ACCOUNTING
STANDARDS
BOARD

Holborn Hall
100 Gray's Inn Road
London WC1X 8AL

Telephone +44 (0) 20 7611 9700
Fax +44 (0) 20 7404 4497

http://www.asb.org.uk

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

24 April 2003

Dear Kimberley

ED 2 'Share-based Payment'

I set out below and in the attached note the views of the UK Accounting Standards Board on ED 2 'Share-based Payment'. As you will be aware, the ASB issued the IASB's draft standard in the UK in the form of a FRED (FRED 31 'Share-based Payment') and invited comment on that FRED. Although we have passed on to you all the letters we received in response to that invitation (other than the ones that are confidential), we have not yet finished analysing those comments and the attached note makes no attempt to summarise the letters or comment on them.

As is explained more fully in the note, we strongly support the proposal that a fair value expense should be recognised in respect of all share-based payment transactions. No exemptions from that principle are necessary, and none should be permitted. We also believe the detailed proposals in ED 2 are based on a coherent and consistently applied framework, and we find that framework more appealing that the one that underpins FAS 123. However, it would appear that the rationale behind the detailed proposals for equity-settled transactions is neither well-understood nor widely accepted. Those proposals are also regarded as unnecessarily complex. These are important concerns because, regardless of the technical arguments in favour of the proposals, they mean that the accounting numbers resulting from the standards' application may not be understood, which would affect their credibility and usefulness.

In our view, *any* standard that implements the principles on which ED 2 is based in a way that produces accounting numbers that are readily understood will significantly improve the quality of financial statements. On the other hand, if the standard produces numbers that are difficult to explain, there is a real danger that the opportunity to improve financial reporting in this important area will not be taken full advantage of. For that reason we urge the IASB to consider certain simplifications to the current detailed proposals. We think the simplifications we propose may also help in achieving convergence with the USA.

We hope that our comments will contribute to your discussions. We appreciate that the suggestions we have made, if accepted, may lead some to argue against the proposals on the grounds that they are an attempt to apply cost accounting to a transaction that has no cost. We do not see it that way. In any event, we wish to emphasise that we are keen to see a fair value expense recognised for share-based payments and our suggestions are made in an effort to assist the IASB in achieving closure to the current debate. We hope to see the IASB's final standard mandated at the earliest opportunity and as a global standard that looks more like ED 2 than FAS 123.

If you have any questions concerning this letter, or would like further information on any of the comments made, please do not hesitate to contact either Paul Ebling (020 7611 9717) or myself (020 7611 9702).

Yours sincerely

Mary Keegan
Chairman

The UK ASB's comments on ED 2 'Share-based Payment'

GENERAL OBSERVATIONS AND SUMMARY

1 We strongly support the objective of the proposed standard. We also strongly support the principles on which the proposed standard is based, which are that:

(a) all share-based payment transactions should result in an expense being recognised by the entity making the payment;

(b) that expense should be recognised over the period in which the services involved are rendered or as the goods involved are received; and

(c) the expense should be measured by reference to fair value.

2 In our view, any standard that implements those three principles would significantly improve the quality of financial statements in an area that has long needed improvement—as long as the resulting accounting numbers are capable of being explained and understood. As explained below, we have some doubts as to the intuitive appeal of some of the detailed proposals and are concerned that may affect the understandability of the resulting information. Subject to addressing those concerns, we encourage the IASB to complete its work as soon as possible and to implement the standard as soon as possible thereafter.

3 We recognise that one of the key issues that the IASB will need to consider in finalising its standard is US convergence. We are very much in favour of the accounting practices adopted around the world converging, and we strongly support the IASB in its efforts to ensure that practice should converge around high quality standards. As we think the draft standard in ED 2 is based on a better set of principles than FAS 123, we encourage the IASB to move forward on a basis that looks more like ED 2 than FAS 123.[1]

4 That is not to say that we believe the proposals in ED 2 cannot be improved. In this note we encourage the IASB to consider making certain changes to make the proposals easier to understand and easier to implement. We think the effect of our suggested changes will be to increase greatly the support for the detail of the standard without compromising the principles (outlined above) on which it is based.

