CL 45

5 March 2003

Kimberley Crook
Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Kimberley

International Accounting Standards Board
Exposure Draft 2 "Share Based Payments"

CPA Australia is pleased to provide comments on IASB Exposure Draft ED 2 "Share Based Payments". Our submission has been prepared by the Victorian Cell of the External Reporting Centre of Excellence and reviewed by the Centre of Excellence. This submission represents the views of CPA Australia.

In general, CPA Australia supports the proposals contained in ED 2, however we do have some differing views on the proposed standard:

1. We support the view that recognition of the equity instrument occurs as the service is received, although we do not agree with your proposed measurement criteria that an amount should be attributed to each unit of service received. Our alternative treatment is outlined in the Appendix.

2. We do not agree that the delivery (service) date is the appropriate date at which the fair value of the goods and services should be measured. Our alternative view is that the measurement date should be the grant date, irrespective of whether the transaction is measured with reference to the fair value of the equity instruments or the goods or services received.

Our comments to the specific issues identified in ED 2 are contained in the attached appendix.

If you have any questions regarding the above, please contact Jim Dixon on Tel: (03) 9606 9608 or email jim.dixon@cpaaustralia.com.au or Naomi Carroll, Accounting and Audit Policy Adviser on Tel: (03) 9606 9872 or email naomi.carroll@cpaaustralia.com.au

Yours sincerely

GREG LARSEN, FCPA
Chief Executive

c.c. K Lewis
J Dixon
N Carroll

APPENDIX

IASB INVITATION TO COMMENT

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 agree with the IASB proposal.

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 agree with the IASB proposal.

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 IASB proposal for the reasons given in the Basis for Conclusions

We do have reservations on how large proprietary companies (unlisted) in Australia will implement this standard and encourage the Board (BC143) to provide guidance on estimating expected volatility for the purposes of applying an option pricing model to options granted by unlisted and newly listed entities.

Question 4

If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured directly, the draft IFRS proposes that fair value should be measured at the date when the entity obtains the goods or receives the services (paragraph 8).

Do you agree that this is the appropriate date at which to measure the fair value of the goods or services received? If not, at which date should the fair value of the goods or services received be measured? Why?

We are concerned that 'obtains" and "receives" will be interpreted as the date of physical receipt of goods and that in some cases there may be significant time lags between the grant date and the delivery date of goods. Therefore we do not agree that the delivery (service) date is necessarily the appropriate date at which the fair value of the goods and services should be measured.

We are of the view that in principle the measurement date should be grant date irrespective of whether the transaction is measured with reference to the fair value of the equity instruments or the goods or services received. In an exchange transaction between knowledgeable willing buyers and sellers the measurement of the transaction would not be materially influenced by measuring either the goods or services received, or the equity instruments granted, i.e. there would be no material difference between the fair value of the goods or services and the fair value of the equity instruments. We therefore support the rebuttable presumptions established in respect of reliability of measurement of goods, services or equity instruments (see response to questions 6 and 7 below.)

However, we believe that some caution needs to be introduced to protect against circumstances in which the direct measurement approach is adopted and where grant date (as defined) and the date at which the entity obtains the goods are different and measuring the fair value of the goods or services at the date the entity obtains those goods or the counterparty renders the services would not necessarily result in the same measurement as at grant date.

Question 5

If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured by reference to the fair value of the equity instruments granted, the draft IFRS proposes that the fair value of the equity instruments granted should be measured at grant date (paragraph 8).

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

We agree with the IASB proposal.

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 approach as explained in paragraph 10.

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?

We agree with the IASB.

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 IASB proposal. The equity instruments should be expensed during the vesting period as the service provided during the vesting period provides the employee with the right to the equity instruments.

Question 9

If the services received are measured by using the fair value of the equity instruments granted as a surrogate measure, the draft IFRS proposes that the entity should determine the amount to attribute to each unit of service received, by dividing the fair value of the equity instruments granted by the number of units of service expected to be received during the vesting period (paragraph 15).

Do you agree that if the fair value of the equity instruments granted is used as a surrogate measure of the fair value of the services received, it is necessary to determine the amount to attribute to each unit of service received? If not, what alternative approach do you propose? If an entity is required to determine the amount to attribute to each unit of service received, do you agree that this should be calculated by dividing the fair value of the equity instruments granted by the number of units of services expected to be received during the vesting period? If not, what alternative method do you propose?

We support the view that recognition of the equity instrument occurs as the service is received, although we do not agree with your measurement criteria that an amount should be attributed to each unit of service received.

The proposed method as illustrated in example 1 of Appendix B has a limitation. This limitation can best be illustrated by assuming no employee leaves the entity. In such a case, the total cost recognised under the example will be 500 x 444.44 x 3 = CU666,660. However, it would be more logical to recognise the full cost of CU750,000. The difference is due to the fact that the deemed fair value of each unit of service is in part dependent on an estimate of employee retention which is subsequently not adjusted, despite the fact that actual retention is used elsewhere in the expense calculation. On the face of it the proposed method could be considered as unduly complex, producing the wrong result, unless fully adjusted for actual units of service received. The method described in

Para 15 and example 1 of Appendix B could be further developed to require an adjustment of the deemed fair value of each unit of service received in order to fully reflect the actual development of the vesting conditions. As an alternative, a simplification could take the form of a straight line depreciation of the initially determined fair value of the services received, adjusted at each reporting date for actual units of services received.

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 with the IASB proposal.

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?

Basically while we agree with the IASB proposal, we feel that option pricing models are complex and further guidance should be given regarding the use of the model(s). We would encourage the IASB to explore other options with valuation specialists.

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 with the IASB proposal.

