SECURITIES INSTITUTE

CL 241

15 May 2003.
Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Dear Sir David

ED 2: Share-based Payment

The Securities Institute of Australia is a national organisation representing professionals involved in the finance and investment industry. Our membership is drawn from a broad range of areas, in stockbroking, merchant banking, accounting, financial planning and funds management. The Institute focuses on representing members' views to government and regulators, and disseminating information to industry practitioners through education, training and continuing professional development activities.

Through our Company Reporting Subcommittee, the Securities Institute is pleased to comment on the IASB's ED 2: *Share-based Payment*.

As part of the process of international convergence and harmonisation, the Institute supports the setting of an appropriate accounting standard for the measurement and recognition of share-based payments to ensure consistency, comparability and transparency in financial reporting. We support the expensing options initiative to further the corporate governance objective of reducing option excesses which have occurred in the past.

Our primary concern is that the standard implemented enables investors and analysts alike to make a meaningful determination about the impact of share-based payments on a company's performance and investment prospects.

In general, the Institute supports the IASB proposals for share-based payment contained in ED 2. The Institute believes that the value of employee shares and options should be recognised and measured at the date of the transaction, the grant date, with amortisation of that value over the performance years, regardless of the potential for forfeiture, lapse or non-exercise. This valuation approach is consistent with the marketplace and conforms with the objective to reflect the substance of the transaction and provide meaningful information to financial report users.

However, on certain practical application aspects or technical points, the Institute holds a different view. Our comments on the specific issues identified in the ED 2 Invitation to Comment section are set out in the attached "Response to Specific Questions" section and summarised in the following "Preliminary Remarks and Overview" section overleaf.

In formulating this new international standard, we believe that the Board should aim to produce the simplest and most accurate means to account for this expense. We are therefore concerned about the amount of detail in the proposed standard and the extent of added detail of proposed disclosure requirements for reporting entities. In particular, we have practical concerns in relation to how to measure and value employee options as they are earned or mature and how to expense service unit costs to reporting periods. Although we support recognising the share-based payment when the service is received by the entity, we do not agree with the proposed measurement method to attribute an amount to each unit of service received.

The Securities Institute of Australia appreciates the opportunity to comment on the proposed IFRS. If you have any queries about any of our comments or wish to discuss any matter further, please contact either myself on (61 3) 9679 1427 or Julie Burke, National Policy Manager at the Institute on (61 2) 8248 7593 or by email (j.burke@securities.edu.au).

Yours sincerely

Craig Drummond FSIA

Chairman, Company Reporting Subcommittee

Preliminary Remarks and Overview:

Valuation difficulty: The Institute considers that the need for an effective standard on share-based payments for directors, executives and employees should outweigh any perceived or inherent difficulty, complexity or unreliability in valuation or accounting treatment.

Grant date: The Institute supports the proposed method to measure and recognise the fair value of share-based payments at the date of grant, irrespective of whether the subject transaction relates to goods or services received or the equity instruments granted.

Despite various technical arguments against grant date, we appreciate that grant date measurement presents a commercially practical method.

Service units: Although we agree that the period from grant date to vesting date represents the period for which the entity receives the employee's service, we do not agree with the IASB proposal to allocate an expense over that vesting period based on the number of service units received in that period.

We believe the service unit allocation proposed is unnecessarily complicated. We believe there is merit in simplifying the accounting treatment of share-based payments and in considering alternative allocation methods, such as progressively revising the forfeiture estimate under the SFAS 123 approach from the US.

Following initial recognition at fair value at grant date, SFAS 123 paragraph 28 provides for the number of equity instruments estimated to vest to be revised each year and for the actual change in value to be expensed in that year; or alternatively, the expense is recognised by estimating the total number of awards that will ultimately vest and adjusting or revising this estimate as necessary when evidence becomes available that a different number of awards is expected to vest. This progressive reassessment method could prove more accurate, as the final cost recognised in the accounts may better reflect the actual cost of the equity instrument to shareholders. Also under this (preferred) alternative method, the expense to the entity should be the same, whether the payment is equity-settled or cash-settled.