---

[1] US convergence is discussed further below, and in our answer to question 24.

THE IASB'S DETAILED PROPOSALS ON THE MEASUREMENT AND RECOGNITION OF A FAIR VALUE EXPENSE FOR AN EQUITY-SETTLED TRANSACTION

The comments below are not structured in terms of the questions posed in the Invitation to Comment. We also attach an annex that summarises, by reference to the questions asked in the Invitation to Comment, the views expressed below, as well as some more detailed views on the issues raised in those questions.

5 We believe that the IASB has developed a coherent framework with which to analyse share-based payment transactions, and it has applied that framework consistently in developing its detailed proposals. We see this as a great strength of the proposals. However, anecdotal evidence, our own consultation on the proposals,[2] and our own discussions suggest that, although fair value expensing is supported by many, ED 2's detailed proposals are not well supported and the rationale behind them is widely misunderstood. This is resulting in some rather confused comments about the proposals and in expressions of incredulity at some of the implications of the proposals. For example:

(a) the IASB has concluded that, in the case of equity-settled transactions, the objective should be to measure and expense the fair value of the goods or services received. It is an inevitable consequence of that decision that an expense will continue to be recognised after an equity-settled scheme has been cancelled, yet many commentators clearly find that proposal incomprehensible.

(b) it is also an inevitable consequence of the fair value measurement objective that the total expense recognised will not, except by coincidence, equal the fair value of the equity instrument issued. Many commentators do not understand why that is the case. As a result, they argue for truing up and criticise aspects of the detailed proposals—such as those relating to the unit of service approach—as being unnecessarily complex.

(c) ED 2 requires a cost-based measurement objective to be adopted for cash-settled share-based payment transactions and a fair value-based objective for equity-settled transactions. This inevitably means that, except by

---

[2] FRED 31 'Share-based Payments' was issued on the same day as ED 2 and had the same comment period. It proposed the adoption in the UK of a standard that is identical to ED 2's draft standard. We have provided you with a copy of all the comments received for the public record in response to the FRED.

coincidence, the expense recognised for a cash-settled transaction will be different from the expense recognised for an equity-settled transaction that is identical save for the manner of settlement. There is a widely held view that transactions should result in identical amounts being expensed, and they cite the fact that the proposals do not have that effect as proof that they are flawed.

6 Put simply, to many people's minds the proposals produce results that, regardless of the technical arguments in their favour, do not pass the common sense test. That so many (including many of those in favour of fair value expensing) hold this view is worrying, because it has a direct impact on the credibility of the resulting accounting numbers. At this stage in the debate, the credibility of the resulting financial information is fundamentally important.

7 For that reason, we have been giving some thought to the underlying reasons for the confusion, lack of understanding and misunderstandings and what may be done to address them. All the principal concerns seem to relate to the proposals for equity-settled transactions. At the centre of those proposals are the following two principles which, we believe, hold the key to developing a satisfactory standard.

(a) Although an equity-settled share-based payment has value, an entity does not incur a cost (in the accounting sense) when it issues equity instruments.

(b) When no cost is incurred in acquiring the goods or services, what should be expensed is the fair value of the goods or services received on the date they are received.

<u>Principle A—An entity does not incur a cost (in the accounting sense) when it issues equity instruments</u>

8 The principle in (a) ('Principle A') is based on an analysis of the Framework. We think that analysis goes broadly as follows:

(a) For a cost to be incurred, the payment must in itself result in a decrease in total recognised net assets.

(b) When an equity instrument issued, there is no decrease in total recognised net assets—and therefore no cost.

