PITCHER PARTNERS
ACCOUNTANTS AUDITORS & ADVISORS

Level 6
161 Collins Street
Melbourne
Victoria 3000

Tel: 03 9289 9999
Fax: 03 9289 9977

Postal Address:
GPO Box 5193 AA
Melbourne Vic 3001
Australia

DX Address:
DX 501 Melbourne

Website: www.pitcher.com.au
E-mail: partners@pitcher.com.au

AN INDEPENDENT MEMBER OF BAKER TILLY
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CONSULTANT: R G PITCHER

AN INDEPENDENT VICTORIAN PARTNERSHIP

24 February 2003

Kimberley Crook
Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Ms Crook,

IASB ED 2 Share-Based Payment

Our comments on this exposure draft are provided in the attached submission. A copy of this submission has also been provided to the Australian Accounting Standards Board.

Pitcher Partners is a large accounting firm of 34 partners and 440 staff, which provides accounting, audit and advisory services to medium and large *Australian* based (ie. local) businesses. Our comments reflect the issues arising in implementing the recommendation of ED 2 to reporting entities in this segment of the market place, in contrast to those primarily concerned with capital markets.

There has been intense public pressure in recent months to address the reporting requirements for share-based payments, and options in particular. We therefore fully endorse the IASB's objective in providing leadership on accounting for share-based payments in the development of this accounting standard.

This proposed standard introduces a new dimension into the emerging fair value accounting model that is currently used, to varying degrees, around the world. In setting a new precedent, it is important that the proposed accounting treatment not only measures the value of the "costs" incurred, but that it also reflects the economic reality of the arrangement.

As an overall observation, the proposed accounting treatments seem reasonable when the share-based payment is *not* conditional on certain events occurring. In these circumstances the argument that the granting of options or similar, forms part of a total remuneration package for services rendered, is rational. In contrast, when the share-based payment *is* conditional on the occurrence of certain events the meaning behind the proposed accounting treatment appears to be detached from the economic substance of the arrangement. This "detachment" becomes even more confusing when conditions are *not* met, and the proposed accounting treatment leads to higher costs being sustained.

This predicament is discussed in further in our submission.

Similarly, the global application of international accounting standards to local, privately owned businesses needs further consideration. Although the IASB may consider that this issue is something that must be addressed in local jurisdictions, it is an important underlying consideration in the determination of accounting pronouncements. The development and application of accounting standards is intended to improve the quality of financial information provided. This includes consideration of the relevance and reliability of that information. Therefore the international accounting framework refers to consideration of the information needs of users, when preparing financial reports. This requirement is subject to further interpretation in local jurisdictions and for example, in Australia, is addressed in Statement of Accounting Concept 1 "Definition of the Reporting Entity".

ED 2, in common with the growing trend, contains sophisticated estimation techniques based on various assumptions. For example, in Appendix 2 Example 1 there are numerous variables that need to be input to determine the appropriate charges. These include share price, exercise price, expected volatility, expected dividends, risk-free interest rate for the life of the option, expected years service, weighted average probability of failure to achieve performance targets. Reasonable estimations may be available for listed entities with a good securities trading record, extensive HR statistics etc and therefore the foundation figures used for estimation are more likely to be reliable. In contrast when smaller entities, with less extensive resources and shares that are not traded regularly, use estimation techniques based on lower quality information, the reliability of information used is questionable.

The development of theoretically based accounting standards today, in contrast to the transaction based accounting standards of past decades, **must** be directly related to the context for their preparation and use to ensure the reliability of the financial information reported. In Australia there are many small listed entities (relative to global scale), and privately owned businesses that do issue share-based payments as compensation to directors and employees. The ability of these entities to prepare reliable estimations of "costs" when the market for their shares is not active, raises serious concerns. The risk is that the inappropriate application of these accounting requirements will escalate rather than address the current crisis in financial reporting.

The following schedules are attached:

(a) Summary of main recommendations

(b) Responses to IASB specific questions 1 to 24

Please contact Dianne Azoor Hughes to discuss further any matters arising from this submission (telephone: +61 3 9289 9772 or e-mail: dhughes@pitcher.com.au).