No reversal following recognition: We do not support the ED 2 proposal to not permit a reversal or adjustment to be made to the expense account to reflect the difference between the estimate and the actual situation.

Expected life and vesting conditions: In an option pricing model, we support using 'expected life' as a means of adjusting fair value for the effects of non-transferability. Although not technically accurate, the 'expected life' measure presents a simple and practical solution, given the difficulty in estimating the discount to apply for lack of transferability.

We agree that vesting conditions should be taken into account in measuring the fair value of shares or options granted.

Disclosure: To make an informed assessment of the value and investment potential of an entity's stock, shareholders, analysts and potential investors need to be provided with a true picture of an entity's capital structure and financial health. We believe that the potential financial impact of share-based remuneration should be fully disclosed in the accounts.

We recommend a stronger emphasis on disclosure of the methodology and assumptions employed by the reporting entity. Better disclosure will improve transparency and consistent and comparable application and interpretation of financial reports, whatever measurement date and valuation method the entity employs. Disclosure requirements should include the number of shares and options on issue, valuation methodology, vesting dates and exercise price, as well as any performance hurdles and the terms and conditions in the year of grant and all subsequent years until fully vested.

Response to Specific Questions in 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 proposed scope of the draft IFRS as appropriate, and support the proposed no exemptions approach in principle.

We do not believe that an expensing exemption for broad-based employee schemes or newly listed entities is justified on the basis that it may be more difficult to determine fair value.

However, we suggest that some consideration could be given to exempting unlisted companies from expensing share-based payments (given that shares in unlisted companies are not open to the market and the shareholder register often consists of a small exclusive group of founding or family members and associated affiliates).

Question 2

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

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

We support the proposed recognition requirements for share-based payment transactions as 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 (e.g. 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 proposed measurement principle of fair value as appropriate and support the no exemptions approach for the reasons given in the Basis for Conclusions.

Although we support uniform application to all reporting entities, we have some concerns about how this measurement requirement would be applied by large unlisted companies in Australia. We urge the Board to provide some more practical implementation guidance and direction on estimating expected volatility in applying an option pricing model to options granted by unlisted entities, as indicated in BC143.

As currently phrased, paragraph 7 seems to allow a choice of methodology (direct/indirect) referable to which basis of the transaction (goods or services received v equity instrument granted) is selected to measure fair value. Our concern here is that this looks at the fair value measurement from different recipient perspectives (grantor v grantee) and different dates (receipt v grant date). It involves a choice between two alternative methods or bases for estimating fair value, and not a choice between two fair values (which would seem contrary to the single amount focus in the FV definition). Therefore, to tie in with readily determining the actual amount rather than comparing fair values, we suggest amending the wording to "whichever amount is more readily determinable". We also suggest that the date of such determination/comparison be clearly specified.

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 do not agree that the date on which the entity receives the goods or services is the appropriate date at which the fair value of the goods and services should be directly measured.

We believe that grant date should be the measurement date for share-based payment transactions, regardless of whether fair value is measured directly or indirectly or with reference to the goods or services received or the equity instruments granted.

This proposed receipt date seems to be inconsistent with the choice presented in paragraph 7 relating to whichever method is "more readily determinable" and with the grant date measurement of share-based payments measured indirectly. Moreover, it seems at odds with the Board's stance in BC104, BC122 and BC128 that it draws no distinction between share-based payment transactions with employees and parties other than employees.

We suggest that preparers implementing this proposed provision could benefit from some guidance on how to 'measure directly' the fair value of goods or services supplied by third party non-employees, given that there may be no established market for such goods or services.

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 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 for measuring the fair value of equity instruments granted in a share-based payment transaction (i.e. indirect measurement).

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 that there is a rebuttable presumption that the fair value of goods or services received from a party other than an employee is usually more readily determinable than the fair value of the equity instruments granted, as explained in paragraph 10.

However, we point out that this presumption may not apply if the goods or services received are highly specialised or unique and no market price exists for comparable goods or services. The focus should be on the existence or reliability of a comparable determination of fair value, not on whether the party providing the goods or services to the entity is an employee or non-employee.