9 Whether or not a cost has been incurred in a transaction is fundamental to the way it is accounted for.

(a) If a cost *has* been incurred, cost-based accounting is normally adopted. That involves measuring the goods or services received at their cost; in other words, at the fair value of the consideration given in exchange for them. In an equity-settled share-based transaction, that would be the fair value of the equity instruments.[3] This would mean that the objective in accounting for equity-settled share-based payment transactions is to determine the fair value of the equity-settled payment, then to allocate that fair value (ie the cost) to the periods benefiting from the goods or services acquired.

(b) If a cost has *not* been incurred, an alternative measurement basis needs to be used. There is no reason why that alternative measurement basis should operate in a similar way to cost. For example, ED 2 proposes (see the principle described in paragraph 7(b) ('Principle B')) that, if the goods or services received cannot be measured at cost because no cost was incurred, they should be measured at their fair value. That fair value is not a proxy for cost; it is a fundamentally different measurement basis. Even in a bargained transaction that fair value could be higher or lower than the fair value of the consideration given in exchange, and it will usually be unaffected by changes in the value of the consideration promised or given after the bargain is struck.

10 We think Principle A is based on a correct analysis of the Framework. We also think however that it is the cause of much of the confusion about the IASB's proposals and much of their perceived complexity. This issue is also the source of some important differences between ED 2 and FAS 123 because, although ED 2 considers no cost to have been incurred, FAS 123 thinks a cost *has* been incurred.[4]

---

3 We are being deliberately vague here as to the appropriate measurement date, because that issue—though very important—is not relevant to this particular discussion.

4 Paragraph 75 of FAS 123 states that "the Board's conclusion that recognizing the costs of all stock-based employee compensation…is the preferable accounting method stems from the following premises: (a) Employee stock options have value. (b) Valuable financial instruments given to employees give rise to compensation cost that is properly included in measuring an entity's net income. (c) [not relevant to this discussion]." In other words, a cost has arisen because something of value has been handed over.

11 We would encourage the IASB to consider whether there might be any room for an alternative interpretation of the Framework that would result in Principle A being revised to say that equity-settled transactions *do* involve the entity incurring a cost. Such a revised principle would mean that the aggregate amount expensed would equal the fair value of the equity instrument issued; an approach which we think makes a lot of sense.

<u>Principle B—When no cost is incurred, what should be expensed is the fair value of the goods or services received on the date they are received</u>

12 As already mentioned, the IASB apparently believes that, under the Framework as currently drafted, an entity does not incur an expense when it issues an equity instrument. Therefore, when accounting for an equity-settled share-based payment transaction, something other than cost needs to be used if an expense is to be recognised in the financial statements. ED 2 proposes that the measure used should be the fair value of the goods or services received.

13 We are not certain of the rationale behind this proposal, but suspect that it is based on the view that there are only two possible measurement bases—cost and fair value—and, if there is no cost information, fair value must be the only relevant measure.[5]

14 It is clear from our own discussions, from anecdotal evidence and from our FRED 31 consultation that very few commentators understand that the ED is applying a fair value-basis of accounting for equity-settled transactions rather than a cost-basis. It appears that most commentators view the exposure draft's use of fair value as some sort of proxy for cost, when in fact a fundamentally different measurement basis is being adopted. This misunderstanding seems to be behind many of the negative comments about the detailed proposals in ED 2. For example, because they do not understand or accept that the IASB is implementing a fair value-basis of accounting, commentators do not understand that it is necessary to have a methodology like the unit of service approach to estimate the fair value of the goods or services received in any given period. Instead, they simply view that approach as unnecessarily complex.

---

5 ED 2's Basis for Conclusions section does discuss the measurement bases to be adopted in the standard in paragraphs BC64 – BC 81, but it does so in a rather different context to that addressed by Principle B.