Yours sincerely

Terry Benfold
PARTNER

S. Dianne Azoor Hughes
TECHNICAL DIRECTOR

Summary of Main Recommendations

- We strongly recommend that a scope paragraph be introduced to limit application of this proposed accounting standard to entities having securities listed on a recognised securities exchange. Given the extent of technical expertise required, the benefits of applying this standard to smaller entities will be outweighed by the associated costs and the increased risk of unreliable estimations being incorporated into the financial statements.
- We recommend that further guidance should be provided regarding the appropriate valuation method to be used and the way in which adjustments are to be incorporated. Such guidance is needed to encourage consistent estimation processes to improve comparability. This includes examples showing adjustments to incorporate vesting conditions or reload features that enhance the original offer.
- We recommend that further guidance material should be developed with audit processes in mind. Given the high level of subjectivity in the estimation techniques adopted, and the scope for adjusting expense amounts through the repricing of options, extensive guidance will be needed to encourage a consistent approach to the application of the requirements of the IFRS. We have concerns as to how an auditor would be able to address those situations where a client seeking a particular outcome, selects assumptions that produce the desired result.
- We recommend that when equity instruments are forfeited for whatever reason, the expense previously recorded should be reversed to reflect the economic substance of the transaction. For example, if a performance hurdle is *not* met causing an option to lapse, then in our view, a benefit has not been received by the entity and the previous expense allocations has no meaning. In this scenario, or if options are not exercised by the end of the vesting period, then equivalent amounts should be transferred back from the options granted account into retained earnings.
- We recommend that the repricing of the option should be treated as a new option grant, and specifically when performance hurdles are not met. The incremental change in fair value should only be taken up (with no other reversals) when the repricing enhances the original terms and conditions.
- We recommend that the IFRS should require that at the end of the vesting period appropriate transfers should be made to other equity accounts to reflect the actual events. For example, if options were exercised, a transfer would be made to relevant share capital account, whereas if the options lapsed, a transfer would be made to retained earnings. The retention of a ‘miscellaneous’ equity account balance after the end of the vesting period, with no meaning or function, is not beneficial to an understanding of the financial report.

Responses to IASB specific questions 1 to 24

Question 1

The scope description refers to the nature of transactions and does not make any reference to the type of entity initiating those transactions. As discussed elsewhere in this submission, we have serious concerns regarding the reliability of measurement when a financial model is used and there is no active market in the securities to be issued. Our particular concern would be for those entities whose securities are not publicly traded on a recognised securities exchange – such as non-listed public companies and proprietary companies.

We have experience of companies in their start-up phase where directors receive options instead of cash remuneration, in recognition of the fact (for example) that a product is still in its development phase, and to minimise the impact on the statement of financial performance and cash flow. Depending on the future success of the product, these options clearly do have some value. However due to the high level of uncertainty regarding both the business prospects, *and* the assumptions used in any valuation model adopted, the amounts to be recognised as an expense in this scenario is little more than speculation. We would question the value and wisdom in providing unreliable financial information.

We strongly recommend that a scope paragraph be introduced to limit application of this proposed accounting standard to entities having securities listed on a recognised securities exchange.

We agree that all share-based transactions should be included within the scope of the proposed IFRS for listed entities.

Question 2

These paragraphs are contrary to Australian taxation laws, which state that a company's share capital will be tainted where a transfer is made to the share capital account from any other account. (*Income Tax Assessment Act* 1936 s160ARDM). The tainting of share capital is detrimental to the entity's taxation position, and therefore application of these paragraphs causes practical concerns.

We understand that the AASB is seeking to resolve this issue with Treasury. Subject to the satisfactory resolution of this issue in the Australian tax legislation, we agree in principle with the proposals set out in paragraphs 4-6.

Question 3

The reliability of fair value measurements is dependent on the quality of the assumptions used, which in turn often requires a certain level of sophistication in the collection and analysis of relevant data. Typically, the nature and scale of unlisted entities means that it is unlikely that resources will be available to support reliable estimations techniques. Also, with unlisted entities, it is more likely that share-based payments will be made only when there is uncertainty about future prospects and a need to protect current cash flows (particularly start-up companies). In these scenarios calculations are little more than speculation and their potential to mislead users is just as great (or maybe greater) than their potential to provide useful information.

We strongly recommend that a scope paragraph be introduced to limit application of this proposed accounting standard to entities having securities listed on a recognised securities exchange.

Question 4

In accordance with the basic concept of accruals accounting, the value should be determined as at the date when the goods or services are received.

Question 5

We agree that the fair value of equity instruments granted measured at grant date can be used to provide a surrogate measure of the fair value of the goods or services received.

Question 6

The presumption that the fair value of goods and services received is more readily determinable than the fair value of the equity instruments granted seems reasonable. However, in our experience this type of exchange occurs predominantly in the sale of business undertakings.

We have some concerns that if (say), the partial sale of business operations to a third party did not fall under the criteria in the proposed standard on *Business Combinations,* then there is increased risk of misstatement in the measurement of fair value. (However, we have not yet considered the provisions of ED 109.)