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 proposal that in most cases, the fair value of equity instruments granted is generally more readily determinable than the fair value of employee services received.

However, this is not necessarily the general rule and it would depend on how an employee's total remuneration is determined. We do not think the paragraph 11 presumption is strong enough to sustain, as there are some employee services for which the fair value might be more readily determinable by direct measurement. We also consider that the current proposal is somewhat restrictive and goes against the paragraph 7 choice, "whichever fair value is more readily determinable".

Therefore, we suggest that the Board reconsider the restrictive paragraph 11 presumption and adopt a similar consistent approach to that taken in paragraphs 9 and 10 to enable direct measurement for transactions with employees.

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 proposed IASB approach in principle, that services rendered by the counterparty in a share-based payment transaction (grantee) are received by the entity (grantor) during the specified service period which the grantee has to complete before they become unconditionally entitled to the equity instruments granted (i.e. vesting condition).

During the vesting period, the equity instruments should be expensed, as the service provided by the grantee during this qualifying period constitutes the consideration for their legal right or claim to the equity-based grant.

We have reservations about assuming that the relevant period of service for vesting will always be the "vesting period". When referring to the period of service to be completed before the grantee becomes unconditionally entitled to the equity instruments granted (service conditions), we suggest the use of "service period", rather than "vesting period" (e.g. paragraph 15(a)).

It is important that the service criteria are not confused with where there are restrictions or time vesting conditions placed on the equity grant. The Board must take care in clearly defining the scope and meaning of "vest on satisfying service condition", as share-based payment arrangements may prescribe interdependent service conditions and performance conditions. We believe that the proposed standard should make a clear distinction between service conditions and vesting conditions: it should stipulate that the service period be solely determined with respect to service conditions, and not by any other vesting conditions (e.g. performance targets or share price targets) that must be met before the equity instruments vest.

The ED 2 approach could be difficult to apply to share-based payment transactions which only vest on satisfying service criteria. Employees granted equity-based payments for their service may have different contractual hours, work different hours each day or have worked for the company for different periods of time. It therefore would seem artificial and incorrect to allocate the same time to each employee for calculation of the service units provided each year, and inconsistent with the BC200 objective "to account for the services subsequently received, not the fair value of the options granted".

We also suggest that the Board should make provision in paragraphs 13 and 14 to cover option schemes where a specific vesting date cannot be specified in advance at grant date, such as options that vest when the share price reaches a prescribed price or percentage increase.

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?

Although we support recognising the fair value of the equity instrument granted as the service is received, we do not agree with the proposed 'units of service' measurement method whereby an amount is attributed to each unit of service received (or expected to be received).

We question the rationale behind the Board's reference to the fair value of equity instruments as a 'surrogate measure' for the value of services expected to be received. Whereas paragraph 7 provides that the fair value of the equity instruments was to be determined from the equity side and expensed on the basis of constructive vesting, the unit of service method proposed here would seem to conflict with the Board's reasoning as set out in the Basis for Conclusions. Based on the services side of the equity transaction, the service unit approach would work to increase subjectivity and move the fair value expensing away from equity instruments to the artificial construct of 'units of service received'.

The unit of service approach may be appropriate in some cases, but we consider that it would likely be too complex, limited and unreliable to apply to all cases. In some cases, it might be more appropriate to apply a straight-line allocation or to expense a periodic cost of the equity instruments granted (consistent with that applied in determining depreciation of plant and equipment).

Attributing a value to each unit of service raises the following concerns:

- the service unit method does not sufficiently distinguish between the normal work which an employee performs within their job description and the additional work or effort required for the share-based payment granted to vest;
- given that employees may work different hours and impact differently on the entity's business, the broader-based an employee share-based payment scheme is, the more complex and artificial it becomes to employ this service unit method;
- in requiring an entity to estimate upfront likely employee turnover for the service period, the proposed service unit allocation method may prove quite subjective and imprecise; it may lead to greater potential for variance within and between entities, increase record-keeping requirements and in the end, not produce a materially different outcome than if the simpler straight-line method of allocation had been used;
- the unit of service method is based on the premise that services received by an employee for share-based payments can be isolated and valued yearly and can be separated from the services they generally provide in the usual course of their employment.