15 We suggest that the IASB considers revising Principle B to ease these problems. One possibility that we think might be particularly effective is to say that, where there is not a cost in the accounting sense but something of value has still been given in exchange for the goods or services acquired, the fair value of the thing of value that has been given will usually be the most relevant measure of the goods or services received. Such a principle would:

(a) greatly simplify the proposals, because it would mean that the total expense to be recognised would be the fair value of the equity instruments. The accounting objective would then be to determine that fair value and allocate it on an appropriate basis;

(b) accord with how many commentators see the transaction. Something of value has been given in exchange for the goods or services and, even though that something may not be a cost in the accounting sense, its value ought still to be a relevant measure of those goods or services; and

(c) bring ED 2 closer to FAS 123, which sees the accounting objective as allocating the fair value of the equity instruments to the accounting periods that benefit from the transaction.

IN AN EQUITY-SETTLED TRANSACTION, WHEN IS THE PAYMENT MADE?

16 If Principle B is to be changed in the way suggested above, it is necessary to decide on the date on which the fair value of the valuable consideration should be measured.

17 We believe that, under the current Framework, an equity instrument is issued on the grant date. (When the entity makes a grant, what it is doing is issuing an equity option with an exercise price that is expressed in terms of vesting conditions and cash payments. Equity options are equity instruments.[6])

---

[6] We recognise that this is not an issue that the IASB had to specifically address in ED 2 because of its conclusion that there is no cost and what should be accounted for is the fair value of the goods or services received. However, we note that paragraph BC104 of ED 2 seems to imply that the IASB has reached the same conclusion as the ASB. (That paragraph explains that, if a measurement date other than grant date is used, it would be necessary to remeasure an equity interest; thus implying that the equity interest comes into existence on grant date.) . It should also be noted that, although our analysis is based on the Framework as currently drafted, we have consistently argued that there is an urgent need to carry out a comprehensive review of the equity/liability classification issue, primarily because we have some concerns about the implications of the current Framework.

18 We note that FAS 123 is based on the view that the consideration is not paid until vesting date.[7] In its view, when service or performance conditions are involved, the grant represents a conditional obligation to issue equity instruments in exchange for valuable consideration at a later date.

19 We do not agree with FAS 123's analysis which seems to us not to be based on the current Framework. In our view the equity instrument has been issued on grant date. For that reason, we think that the objective, in accounting for equity-settled share-based payment transactions, should be to determine the *grant date* fair value of the equity instruments issued, and then to allocate that fair value over the service period.[8]

20 We believe that, putting frameworks aside, this objective reflects a common-sense view of the transaction and is therefore one that ought to appeal to commentators. When an entity enters into a share-based payment transaction, it considers itself to have given something of value on the grant date. If the entity's share price subsequently rises, the entity does not think it has made a further payment—the payment was made in full at the outset.

21 Another reason why we believe many will find this objective attractive is that it would eliminate any need to true up expenses recognised prior to vesting date. We see the requirement in the US standard to true up expenses as a complication that is best avoided if at all possible.

---

7 FAS 123 considers that, on grant date, the entity conditionally transfers an equity instrument to another party under an arrangement that permits that party to choose at a later date or for a specified time whether to deliver the consideration for it to forfeit the right to the conditionally transferred instrument with no further obligation. Under this view, the equity instrument is not issued until the issuing entity has received the consideration, such as cash, an enforceable right to receive cash, other financial instruments, goods, or services, agreed to by the parties to the transactions.

8 That grant date fair value should be determined in the way described in the ED and would therefore take into account expected levels of forfeiture.

Annex—The UK ASB'S answers to some of the questions posed in the IASB's 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?

A significant number of commentators are suggesting that there should be an exemption for at least some kinds of all-employee schemes, perhaps along the lines of the exemption in FAS 123 for certain employee share purchase plans. A number of arguments are used to support such an exemption, with the main accounting argument being that such schemes and plans are not remunerative. We do not accept that argument. Nor do we see any other justification for exempting such schemes from the scope of the standard.

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 consider the proposals to be appropriate.

