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Dear Ms Crook

COMMENTS ON ED-2 *SHARE-BASED PA YMENT*

The Commission wishes to submit its comments to the International Accounting Standards Board on ED-2. We thank you for the opportunity to submit our comments to the IASB.

The Commission has considered the Exposure Draft, and submits its responses to the questions set out in the Invitation to Comment in the attached Appendix. Our comments and responses reflect our interest, as a securities market regulator, in the financial reporting and other information disclosures made to markets by *issuers of securities.*

The Commission welcomes the IASB's proposal to introduce a new financial reporting standard for share-based payments, for implementation in 2004. We wish to express our support for the project, and our appreciation of the IASB's initiative.

As a general point, we are of the view that it is desirable that all issuers and other entities who prepare financial reports for external users, and who enter into share-based payment transactions, including employee share options, be required to account for these transactions in a consistent and comparable way. We think that this would enhance the usefulness of financial reports to users.

We present, in the body of this submission, the Commission's views on certain matters which it considers arc key issues for comment in the proposed International Financial Reporting Standard. We present our further responses to the IASB's questions contained in the Invitation to Comment for ED2 in the Appendix attached to this submission.

1. *Overall agreement with recognition and measurement principles*

(Refer to Question 2)

With regard to the comments and responses that we have made to the Exposure Draft, we wish to emphasize our agreement with the general recognition and measurement principles contained in the proposed standard We support the general principles of:

a) measurement of the estimated fair value of share-based payments given for resources acquired by the entity, whether from employees in compensation for services or from non-employees for goods and services provided; and

b) recognising those payments as expenses in a manner which reflects receipt of the resources and consumption of the benefits embodied in those resources, by the entity.

In relation to the principle in point b) above we support application of this principle on the principles of accounting for executory contracts.

2. *Application of the criterion of liability for measurement*

(Refer to Questions 3 and 6)

We note also that we express a different view on a particular aspect of the proposed approach to measuring fair value of such payments, We think that measurement of any transaction on a fair value basis ought to give primary consideration to the criterion of reliable measurement of fair value. Whereas the fair value measurement of each side of a transaction, consideration received or consideration given, would, at the date of agreement between the parties to the transaction, normally be equivalent in the situation where each side of the transaction can be reliably measured, this may not be the case when either side is not able to be measured reliably, or can only be measured with a lower degree of reliability.

We think that the criterion of reliable measurement' should be a primary consideration in accounting for share-based payments on a fair value basis. This would mean that for purposes of measuring the expense for the resources received (the primary accounting objective), measurement can be done with reference to either the consideration given for the resources or the consideration received in respect of the payment, whichever side of the transaction is more *reliably* measurable.

If both sides of the transaction are reliably measurable there should be no difference in fair value assessed from either side of the transaction, and consequently entities may, in principle, measure the transaction with reference to either the consideration received or the consideration given. In such circumstances, the IASB's suggested approach that the measurement be perniitted to be done on the basis of whichever side is 'readily measurable' would be appropriate.

In this regard we note that existing financial reporting standards (for example business combinations) require fair value measurement on the basis of the consideration given. We think that, in the interests of consistency of application, it is preferable that the approach to fair value measurement across all financial reporting standards be consistent, wherever possible.

3. Reliability considerations in measurement of employee share options. (Refer to Question 7)

We agree with the IASB's comments in the Basis for Conclusions (paragraph 62) that, for employee share options, it is usually difficult to measure the value of services received for a variety of reasons.

In view of this a presumption can be made that it will typically be the value of the consideration given, the shares, options or other equity instruments, which gives the more reliable measurement basis for accounting for the transaction. Accordingly we suggest that the IASB's approach should be to require that employee share options be accounted for on the basis of the fair value of the equity instruments granted to an employee, on the basis of this presumption. However we think that, since there may be circumstances when measurement of the fair value of employee services received will provide a more reliable basis for measuring the transaction, the presumption should be applied on a rebuttable basis.

4 *Grant date measurement for all equity-settled transactions (Refer to Questions* & 5)

We are of the view that the date of agreement between the parties to the transaction is the relevant measurernent date for the transaction. We think that the IASB's proposal pertaining to share-based payments to employees, which is that the grant date is the date on which the parties are presumed to reach substantive agreement with regard to the transaction, should extend to the measurement of all equity-settled transactions, and not only those entered into with employees There should be no differentiation in the measurement date depending on the nature of the counterparty to the transaction.