We recommend that the IASB consider requiring one of the following alternatives to the unit of service methodology:

(i) immediate expense of the option value at grant date;
(ii) straight-line recognition of the expense over the vesting period; or
(iii) prescribe only the principle of expensing and allow entities to use their judgment in devising an appropriate method of allocation over the vesting period.

The simple alternative method we favour involves (ii) a straight-line depreciation of the fair value determination of the services received, adjusted at each reporting date for actual units of services received. This is the approach put forward by SFAS 123 in the US and may be one of the practical solutions for the IASB to consider.

We think that the accounting treatment could be made simpler and more understandable and therefore we urge the IASB to consider other ways of expensing options.

The IASB service unit approach is very technical and overly complex and arguably not as commercial or as practical as the FASB approach, which treats the accrual on an annual basis. FASB's SFAS 123 treats the options grant as an estimate which is booked as an expense initially, and subsequently adjusted on an annual basis to account for what happens in reality. This recognition approach may ultimately yield a final cost in the accounts that would approximate the actual cost of the equity instrument to shareholders, rather than the initial 'best estimate' of that cost proposed by ED 2.

Although perhaps not as technically accurate or elegant as IASB's proposed service units approach, FASB's simple approach of revising the estimate of the number of equity instruments granted each year and expensing the change in value in that year would seem more commercially practical and understandable for both users and preparers of financial statements. Moreover, it would provide the attractive benefits of ease of application and consistency of approach.

Again, we suggest that the standard should refer to this period as the ‘service period’, rather than the ‘vesting period’. We also note the requirements refer to ‘units of service’ only, and not to ‘goods’.

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 (i.e. a transfer from one component of equity to another).

Do you agree with this proposed requirement? If not, in what circumstances should an adjustment be made to total equity and why?

We agree that once an expense has been recognised for an equity-settled share-based payment transaction with an increase in equity, total equity should not subsequently be adjusted to reflect an increase or decrease, even where vesting or exercise does not eventuate. No subsequent adjustment to the amounts recognised in the total equity for the services received from the grantee should be made due to any change in the value of the equity instrument (including non-exercise of options or non-fulfilment of vesting requirements).

Where options granted are not exercised, no adjustment to total equity should be required because the cost to the entity for the services received has been overstated and reported earnings have been understated.

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?

In the absence of an observable market value, we support the adoption of an option pricing model that takes into account the six factors above as an appropriate method for estimating the fair value of options granted.

In relation to measurement models for valuing options, we believe the IFRS should provide that a reporting entity should select a widely recognised, technically acceptable option valuation model that considers the six market factors in the valuation and then should leave it to the individual valuer and others to define what is appropriate to the subject entity, given their business and employee structure and remuneration practices.

The Black-Scholes model (modified for dividends) takes into account the six variables set out in paragraph 16 and is widely accepted and used internationally in the calculation of European options. The binomial method (suggested in paragraph 20) also has merits and is preferred by some companies with the ability to account for dividends and American options. Either pricing option method, if specified in the standard and used universally by entities, would offer an acceptable means to value options. However, if any modifications are made to the standard pricing model selected, these should be adequately disclosed in the accounts.

If the IFRS permits an entity to simply choose to apply either of these standard option pricing models, there could be further scope for inconsistency and variance. These standard models were developed to value short-term publicly-traded options and therefore they could well prove unreliable or inaccurate when applied to long-term employee options, or could require substantial adjustments to allow for the longer vesting periods, non-transferability or nonexistence or unavailability of forecasting and comparison data. The selection procedure is complicated by the fact that there are now an unlimited number of modified Black-Scholes models to apply, such that it no longer represents a pure, consistent model.

We would encourage the Board to provide some guidance on the use of an appropriate option pricing model in practice and to confer with expert valuation specialists and actuaries on the suitability and application of available pricing models.