Question 13

If a grant of shares or options is conditional upon satisfying specified vesting conditions, the draft IFRS proposes that these conditions should be taken into account when an entity measures the fair value of the shares or options granted. In the case of options, vesting conditions should be taken into account either by incorporating them into the application of an option pricing model or by making an appropriate adjustment to the value produced by such a model (paragraph 24).

Do you agree that vesting conditions should be taken into account when estimating the fair value of options or shares granted? If not, why not? Do you have any suggestions for how vesting conditions should be taken into account when estimating the fair value of shares or options granted?

We agree that vesting conditions should effect the expense recognised. However, we believe it would be more logical (and less confusing) not to include these in the calculation of the fair value of the option, but instead require an adjustment to the fair value produced by such a model. Such an "adjusted" fair value best reflects the fair value of the services expected to be received at grant date.

When vesting conditions comprise performance conditions that must be satisfied, we believe determination of the "appropriate adjustment" can become very arbitrary. For instance, when vesting conditions are linked with the future performance of other organisations (eg entity share price developments versus industry index), we believe the determination of the weighted average probability that the performance target will be achieved, is very judgemental.

We encourage the IASB to explore other options with valuation specialists.

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 agree that the reload feature should be treated as a new option in the situation where the reload was issued subsequent to the initial issue of the option. However, if the reload feature is included in the original value of the option, it should not be accounted for as a new option, as we believe that the reload feature would be included in the original value of the option.

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 are not aware of any other features common to employee share options.

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 the Board's approach not to prescribe in detail how the fair value of options should be estimated.

Question 17

If an entity reprices a share option, or otherwise modifies the terms or conditions on which equity instruments were granted, the draft IFRS proposes that the entity should measure the incremental value granted upon repricing, and include that incremental value when measuring the services received. This means that the entity is required to recognise additional amounts for services received during the remainder of the vesting period, ie additional to the amounts recognised in respect of the original option grant.

Example 3 in Appendix B illustrates this requirement. As shown in that example, the incremental value granted on repricing is treated as a new option grant, in addition to the original option grant. An alternative approach is also illustrated, whereby the two grants are averaged and spread over the remainder of the vesting period.

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

We agree that if an entity reprices a share option, or otherwise modifies the terms and conditions on which equity instruments were granted, it should measure the incremental value granted, upon repricing and include the incremental value when measuring services received during the remainder of the vesting period. We believe that the alternative method illustrated in example 3 of Appendix B is the most appropriate method because under this method the total expense of the services is better matched with the period in which the service is actually received (i.e. year 3 and 4 in example 3). After all, the Board concluded (BC60) that, when accounting for an equity-settled share based payment transaction, the primary accounting objective is to account for the goods and services received as consideration. In addition, the alternative method reflects the fact that a repricing took place instead of assuming the original option grant is still in place, as is done under the first method.

Question 18

If an entity cancels a share or option grant during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied), the draft IFRS proposes that the entity should continue to recognise the services rendered by the counterparty in the remainder of the vesting period, as if that grant had not been cancelled. The draft IFRS also proposes requirements for dealing with any payment made on cancellation and/or a grant of replacement options, and for the repurchase of vested equity instruments.

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

We agree with the IASB proposal.

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 IASB proposal.

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 IASB proposal in paras 35 to 44.

Question 21

The draft IFRS proposes that an entity should disclose information to enable users of financial statements to understand:

1. **the nature and extent of share-based payment arrangements that existed during the period,**

2. **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**

3. **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 support the disclosure principles set out in paras 45,47 and 51 but believe the minimum disclosure requirement set out in detail, and most particularly in Para 48, are excessive. After all, the disclosures should support the understanding and interpretation of the amounts recognised and are not considered as stand alone information. Disclosure should concentrate on the factors to which the estimated amounts are the most sensitive, particularly if they relate to an assumption that is essentially subjective. The object of disclosure should not be to enable users to check the calculation made by the entity. It would be better therefore to treat Para 46,48 and 52 as illustrative of the sort of disclosure needed to meet the requirements set out in bold paragraphs rather than minimum disclosure rules.

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 (i. e. the amount that would have been paid on settlement of the liability had the counterparty demanded settlement at the date the liability is measured).

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

Generally, we agree but we make the following observations. Alternative transitional provisions in respect of share-based payment transactions that have not vested at the beginning of the year in which the standard is first applied could be as follows:

- no comparative figures are required to be presented in the first period of application of the standard with regard to items that have not been disclosed in the entity's financial statements of the prior period;
- where an entity, prior to the beginning of the period in which the standard is first applied, recognised share-based payment transactions using a fair value measurement basis, the values attributed to such transactions at the end of the period immediately prior to that in which the standard is first applied are deemed to have been determined in accordance with the standard;
- where an entity, prior to the beginning of the period in which the standard is first applied, recognised share-based payment transactions using a measurement basis other than fair value, or where an entity has not previously recognised share-based payment transactions, the financial statements must be adjusted as if the requirements of the standard had been applicable when the

shares/options were granted. This adjustment must be recognised in the statement of movements in equity as an adjustment against equity at the beginning of the period in which the standard is first applied and relevant portions of this amount must be included in any components of equity that are separately disclosed. If measurement of the transaction at fair value at grant date would result in undue cost and effort to the entity, the entity is allowed to measure the transaction at fair value as at the beginning of the period in which the standard is first applied.

Although the alternative transitional provisions would not necessary result in the share-based payment transaction being measured at grant date, the transaction would be measured using a fair value measurement basis which would enhance the comparability of financial statements.

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 IASB proposal.

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 believe the IASB proposed treatment is more appropriate in the above cases, except for the points discussed under (b). In regards to our view point (b) we refer to our draft responses to question 9.

Question 25

Do you have any other comments on the Exposure Draft?

We have no further comments