We also suggest that it is desirable that there be internal consistency between financial reporting standards in addressing the matter of what the transaction measurement date should be, where equity instruments are issued as payment for acquisition transactions (for example, business combinations).

The fair value of the equity instrument given, and the fair value of the goods and services received, are likely to be equal only at the date the parties contractually agree to enter into the transaction, the grant date. If there is a time difference between grant date and the date when services are received/consumed there could forseeably be some cases where this would have a material distortive effect in the measurement of the accounting estimate for the expense. Accordingly, we do not think that the date of receipt of the services by the entity presents the best date for measuring fair value of the transaction from the perspective of both parties to the transaction.

5. Reliable measurement of grants of equity instruments Use of option pricing models (Refer to Question if)

The Commission is of the view that the IASB’s approach in not prescribing any particular valuation model is correct.

We are satisfied that there is sufficient evidence available to support the viewpoint that reliable measurement of grants of equity instruments given in payment for services obtained from employees and otherwise can be achieved, whether through use of:

i) existing valuation models for equity instruments with certain adjustments (for example option pricing models) or

ii) new valuation models under development which aim to cope with the specific conditions of valuing equity-settled share-based payment transactions.

We would note, however, that the IASB will need to provide extensive guidance to preparers of financial reports on the application of equity-instrument valuation, to ensure the validity of estimates derived from pricing models where adjustments need to made to assumptions and other inputs of those models. The reliability of the estimates of the accounting expense derived from use of the models can only be as good as the quality of the inputs to the model (which may themselves comprise estimates and subjective elements), and the robustness of the model to cope with different valuation conditions.

6. Forfeited options
(Refer to Questions 9 & 10)

The Commission of the view that when a share option grant is forfeited by the grantee, for reasons of not vesting that there should be no cast recognised for these options.

We suggest that the appropriate way to ensure this is by revising the accounting estimate of the expense for vesting options, which is derived at grant date, be adjusted in each financial reporting period when there is evidence that the number of options which are expected to vest will change.

This process will remove the possibility that the amount recognised as the expense in a period and the corresponding credit to equity are not overstated.

7. *Cancelled share option scheme*

(Refer to Question 1 8)

The Commission is of the view that when a share or option grant is cancelled by the entity (ie other than by forfeiture when vesting conditions are not satisfied) that the recognition of an expense in relation to that grant should cease.

The view is based on the assumption that, on cancellation, the contractual agreement between the issuer and the employee ceases: the issuer will not transfer value to the employee for services received in the form of equity-settled instruments, and the employee stands to gain no further compensation under this payment method for services provided to the issuer.

We think that the it is inappropriate to infer an expense for services received on a continuing basis, through continued recognition of an expense, once the grant is cancelled. The treatment adopted should follow the same principle as forfeited options

We agree, however, that amounts previously recognised as expenses for the grant should not be restated.

For our further responses, we refer you to the attached Appendix.

Conclusion

The Commission is of the view that creation of a financial reporting standard that requires issuers to recognise changes in the net assets of the entity arising from share-based payments in their financial statements, is an important development. We think that recognition of the economic effects of share-based payments in financial statements will improve the quality of financial reporting to external users.

Overall, the Commission supports the proposed standard, subject to the need for adjustments to the standard to take account of the issues raised above, which we think would improve the standard further.

We thank you kindly for accepting our submission at this stage, and apologise for any inconvenience due to its lateness.

Yours Sincerely

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Appendix: *Comments submitted to the International Accounting Standards Board by the Securities Commission in New Zealand on Exposure Draft 2 Share-Based Payment – Responses to Other Questions*

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?**

Comment

We agree with the IASB's approach.

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?**

Comment

We agree that the requirement to recognise an expense in respect of share-based payments is appropriate.

We think that the proposed Standard should clarify the recognition of expenses obtained under contractual agreements along the lines of executory contract accounting principles, and link this to the suggested approach to the timing of the recognition of an expense where there are vesting conditions.

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?**

Comment

Refer to the Commission's comments in the main body of its submission, at paragraph 2.

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?**

Comment

Refer to the Commission's comments in the main body of its submission, at paragraph 4.

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?**

Comment

Refer to the Commission's comments in the main body of its submission, at paragraph 4.

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?**

Comment

Refer to the Commission's comments in the main body of its submission, at paragraph 2.