Question 12

If an option is non-transferable, the draft IFRS proposes that the expected life of an option rather than its contracted life should be used in applying an option pricing model (paragraph 21). The draft IFRS also proposes requirements for options that are subject to vesting conditions and therefore cannot be exercised during the vesting period (paragraph 22).

Do you agree that replacing an option's contracted life with its expected life when applying an option pricing model is an appropriate means of adjusting the option's fair value for the effects of non-transferability? If not, do you have an alternative suggestion?

In applying an option pricing model, replacing an option's 'contracted life' with 'expected life' may be a practical means of adjusting the option's fair value for the effects of non-transferability. We support the use of 'expected life' when this measure can be reliably determined; if not, 'contracted life' could be used, irrespective of transferability.

We query whether the IASB is proposing that 'expected life' be used for all non-transferable options and 'contracted life' for all transferable options, or that using the 'expected life' measure is justified on the basis that 'expected life' at maximum intrinsic value represents a surrogate measure for non-transferability.

We are not entirely convinced that the use of 'expected life' is an acceptable surrogate for the effect of non-transferability. However, while not technically accurate, we appreciate that using 'expected life' to reflect non-transferability offers a practical solution. It is also simple to apply and avoids the likely broad range of estimates that would be used to discount for lack of transferability.

We would encourage the IASB to investigate this further with actuaries and valuation experts.

As an alternative, we encourage the Board to look at the FASB approach in SFAS 123, which is quite commercial, pragmatic and practical. Acknowledging that rather than wait until the end of the option period when the options are at maximum value, grantees are likely to exercise the options when or as soon as they can, SFAS 123 enables a fair estimate of that period to constitute the expected life of the options within that company or industry.

Is the proposed requirement for taking into account the inability to exercise an option during the vesting period appropriate?

We agree that the proposed requirement for taking into account the inability to exercise an option during the vesting period is appropriate. If vesting conditions prevent the exercise of options in a certain period, this should be allowed for in the valuation.

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 affect the expense recognised and should be taken into account when estimating the fair value of options or shares granted.

Vesting conditions are an integral part of certain option and share schemes and should therefore be taken into account in the measurement process. The manner in which this is done should not be specified, but left to reflect the circumstances and environment in each case. We suggest that further guidance would facilitate practical application, particularly where there are multiple vesting periods.

We do not think there should be any prescriptive guidance on how to include vesting conditions in the estimation of fair value. We contend that it would be better to simply require an adjustment to the fair value estimate produced by such a model. Such an 'adjusted' fair value would better reflect 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 quite arbitrary. For instance, when vesting conditions are linked with the future performance of other organisations (e.g. entity share price developments versus industry index), we believe that determining the weighted average probability that the performance target will be achieved may be a matter of judgment.

We encourage the Board to explore other options with expert valuation specialists and actuaries.

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 are not convinced that the proposed requirements for dealing with options with a reload feature, as outlined in paragraph 25, are appropriate. We are concerned how service requirements related to reload options should be taken into account when estimating the fair value of service units related to the combined grant. We believe that it may be more appropriate to generally require reload options granted to be accounted for as a new option grant.

Where the reload feature is included in the initial valuation of the option, it should be included in the initial valuation where practicable. If issued subsequent to the initial issue of the option, the reload feature should be treated as a new option grant, and expensed at the date of the reload.

We note that the Listing Rules of the Australian Stock Exchange specifically exclude reload features and reloading of options.

Question 15

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

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

We believe that the proposed IFRS sets out the most common features of employee share options, as specified in paragraphs 21-25.

However, to ensure consistent application, we suggest that the following additional features be taken into account:

- salary sacrifice plans;
- restricted/deferred share plans with restrictions and forfeiture conditions; and
- non-recourse employee loan plans for share purchases.

We suggest also that the standard should require the entity to state the option features it took into account in estimating the fair value of the options granted.

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 fully support the Board's approach not to prescribe the valuation methodology for estimating the fair value of options, in accord with setting principles-based standards and allowing for future developments in valuation methodology. Although this approach allows for flexibility and adjustment, more guidance is arguably required on how to calculate fair value in specific circumstances and to adjust value.