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 much of the analysis underpinning this proposal. However, as explained in the main body of our response, we think the IASB should consider tempering the principle that leads to the above proposal in order to simplify the requirements overall and make them easier to understand and implement.

On the subject of exemptions, some commentators are suggesting that there should be some sort of practicality exemption for unlisted entities (or private entities) where the lack of market-based information about the value of the entities' equity instruments allegedly makes it impractical to estimate reliable fair value measures. An alternative suggested by some is to incorporate into the IFRS provisions, similar to those in FAS 123, permitting unlisted (non-public) entities to apply the minimum value method when estimating the value of share options. We made clear in FRED 31 our view that, very small companies aside, the standard and its measurement requirements should apply to all entities equally.

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?

As already mentioned, we think the IASB should consider tempering the principle that leads it to conclude that the objective in accounting for equity-settled transactions is to account for the service date fair value of the goods or services received. Our suggestion is that the objective should be to measure and account for the goods or services received based on the grant date fair value of the equity instrument issued.

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 that grant date is the appropriate date. See paragraphs 17-21 of our note.

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. However, our suggestions as to the accounting objective would have consequences for the way in which the IASB states its views in this area.

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?

As already mentioned, we think the IASB should consider tempering the principle that leads it to conclude that equity-settled transactions should be measured at the service date fair value of the goods or services received.

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?

In our view, just because the vesting date of a share-based payment is later than the grant date, it does not follow that <u>all</u> the payment is being made for future service. However, it is not clear to us how it might be possible to write an accounting standard that identifies such instances and ensures that they are appropriately accounted for and we would be reluctant to encourage greater flexibility in this area because of the earnings management opportunities it would create. For that reason, we agree that, for the purposes of the accounting, it should be assumed that, when vesting conditions are involved, performance is all in the future.

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?

The perceived complexity of the unit of service method was one of the reasons why we have suggested that the IASB consider tempering the principle that leads it to conclude that the objective in accounting for equity-settled transactions is to measure and account for the service date fair value of the goods or services received. If that objective was changed to accounting for the grant date fair value of the equity instruments issued, the proposals described in the question would not be needed.

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?

As already mentioned, we think the IASB should consider tempering the principle that leads it to conclude that equity-settled transactions should be measured at the service date fair value of the goods or services received. We have suggested that the objective should be to account for the grant date fair value of the equity instruments issued. That fair value would take into account the expected level of forfeitures, and that estimate would not be adjusted subsequently to reflect the actual level of forfeitures.

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 agree with the proposed approach.

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?

Although we have not yet reached a conclusion on this issue, we are aware of concerns being expressed amongst the user community as to the opportunities it provides to undervalue share-based payments and therefore understate the P&L expense.

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 agree with the proposed approach.

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, i.e. 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 a repricing represents an incremental share-based payment—as does a scheme cancellation that is linked to the introduction of a new scheme. However, as already mentioned, we think the IASB should consider tempering the principle that leads it to conclude that equity-settled transactions should be measured at the service date fair value of the goods or services received. If that objective was changed to accounting for the grant date fair value of the equity instruments issued, the objective when accounting for a repricing would be to allocate the grant date fair value of all the equity instruments issued over the service period.

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.

This proposal is one of the reasons why we have suggested that the IASB consider tempering the principle that leads it to conclude that the objective in accounting for equity-settled transactions should be to measure and account for the service date fair value of the goods or services received.

We have suggested that the objective should be to measure and account for the grant date fair value of the equity instruments issued over the service period. It seems to us to follow from such an objective that, were a scheme to be cancelled, any unallocated expenses should be recognised immediately in the P&L. The rationale here is that the *entity, in issuing equity instruments, has paid in advance for something that it expects to receive over the service period. That payment is, in normal circumstances, allocated over the service period because the entity does indeed receive service over that period. However, if the scheme is cancelled, a sort of impairment has occurred, hence the immediate write off.*

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.