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?**

Comment

We refer to the Commission's comments in the main body of its submission, at paragraphs 2 and 3, and to our further comments below.

In the *Basis for Conclusions* at paragraph BC62, the IASB states that, particularly in the case of share-based payments involving employee services, it is usually difficult to measure directly the value of the services received. Reasons for this are that shares or options are granted to employees as component of their pay package, either as a component of basic pay or a part of a bonus arrangement where additional remuneration is offered to obtain additional benefits. It is difficult to estimate the fair value of those additional benefits.

We agree with that, generally speaking, this is the case for share-based payments to employees.

We also think, however, that there will be other situations where the reverse situation applies, and the value of the services rendered will be more reliably determinable than the fair value of the equity instruments issued. For example, in the case of a start-up entity with no track record of historical performance, fair value may only be determinable on the basis of forecasts resting on highly uncertain assumptions about future conditions. Conceivably, in such a situation, the value of the services to be provided by the employees can be established more reliably (with reference to market prices for similar services in employment markets) than an estimate of the fair value of the entity's equity instruments granted in return for services.

We think that this approach to measurement of share-based payments for employee services might perhaps be more appropriately stated as a *rebuttable presumption*. We think that it is desirable, and certainly beneficial to users of financial statements, that the accounting treatment of equity-settled transactions with employees be required to follow a consistent measurement approach.

For this reason we agree with the approach taken by the IASB in requiring these payments to be measured on the basis of estimating the fair value of the equity instruments issued. However we think that an entity should be permitted to apply the alternative approach to measure the transaction according to the fair value of the services received/consumed if this is clearly a more reliable basis for measurement of the transaction and that measurement of the transaction on the basis of the fair value of the equity instruments issued would produce a misleading result.

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?**

Comment

See the Commission's comments under Question 2 above.

If the vesting depends solely on future performance we agree that it is reasonable to presume that the services are rendered during the vesting period. However we suggest that the standard will need to include guidance for situations where both service and performance conditions apply for vesting to occur. It will then be necessary to establish a ranking of the service and performance conditions in order to determine how the related expense should be recognised between the grant date and the vesting date.

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?**

Comment

We agree with the IASB's proposed approach for allocating the fair value of the expense attributable to units of service received, for purposes of recognising the expense as services are rendered during the vesting period.

However, refer to our comments Question 8 above in relation to performance-based vesting conditions rather than service(time)-based vesting conditions. The Exposure Draft illustrates this measurement with reference to the number of units of service expected to be received during the vesting period with reference to service (time-based) vesting conditions. It may be, however, that the primary vesting conditions are performance-based rather than service-based so that the estimated number of units expected to be received in the vesting period needs to incorporate estimates of vesting under the performance-based conditions. Presumably there may be little correlation between allocating units based on passage of time and the achievement of the performance target, other than by coincidence.

We suggest that it would be helpful if the Standard incorporated additional guidance for measuring and allocating the expense based on expected service units taking account of contractual performance conditions for vesting.

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?**

Comment

Refer to the Commission's comments included in the main body of its submission, at paragraphs 6, and our comments under Question 9 above.

Refer also to our comments under Question 18 pertaining to cancellations of shares or option grants. In the event of cancellation, if that event obliges the entity to compensate the option holders, either in cash/issue of replacement equity instruments, the cancellation should be treated as a reduction/return of capital/buy-back transaction in accordance with its substance and recognised as an adjustment to total equity.

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?**

Comment

Refer to the Commission's comments in the main body of its submission, at paragraph 5.

We think that in the final standard that is approved for this accounting topic, the IASB should clearly spell out for preparers and users of financial statements the judgements, assumptions and potential anomalies that reside in fair value estimations produced from option-pricing models. Entities will need guidance in the application of option pricing models for varying underlying conditions, and to determine properly the inputs required for the models. This guidance will be especially important in the case for options granted by unlisted and newly-listed entities, eg estimating expected volatility of the underlying securities.

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?**

Comment

We agree, however refer to our comments under Question 10 above.

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?**

Comment

We agree with the need to incorporate the estimated effects of vesting conditions in the valuation model used in the equity-instrument valuation model, as a variable which affects the fair value of the equity instruments granted as measured at grant date.

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?**

Comment

We agree with the IASB's proposal. We think that the Standard should make it pertinently clear that all factors which, as at grant measurement date when fair value is determined, represent variables which are likely to materially affect the output of the valuation model are required to be incorporated into the fair value measurement exercise.