In providing any supporting guidance documentation, the IASB should encourage entities to develop robust valuation methodologies consistent with these principles and those adopted by other companies within their industry/business sector, and to adequately disclose and describe details of their methods where appropriate.

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?

In repricing or otherwise modifying the terms and conditions of an employee option grant prior to vesting, we agree that the incremental value granted to the employee should be taken into account in the measurement of the services received. Repricing of options should be calculated on the basis of changes in incremental value and applied prospectively over the remainder of the vesting period.

We believe this situation would not happen very often in practice and note that the Listing Rules of the Australian Stock Exchange place restrictions and limitations on making changes or modifications to the terms and conditions of options granted.

In relation to the two methods used in Example 3, it may be appropriate for either method to be used; essentially, it would depend on the entity's particular circumstances. Sufficient information is not provided in the example to determine or comment on the methods shown. Therefore, we offer the following brief comments:

Of the two methods proposed, the alternative method, the averaging approach in Appendix B may be more appropriate, as it allows a smooth and consistent valuation of the service units and so more clearly reflects the economic substance of the transaction.

Under this method, the total expense of services is better matched with the period in which the service is actually received (i.e. Year 3 and 4 in Example 3). Rather than assume that the original option grant is still in place as the first method does, the method reflects the fact that a repricing took place. It presents a better measure of the services consumed by the entity over the remaining period of the option scheme following the repricing, which involve extending an existing scheme rather than creating a new one.

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 do not support the proposed requirements as appropriate. Although recognising that they could act as a deterrent and overcome the potential for inappropriate use or abuse, we believe that continuing to recognise the services for the remaining vesting period as if cancellation had not occurred would seem to be an artificial accounting treatment and go against the basic concept of charging the expense to the periods in which the employee services were consumed or received by the entity. After cancellation, the services received by the entity should relate to the repriced option scheme, not the initial cancelled scheme.

We do not believe that once an option grant has been cancelled, there should be any carry-over effect in subsequent years leading up to vesting. In the event of cancellation of an option grant before vesting, we would suggest that the outstanding amount should be expensed in full in that period, similar to a share buyback situation. This would mean that the expensing treatment would be completed in the year when the cancellation took place.

However, we query why the proposed requirements do not appear to cover the repricing of vested options or the replacement of a cancelled vested grant with another grant.

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 that proposed requirements for measuring cash-settled share-based payment transactions are appropriate. This approach for cash-settled share-based payments is consistent with that adopted for measuring foreign currency liabilities. We support using fair value to measure the liability as at the end of each reporting period and recognising any changes in the income statement.

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 substantially agree with the requirements proposed and the equity-settled/cash-settled classification focus on the substance, not form, of the transaction. However, more guidance could be provided on how to account for transition from one classification type to the other, and attention paid to eliminating some overly prescriptive detail and inconsistencies.

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)?

As a general principle, we fully endorse disclosure to facilitate interpretation and understanding of how the remuneration amounts were determined, measured and recognised in the accounts, including disclosure of methodology, assumptions, sensitivity and risk factors.

Although we consider the proposed disclosure requirements of paragraphs 45, 47 and 51 to be appropriate, we have practical concerns about the extent and detail of disclosure required.

The detail of minimum disclosure requirements, especially those set out in paragraphs 46, 48 and 52, seems somewhat excessive. We would suggest that these paragraphs should be used to exemplify the type and level of disclosure needed to meet the IFRS requirements, rather than be presented as setting down rules for minimum disclosure.

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.

In general, we support the transitional requirements proposed, in so far as they provide for entities to determine how to expense share–based remuneration payments before the IFRS comes into effect. We hope that the transitional reporting process will highlight any practical difficulties or teething problems that need to be addressed before implementing the standard.

We make the following comments regarding the transitional arrangements:

It must be borne in mind that for the first few times, the expensing of share-based payments which are non-cash items may prove somewhat confusing to users.

We think that the Board needs to clarify the transitional provisions relating to recognition of options granted but not vested after a specific date, rather than the more usual financial year cut-off. In particular, whether there will be some retrospective application of the new rules to shares issued or options granted after release of ED 2 but which have not yet vested at the time the standard comes into effect.