For example, a company exchanges the segment assets of one operating division for shares in another entity. When both companies are proprietary companies (ie. no market prices), determination of fair values may become an arbitrary exercise.

Question 7

When equity instruments are issued as compensation for employee services to minimise cash out-flows because the entity is in a start-up phase, an estimate of the “cash salary sacrifice” might be more reliable than speculation in determining fair values based on assumptions with no track records.

(However, if the proposed IFRS were to include a scope paragraph that limited application of this proposed accounting standard to entities having securities listed on a recognised securities exchange, this problem would be largely overcome.)

Question 8

In the examples mentioned above re start-up entities, it is probable that options would be granted with a long vesting period, to allow the business to develop before further commitments of capital. In these scenarios, the timing of when options may be exercised are more closely aligned with the business lifecycle, rather than the period when employee services are received.

In contrast, when options are granted incorporating performance hurdles there is a clear indication that the services are receivable during the period when the performance hurdle is sought after or achieved.

Question 9

Except for matters arising re start-up entities discussed in question 8 above, we concur with apportionment of cost by reference to service units used during the vesting period. This method supports the fundamental principle of accruals accounting.

Clarification of the appropriate accounting entries would be useful to deter manipulation of balances in the financial report. For example, are the service units receivable at the reporting date to be taken up as an asset, with a corresponding amount as equity, or as a liability? Or is the equity account built up as the services are received?

Scenario (i)
At first reporting date after grant date if options are recognised in full:
DR Employee services receivable
CR Equity – options granted

And at subsequent reporting dates:
DR Employee expense
CR Employee service receivable

Scenario (ii)
At first reporting date after grant date and future employee commitments shown as a receivable and liability:
DR Employee services receivable
CR Liability – to fund future employee services receivable

And at subsequent reporting dates:
DR Employee expense
CR Employee service receivable

DR Liability – to fund future employee services receivable
CR Equity – options granted

Scenario (iii)
At each reporting date:
DR Employee expense
CR Equity (share-based payments account)
With amount corresponding to the number of service units used.

Question 10

In practice, we would anticipate that at the end of the vesting period appropriate transfers would be made to other equity accounts to reflect the actual events. For example, if options were exercised, a transfer would be made to relevant share capital account, whereas if the options lapsed, a transfer would be made to retained earnings.

The retention of a ‘miscellaneous’ equity account balance after the end of the vesting period, with no meaning or function, is not beneficial to an understanding of the financial report.

Question 11

We agree that in the absence of a market price, an option pricing model is likely to provide a best estimate of fair value. However, due to the existence of different valuation models it would be feasible that an entity could manipulate results to suit the circumstances. We also have serious reservations regarding the reliability of the information generated in certain circumstances.

For example consider the scenario where there is not an active market in the entity’s securities or securities are not traded on a securities exchange. Typically, these entities are likely to be smaller listed entities, or privately owned businesses. Assumptions relating to the current price of the underlying securities and expected volatility will require technical expertise and resources to determine appropriate estimates. In smaller[1] entities it is unlikely that the technical expertise will be available in-house. This means that estimations might be made by those without a proper understanding of the financial model, or that estimations need to be obtained at the cost of hiring the financial expertise. This issue is further compounded by the fact that there is more than one form of a financial model such as the Black-Scholes model, which will each include the six specified factors, but produce different results. It is necessary to select the appropriate adaptation of the model for the situation – again requiring significant technical expertise.

We believe that given the extent of technical expertise required, there is a need to carefully evaluate whether it is beneficial to apply this standard to smaller entities, having regard to the associated costs and the increased risk of unreliable estimations being incorporated into the financial statements.

We also recommend that further guidance should be provided regarding the appropriate valuation method to be used, to encourage consistent estimation processes that would improve comparability.

Question 12

Replacing an option’s contracted life with its expected life seems to provide a prima facie solution for adjusting the option’s fair value for the effects of non-transferability. However, we are unable to comment as to whether the theoretical basis for this adjustment is valid.

We agree with the use of a model such as Black-Scholes, which assumes that the option is only exercised at the end of the vesting period, for those options that are subject to vesting conditions, and which therefore cannot be exercised during the vesting period.

[1] The term ‘smaller’ is used in relation to multinational corporations and not in the sense of an SME. Many ‘large’ entities, as defined by legislation, and including smaller listed entities, will not have in-house technical expertise that extends beyond basic historical cost accounts’ preparation.