Forseeably, in the absence of detailed guidance, preparers may not properly appreciate the potential effect of various factors associated with the grant of equity instruments which could affect the valuation output. We re-iterate the point that preparers will need comprehensive guidance on the use of equity valuation models.

For the related reason of placing users of the financial report in a position to assess the reliability of the fair value measurements for equity-settled share based payments, we are of the view that it is important that disclosure be made of the qualifications of the valuer who performs the valuation calculation from which the fair value estimate is derived.

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?**

Comment

Refer to our comments under Question 14 above.

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?**

Comment

Refer to the Commission's comments in the main body of its submission, at paragraph 5.

Question 17

If an entity reprices a share option, or otherwise modifies the terms or conditions on which equity instruments were granted,

the draft IFRS proposes that the entity should measure the incremental value granted upon repricing, and include that incremental value when measuring the services received. This means that the entity is required to recognise additional amounts for services received during the remainder of the vesting period, ie additional to the amounts recognised in respect off 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?**

Comment

We agree that if an entity reprices an option so that the terms and conditions associated with the initial grant are modified and the modification produces incremental value, the additional value should be recognised as an expense over the remainder of the vesting period. We think that the approach set out in the proposed standard is appropriate (not the alternative approach of averaging the grants).

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.**

Comment

Refer to the Commission's comments contained in the main body of the submission, at paragraph 7.

We agree that cash settlements made to employees upon cancellation should be treated as a repurchase transaction, and debited to equity.

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.**

Comment

We agree with the IASB's proposed approach. We think that it is appropriate to measure the expense for cash-settled transactions based on the fair value of the liability at reporting date and he actual settlements (in excess of amounts previously recognised) during the period.

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.**

Comment

The current recognition approach differs between issuer and counterparty, where there is no liability for cash settlement. We suggest that the approach to recognition of the expense and the related credit as a liability or as equity should be on a uniform basis, whether the entity or the counterparty has the choice as to the form of settlement and there is no clear indication that a liability exists.

We think that the recognition principles applied to hybrid instruments in the context of share-based payments should be consistent with the principles applied to those instruments in IAS39.

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)?**

Comment

We agree that the proposed disclosures are appropriate. We think that extensive disclosures concerning share-based payments are warranted to increase the transparency of reported earnings in the statement of financial performance and to enable users to appreciate the impact of share-based payments on the entity's capital structure reflected in the statement of financial position.

We think that the IASB's proposed disclosures may be extended further to include a disclosure as to whether the fair value estimates used for recording share-based payment transactions were determined by an external valuer. This should widen the basis for users' to assess the reliability of the recorded values.

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.**

Comment

We agree with the IASB's proposed approach to transitional arrangements on introduction of the proposed Standard.

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?**

Comment

We agree with the IASB's proposal.

Question 24

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

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

- employee share purchase plans are excluded from SFAS 123, provided specified criteria are met, such as the discount given to employees is relatively small;
- SFAS 123 encourages, but does not require, entities to apply its fair value measurement method to recognise transactions with employees; entities are permitted to apply instead the intrinsic value measurement method in Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees* (paragraphs BC70–BC74 in the Basis for Conclusions give an explanation of intrinsic value); and
- unlisted (non-public) entities are permitted to apply the minimum value method when estimating the value of share options, which excludes from the valuation the effects of expected share price volatility (paragraphs BC75–BC78 in the Basis for Conclusions give an explanation of minimum value).

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

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

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

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

(d) SFAS 123 does not specify a measurement date for transactions with parties other than employees that are measured at the fair value of the equity instruments issued. Emerging Issues Task Force Issue 96–18 *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* requires the fair value of the equity instruments issued to be measured at the earlier of (i) the date a performance commitment is reached or (ii) the date performance is complete. This date might be later than grant date, for example, if there is no performance commitment at grant date. Under the draft IFRS, the fair value of the equity instruments granted is measured at grant date in all cases.

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

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

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

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

Comment

We think that the IASB proposed treatments, or alternatively the approaches suggested in our responses set out to Questions 1 to 23 above, are preferable to the accounting treatments set out above.

In relation to point (b) above refer to the Commission's comments contained in the main body of its submission, under paragraph 6, and to our responses under Questions 10 and 13 above.

Question 25

Do you have any other comments on the Exposure Draft?

Comment

We have no other comments.