We suggest the following alternative transitional provisions could apply to those share-based payment transactions that have not vested at the beginning of the year in which the standard is first applied:

- require comparative figures to be presented in the first period of application of the standard relating to items that have not been disclosed in the entity's financial statements of the prior period;
- where prior to the beginning of the period in which the standard is first applied, an entity has 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 prior to the beginning of the period in which the standard is first applied, an entity either (i) has recognised share-based payment transactions using a measurement basis other than fair value; or (ii) has not previously recognised share-based payment transactions, the entity must adjust the financial statements as if the requirements of the standard had been applicable when the shares/options were granted.

Rather than providing for ‘grandfathering’ of existing liabilities (paragraph 55), we suggest that the general retrospectivity requirements be modified to exempt the following:

- exempt from remeasurement all liabilities recognised immediately prior to the effective date of the proposed IFRS; and
- exempt from recognition prior to the IFRS effective date any liabilities that were not recognised immediately prior to that effective date, but will then have to be recognised and measured once the IFRS is operative.

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 that all tax effects of share-based payment transactions should be recognised in the income statement, rather than in equity.

Given that there are marked differences between jurisdictions in accounting for the tax effect of share-based payments, we are concerned that the limited example given (Example 5 of Appendix E) proposed as a consequential amendment to IAS 12 may cause problems in consistent application, interpretation and comparability. In presenting only one specific case of possible tax treatments, we believe that the proposed standard currently provides insufficient guidance and explanation of the tax and accounting principles applied. We recommend the inclusion of some additional information that sets out and explains the general tax effect principles and assumptions that make share-based payment transactions subject to deferred taxation.

We note that in the IFRS proposed requirements for expensing equity-settled share-based payment transactions, the effect of a decrease in taxation liabilities, and not an increase in taxation liabilities, seem to be covered.

In Australia, negative tax consequences may arise from expensing options, in particular, tainting of the share capital for franking purposes. Currently, equity-settled transactions are not tax deductible under Australian taxation law and may result in an entity paying an additional tax for 'untainting' the share capital account, caused by crediting that account with an expense.

When an option is exercised, a tax issue arises and the option premium is transferred to the share capital account – since this transfer "taints" the account, franking balances are no longer available. Although an entity may elect to rectify the share capital account, this comes at a cost. Currently, Australian entities avoid this tainting issue and tend not to transfer the balance in their option premium reserve to the share capital account. This however results in the option premium reserve account balance bearing no relationship to the options on issue.

If Australian tax laws were not amended to deal with the IFRS standard on share-based payments, Australian companies would be placed at a disadvantage due to the inconsistent accounting and tax treatment of options.

<u>Question 24</u>

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)–(f).***

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.

We generally favour the proposed IASB accounting treatment in most cases, with the exception of the units of service methodology, as set out in our response to Questions 9 and 24(b) below.

(a) Exemptions from applying IFRS or fair value measurements

As outlined in Question 1, we support the proposed IFRS approach to permit no exemptions from applying IFRS or fair value measurement. We do not support the exemptions proposed under SFAS 123 - and in particular, we oppose making an exemption for broad-based employee share purchase plans, even under SFAS 123 specified conditions.

We would however support some exemption for unlisted companies or at a minimum, some allowance for unlisted companies to apply a modified methodology to their share-based payment transactions. If such an exemption or exception were permitted, the scope and limit of such a provision must be clearly defined to avoid any potential for abuse or accounting manipulation.

We support fair value as the best method of valuing share-based payments. We do not support any alternative to use the intrinsic value method, which remeasures options at each balance date. However, we have some practical reservations about making SFAS 123-type subjective adjustments to fair value to account for vesting conditions, employee turnover levels and forfeiture conditions.

(b) For transactions in which equity instruments are granted to employees, differences between measurement methods in SFAS 123 and the draft IFRS.

We do not fully support the measurement method under either standard of accounting for equity instruments to employees.