Question 13

We believe that vesting conditions do impact on the fair value of an option. We also agree, in principle, with incorporating vesting conditions into the application of an option pricing model. However, in the absence of a clear direction as to *how* an appropriate adjustment could be made, the ability to manipulate the fair value amount clearly exists. This impacts directly on the reliability of the estimate and the risk of incorporating unreliable financial information into the financial statements.

Question 14

A reload option would ordinarily be triggered by a change of circumstances. As such this is a new option grant rather than a component feature of the original option. In the absence of a specific link between the original grant and the reload option, we would expect the reload option to be accounted for as a new option grant.

We have concerns as to *how* a reload feature should be taken into account. Again, without specific guidance, there is scope for manipulation.

Question 15

We believe that the major features of employee share options have been considered.

Question 16

The application of the appropriate valuation methodology is a highly specialised area and we do not believe it is feasible for the IFRS to be more specific in mandating a particular approach. It would be useful if the IFRS emphasised that professional judgment and expertise is required to determine the form of the most appropriate valuation model to be adopted. It would also be useful if further examples could be provided to explain the appropriate approach in different circumstances.

Question 17

The reasons behind any modification to prices, terms or conditions of the option are fundamental to the way the change in estimate of the fair value of an equity instrument is treated. For example, when the option terms are modified to enhance the original offer it would be appropriate to allocate (average) the change in estimate over the remaining vesting period. In contrast, when it is clear that performance hurdles will not be met and the option terms are modified to respond to that change in expectations, the original costs should be reversed and the new costs allocated over the new vesting period.

Regarding the examples provided (Appendix B Examples 1-3) – the overall methodology seems to provide a reasonable approach subject to our comments below:

- We note that a small variation in the assumptions used can make a significant difference to the total fair value. Given the subjectivity associated with the assumptions on which estimates of probability are based, the quality of the financial information produced can only be described as “soft”. We also have concerns as to how an auditor would be able to address those situations where a client seeking a particular outcome, selects assumptions that produce the desired result. For example, in the absence of appropriate employee histories being available, it would be difficult for an auditor to explicitly demonstrate that assumptions are inappropriate when they are based on subjective management expectations.

- We note that the amounts recognised each year are not subsequently adjusted, even if the performance target is not achieved. It is feasible that in a dynamic business environment there could be a significant change in circumstances. The IFRS effectively presumes that repricing the option would reflect such changes. We agree that this is a likely outcome in practice.
- We have some concerns as to the meaning of the calculated costs when the granting of an option is linked to say an increase in share price (as per example 2). When an option is linked to this type of performance hurdle there is an implicit understanding that the service being provided by the employee will correspond to the 'value added' to the entity's market value. If the performance hurdle is not met, this suggests that the employee has not provided the 'value adding service'. However, by recording an expense, the assumption is that a service has been received. When the option is repriced the total expense over the period *for not receiving the value-adding service* will be greater than the total expense that would be recorded if the hurdle had been met (and hence value-adding service received). This outcome seems contrary to the substance of the arrangement. If the performance hurdle is *not* met, then previous expense allocations have no meaning and should be reversed. The repricing of the option should be treated as a new option grant.
- When performance hurdles are not met (as above) and need to be reversed, or for whatever reason options are not exercised, the significance of the balance recorded in the options granted account (as a component of equity) is not clear. Is this amount now available for distribution? Or does it need to be maintained separately, and if so for what purpose? If performance hurdles are not met, or if options are not exercised by the end of the vesting period, then the equivalent amounts should be transferred back from the options granted account into retained earnings. This would also necessitate a negative adjustment in the current year remuneration disclosures in relation to share-based payments for prior years not received or not taken up.
- Given the high level of subjectivity in the estimation techniques adopted, and the scope for adjusting expense amounts through the repricing of options, extensive guidance will be needed to encourage a consistent approach to the application of the requirements of the IFRS.

Question 18

Paragraph 27 recognises that the fair value of the options granted is a reasonable surrogate measure of the fair value of the services received. Therefore any changes to the terms and conditions on which the options were granted must be taken into account when measuring the services received. This requirement articulates the intrinsic relationship between the service delivered and value received. We concur with this relationship.

However when a grant of shares or options are cancelled during the vesting period, the requirement in paragraph 29(a) is contradictory to the first proposition. If the share-based payment is cancelled, there is a high likelihood that the service has not actually been received. We strongly disagree with the requirement in paragraph 29(a).

If a share-based payment is cancelled, the expense (and corresponding equity account entry) should be reversed. This entry is akin to the reversal of a liability that ceases to exist.

