and suggest that this be stated.

Question 9

Generally, the definition does not seem to envisage anything other than a time-based method of allocation and it seems to leave the entity free to determine the period of time that defines a unit. However, if a unit is longer than the minimum reporting period that the entity is obliged to follow, e.g. (semi) annual or quarterly, there may be difficulties in performing the accounting for the shorter reporting period.

Question 11

It is unclear how paragraph 18 should be interpreted. If it is intended to give guidance that all terms and conditions should be included, rather than just those listed, then we think this could be stated more clearly. We also wonder if the word *discussion* should be *guidance*.

The definition of risk-free interest rate in the Glossary includes the phrase *currently available*. We assume that this is intended to mean that the rate is measured at the date of measurement of the option. It might be clearer if these words are deleted from the definition, and an explanation along these lines included in paragraph 20 (f).

The definition of risk-free interest rate assumes it always is possible to determine the country in which an entity's shares are principally traded, but we are unsure if this always will be the case. We suggest that the Implementation Guidance could be expanded to discuss how to determine this if it is not clear.

Question 14

In the Glossary the definition of reload feature might be clearer to those unfamiliar with the term if "*…for a share used…*" was replaced by "*…in return for using a share (instead of cash)…*".

Question 17

We wonder if the first sentence of paragraph 27 is more appropriately included in the Basis for Conclusions, and we suggest deleting "*Therefore*" at the beginning of the next sentence.

While it appears clear from the example in the appendix that the estimate of units of service is reassessed at the date of re-pricing, the first sentence of paragraph 28 is not entirely clear. We suggest the following:

"To apply the requirement in paragraph 27, at the date of re-pricing the entity shall estimate the number of (outstanding original and incremental) units of service it expects to receive during the period from the date of re-pricing until the end of the vesting period of the re-priced options. To determine the amount to attribute to each unit of service received in respect of the incremental value granted, the entity shall divide the incremental value granted by the number of (outstanding original and incremental) units of service, so estimated."

To increase clarity we also suggest adding four words (underlined) in the third sentence "…in each period <u>from re-pricing to vesting</u> by multiplying…"

In example 3, appendix B, third paragraph of APPLICATION OF REQUIREMENTS, we suggest that adding the words underlined would assist the reader to understand that it is only the calculations after re-pricing that are re-estimated. "Suppose everything <u>after re-pricing</u> turns out as expected." We also suggest that it would be helpful to indicate what would happen if everything did not turn out as expected. (We assume that the outcome would be the same as in example 1).

Question 18

In paragraph 30, we assume that the intention is to measure the fair value of the equity instruments at repurchase date. If so, we suggest the addition of a word (underlined) as follows: *"…instruments repurchased, <u>measured</u> at the repurchase date."*

We think that the reference in the fifth paragraph in example 4 of Appendix B is meant to refer to example 3 instead of 4.

Question 19

We suggest that the first "*at*" in paragraph 31 should be "*by reference to*" in line with the footnote to paragraph 7.

The example in paragraph 34 reflects a simple set of circumstances. We wonder if this is the appropriate place to put the example and suggest it might fit better in the appendix. We think that the appendix is helpful in explaining the simple case, but we think that more complicated examples should be included as well, together with guidance on how to interpret the requirements.

In paragraph 34 there is a requirement to re-measure at each reporting date. We assume that re-measurement also would be required at interim reporting dates. We suggest that guidance is included in the Implementation Guidance to clarify this.

We note that the changes in fair value are recognised in *profit or loss;* we wonder if *income statement* was the intended description in line with Question 19.

The rounding in almost all the examples in Appendix B is an inconsistent mixture of exact and inexact calculations to many decimal places (CU 444.4444444444+).

Appendix B, example 3 in paragraph B5, makes no adjustment in calculating the incremental value for expected leavers. This appears to be an error, which would lead to misapplication of the standard. If intentional, please explain (especially why the treatment is different from that in example 1).

In IG27 we think that adding the words *'..to which the employee is not entitled.'* at the end of the paragraph would make it easier to understand.

The final text paragraph in Appendix C mentions that intrinsic value is shown and then these values are used for completeness to show the flow through the income statement. We think this is helpful, but suggest that *intrinsic value* is defined in the Glossary.