We do not support the IFRS proposal to allocate an expense for stock options over their vesting period based on the number of service units expected to be received in that period.

(c) If, during the vesting period, an entity settles in cash a grant of equity instruments …

We do not support the IFRS proposal to ignore cash payment and require the entity to continue to recognise the services received and the resulting expense over the remainder of the vesting period, as if that grant of equity instruments had not been cancelled.

We support the SFAS 123 approach that treats those equity instruments as having immediately vested and requires recognition at the date of settlement (cash payment) of the amount of compensation expense measured at grant date but not yet recognised.

(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. Under the draft IFRS, the fair value of the equity instruments granted is measured at grant date in all cases.

We consider the consistent treatment in the IFRS measurement and recognition requirements of transactions with employees and parties other than employees to be appropriate. However, we would not agree that "measured at grant date in all cases" really correctly describes the IFRS proposals as set out in ED 2.

In SFAS 123, we note that the lack of guidance on how to measure equity compensation transaction with non-employees.

(e) Liabilities for cash-settled share appreciation rights (cash SARs)

We support the IFRS proposal to measure cash SARs using a fair value measurement method (and an option pricing model, as appropriate). However, we are not convinced that the fair value method should be applied to unvested rights not yet considered to be 'constructive liabilities'.

We do not support the SFAS 123 requirement that liabilities for cash SARs be measured using an intrinsic value measurement method.

(f) Treatment of realised tax benefits

We support the IFRS proposal requiring all tax effects of share-based payment transactions to be recognised in the profit and loss statement, as part of the tax expense.

We do not favour the SFAS 123 requirement that realised tax benefits 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.

Question 25
Do you have any other comments on the Exposure Draft?

We make the following additional comments on the Exposure Draft:

We urge the IASB to develop ‘user-friendly’ and authoritative guidance on application of this complex accounting standard. Considerable support needs to be given to ensure that preparers of financial statements can comply with the standard consistently and accurately, without inappropriate reliance on or assistance from their auditor.

We do not support any increase in accounting complexity that is not underpinned by increased disclosure of useful information or increased accuracy in expense recognition.

We believe that the current proposals will not cause undue concern to the professional market, as analysts already make their own adjustments to reported profits to normalise them. Our concern is how the IFRS requirement will impact on the individual private investor’s understanding of this issue in the accounts. The most likely outcome however is that companies will step back from issuing employee share and option schemes in the future, so as to reduce any adverse impact on their profit statements.

We would like to highlight a problematic point not made in the ED 2 documentation that at the regulatory income tax level, there will be a perception that the accounting value will be consistent with the commercial value. This perception is in fact not correct.

In practice or by convention, many CEOS who are terminated or sacked are nevertheless allowed to retain their option entitlements in any event, as part of their termination package. This is an asymmetric accounting treatment – you take account of the statistical chance of his being sacked within a certain timeframe and if and when the sacking does take place, there is no transaction to account for, no adjustment is made for the fact, and the departing CEO gets to keep the options anyway.

This raises the question whether you should give any discount at all if in practice, most companies pay out a substantial proportion - if not the entirety - of the value of the options as part of the termination package. Should you take that into account in the upfront valuation of the cost to the company?

We do not think it is correct in pricing options to take account of the probability of a specific event occurring (e.g. sacking of the CEO) without also taking account of the fact that if that event does actually happen, corporate practice or community business practice dictates that the company will pay compensation for that occurrence.

The IASB should be conscious of some confusing or even contrary definitional shifts creeping in to the fair value concept, and making some unnecessary application distinctions in measurement basis or measurement date as between employees and non-employees.

We are concerned that in some parts, the proposed IFRS approach seems to focus on an academic perspective of "equity" and to confuse concepts of "value" and "cost", which tends to the issues more complicated than they need to be and arguably would render the P&L Statement less accurate or useful.

We also suggest that there should be some guidance on how a reporting entity reports this expense in the financial statements – for example, that the expense relating to share-based payments must be recorded as a separate cost line before reporting pre-tax profit and that it cannot be included as a significant item, abnormal expense, extraordinary item (or similar terminology) below the bottom line.