If a payment is made on cancellation of the grant we concur with the proposed treatment in paragraph 29(b) (also paragraph 30) to account for the payment as a repurchase of the equity interest. We also agree that any excess payment over the fair value of shares or options granted should be recognised as an expense. However, when such payments are less than the fair value of the shares or options granted, the balance in the 'options granted equity account' should be transferred back into retained earnings. Any balance held as a miscellaneous equity account has no meaning or purpose in isolation.

If a new option is granted, they should be treated in the same way as for the repricing of options. However, we do not concur with the accounting treatment proposed in the IFRS for repricing, as explained in the response to question 17 above. If the terms of an option are varied, this signifies that the required benefits have not been received by the entity, as determined at the grant date, and therefore expense entries should be reversed to the date of repricing. The value of the repriced option and future service as at the repricing date should be allocated over the new vesting period.

This alternative treatment represents the substance of the transaction when no benefit actually passes to the employee due to a variation in the terms and conditions. We consider that when there are nil benefits there can be no service delivered, and hence no expense.

Question 19

We concur with the proposed treatment for cash-settled share-based payment transactions.

Question 20

The proposed accounting treatments for share-based payments in which either the entity or the supplier of goods can choose whether the entity settles in cash or by issuing equity instruments appears reasonable. However, in practice the only transactions we have encountered that might fall into this category would be in relation to the sale of business assets. As stated above, we have some concerns that if (say), the partial sale of business operations to a third party did not fall under the criteria in the proposed standard on *Business Combinations*, then there is increased risk of misstatement in the measurement of fair value. (However, we have not yet considered the provisions of ED 109.)

Question 21

Although there is justification in providing the extensive disclosures proposed in paragraphs 45 to 53, we question whether even sophisticated users will appreciate the significance or impact that a change in any factor could make to the overall result. The information required per paragraph 48 is very technical and not particularly helpful unless a user has a good understanding of the financial model and the underlying assumptions.

Given the uncertainty in capital markets and the fact that historical volatility will not necessarily reflect future volatility, it might be more useful to provide a sensitivity analysis, demonstrating the impact on expenses if key assumptions were varied by a small percentage.

The essential disclosures are stated in paragraphs 45, 47 and 52(a). Detailed disclosures in the remaining paragraphs should be voluntary rather than prescribed.

Question22

We consider that an entity should apply the requirements of the IFRS to grants of equity that had not vested at the effective date of the IFRS, and that the requirements should be applied retrospectively. However, the equity instruments should be measured at fair value rather than settlement amount to maintain consistency and comparability. We are doubtful that the calculation of the settlement amount would provide more reliable information or an easier calculation for transition, except when the exercise date is imminent.

Question 23

There is general acceptance that the taxation consequences of any transactions should be recognised at the time the transaction is recorded. Following this principle, it is appropriate for the tax effects of share-based payment transactions to be recognised in the income statement. However, given that different jurisdictions will have different tax consequences, which could also change over time, the value in providing detailed examples is limited.

Question 24

- We consider that employee share purchase plans should be excluded when certain specified criteria is met, so that resources are not diverted into preparation and presentation of information that is not significant to the overall performance of the entity. The example of options with only a small discount from market value illustrate this point as only a small benefit is transferred to employees, but they would still necessitate disclosures that could be lengthy and complex.
- We strongly believe the concessions should be available for unlisted (non-public) entities. Where there is limited external finance and limited information regarding share prices and volatility, the quality of the estimates produced using financial models such as Black-Scholes is contentious. The minimum value method is probably a reasonable less complex alternative.
- Regarding newly listed entities, we do not believe that using the historic volatility of similar entities during a comparable period is a valid approach. We would prefer to see a concession to allow use of an alternative method

such as the minimum value method, during the early period of listing (say 3 years) until the securities develop trading patterns, also to properly identify comparable entities.

- We strongly believe that when the equity instruments granted are forfeited for any reason, the amounts previously recognised for those instruments should be reversed.
- We agree that if an equity instrument is settled in cash, that instrument should be regarded as having immediately vested.

Question 25

We have serious concerns about the length and complexity of this IFRS. An entity will require significant in-house technical expertise to be able to apply its provisions competently. Similarly, smaller accounting practices will also need a high level of expertise and resources to adopt a fair value accounting model. To overcome these very real practical issues, the application of this IFRS should be limited to those entities that operate in the public domain with a high level of external finance, such as listed entities.

We also have concerns that a proposed IFRS should be issued for comment with 24 specific issues requiring comment, suggesting a high level of discord amongst its proponents. Perhaps further research was required in its development to arrive at a more acceptable consensus before seeking public comment.