Please see our answer to question 24(e). We would also point out that, on a strict interpretation of the definitions of equity-settled and cash-settled, a share-based payment transaction that involves one entity issuing equity instruments in another entity (as is often the case in group schemes) would be treated as a cash-settled transaction. If that is the intention, it would be helpful to make it clear (and perhaps acknowledge that 'cash-settled' is something of a misnomer).

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 that the objective here should be to implement the agreed equity/liability classification set out elsewhere in the IASB literature to share-based payments. (We have already made our views on that literature known to the IASB as part of the IAS 32 consultation process.) We think the proposals do that, subject to the inconsistency between IAS 32 and the Framework which, on a practical level, does not concern us greatly in the context of share-based payments.

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 think the proposed disclosure requirements are excessive. (The illustration included in ED 2 is presumably intended to show, inter alia, that the disclosures will not be as extensive as they appear, but we are not convinced: we think in many cases the arrangements will be a lot more complex than those in the illustration.)

Currently in most jurisdictions there is an extensive amount of disclosure provided on share-based payments, primarily because of the justified concerns about the numbers provided in the primary statements. It ought to follow that, when those concerns have eased—as they should do either on implementation of the IFRS or once users have got used to the numbers the IFRS produces—the volume of disclosure should be reduced. The aim eventually should be to require a volume of disclosure that is commensurate with the disclosures provided about any other complex aspect of employee remuneration, such as for example, profit-related-pay or bonus schemes.

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 agree with the proposals with one exception: entities should be permitted (if they so wish) to apply the standard retrospectively to all share-based payments granted prior to the implementation date but not by then vested. Such an amendment would help *entities concerned about the possible 'ramping up' effect of prospective application that have the information available. FASB has amended FAS 123 to allow such an approach, and we think the IASB should permit it too.*

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;

  As explained in our answer to question 1, we do not support the inclusion of such an exemption in the IFRS.

- 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

  As explained in paragraphs 1 and 2 of our note, we think it essential that there be a requirement.

- 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).

  As explained in our answer to question 3, we do not support the inclusion of *such an exemption in the IFRS.*

(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.

  We prefer the IASB's approach.

- 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.

  We do not agree with FAS 123's view that the equity instruments are not issued until vesting date. As explained in the main body of our note, we believe they are issued on grant date.

  As already mentioned, we also think the IASB should consider tempering the principle that leads it to conclude that the objective in accounting for *equity-settled transactions should be to measure and account for the service date fair value of the goods or services received.*

(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.

See our answer to question 18.

(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.

We prefer the IASB's approach, which we consider to be both more correct and simpler.

(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).

Taken in isolation, we do not have any strong views on whether such liabilities are measured at intrinsic value or at fair value (ie intrinsic value plus the value of the *right to participate in future increases in the share price). An intrinsic value approach has the advantage of being simple and also has intuitive appeal. On the other hand, a fair value standard should demand the use of 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.

We have no comment on this issue.

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.

There is another important convergence issue that needs to be addressed: the timetable. As we have made clear already, we strongly support ED 2's objective and would like to see a standard based on the ED implemented as soon as possible. We recognise that companies have genuine concerns about being in a jurisdiction that requires fair value expensing of share-based payments when their competitors are in a jurisdiction that does not mandate fair value expensing. In our view such an argument can never be persuasive in itself, because it would prevent standard-setters taking a lead on any issue and it could result in accounting moving forward at the pace of the slowest. It is therefore important to consider each case on its merits. In this case, although the FASB has recently announced that it intends to look again at its existing requirements on share-based payments, it is too early in the process to know whether its projected timetable (exposure draft this year, final standard in 2004) is realistic. A significant number of large US companies have however already announced that they intend to start fair value expensing (even though that will be done on a FAS 123 basis rather than an ED 2) basis. In the circumstances, and bearing in mind the improvements that will result from a standard on this issue, we believe that the IASB should continue to move as quickly as possible to final implementation of its standard.