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14 March 2003

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

ED 2 Share-based payment

Dear Ms Crook:

The global organization of Ernst & Young is pleased to comment on the above document. The present lack of guidance in the IASB's literature on this complex area is a significant detriment to the international comparability of the financial results of different enterprises. We therefore strongly support the IASB's efforts to develop an internationally agreed upon approach to the manner in which the cost of share-based payments is recognized and disclosed in the financial statements of reporting entities.

We agree with certain fundamental principles upon which ED 2 is based. First, we agree that share-based payments made for goods or services represent compensation for those goods or services. Second, we believe that those share-based payments should be recognized at an amount based on their fair value (although, as described below, we have significant reservations about the reliability and comparability of fair values estimated with option-pricing models). Third, we also agree that share-based payments should be recognized as goods or services are received (generally, during the vesting period).

Although we agree with certain fundamental principles upon which ED 2 is based, we believe that revisions are necessary in finalizing an IFRS because we disagree with certain important aspects of ED 2. In addition, we believe that more guidance is necessary on certain concepts. Our most significant concern relates to the subjectivity and reliability of valuation of share options. We provide a more detailed discussion of those concerns, as well as comments on other aspects of ED 2, in the Appendix to this letter.

We continue to have significant concerns about the subjectivity and reliability of employee share option values derived from traditional option-pricing models. We believe that such models were not designed for employee share options and, as a result, the model assumptions are arbitrarily modified to derive a value that is asserted to take into account the unique aspects of employee share options (for example, lack of transferability, vesting requirements and numerous other characteristics). We also continue to be concerned that the subjectivity of certain assumptions that have a dramatic impact on option values (for example, volatility and expected life of the option) significantly reduces the reliability and comparability of estimated values for employee share options. We believe that in finalizing an IFRS, the IASB and others should devote significant additional effort to improved valuation methodologies and additional valuation guidance. Our concerns about valuation are discussed further in our response to Question 11.

Our other more significant concerns regarding ED 2 are as follows:

- **Measurement date** – The Board has proposed in ED 2 that an exchange of equity instruments for goods or services be measured on the grant date if the measurement is based on the fair value of the equity instrument, and on the date goods or services are received if the exchange is measured based on the fair value of those goods or services. As discussed further in our response to Question 4, we believe that all equity awards should be measured on the grant date, regardless of how the exchange is measured. Because those values are likely to be equal only on the grant date, we believe that the grant date is the only appropriate measurement date. We believe that our view is consistent with the discussion in paragraph BC90 of ED 2, which states that "at grant date, it is reasonable to presume that the fair value of both sides of the contract are substantially the same, i.e., the fair value of the services expected to be received is substantially the same as the fair value of the instruments granted."

- **Accounting for forfeitures** – The Board has proposed in ED 2 that vesting conditions (including the possibility of forfeiture) be incorporated into the grant date measurement of share-based payments, and that those estimates are not adjusted to reflect actual forfeitures. We view the forfeiture of a share-based payment as, essentially, the failure of the grantee to pay (in the form of goods or services) for that award. Accordingly, we believe forfeitures should impact whether the measured cost is recognized, not how share-based payments are measured. That is, no compensation cost should be recognized for forfeited awards. Our view on forfeitures is discussed more fully in our response to Question 10.

- **Accounting for cancellations** – The Board has proposed in ED 2 that if an entity cancels a grant of shares or options during the vesting period, the portion of the compensation cost measured on the grant date but not yet recognized should continue to be recognized as services are rendered. This accounting is required even if the service provider is not required to continue to provide services in exchange for the consideration received for the cancellation (e.g., cash). As discussed more fully in response to Question 18, we believe that it is inappropriate to continue to recognize compensation expense in that situation, because the entity is no longer entitled to receive services related to the cancelled equity instrument.

- **Inadequate distinction between liabilities and equity** – We have several significant concerns (discussed in greater detail in our responses to Questions 19 and 20) that lead us to conclude that the guidance provided in ED 2 for distinguishing liabilities and equity is inadequate. We also have a much more pervasive concern that ED 2 assumes that IAS 32, *Financial Instruments: Disclosure and Presentation*, provides clear guidance on the differentiation of equity-settled from cash-settled transactions. We are not convinced that this is always the case and, therefore, believe our comments on ED 2 also should be considered in the context of the amendments to IAS 32 as well. In summary, our concerns include:

    a. ED 2 generally classifies a financial instrument as a liability by reference to the rights *of the holder* of that instrument. In some circumstances, while an option holder may have no right to receive cash, the entity may be required to satisfy the obligation by purchasing shares in the market. It appears that the obligation is not accounted for as a liability under ED 2, even though the company will be compelled to suffer a cash outflow because of its commitments taken as a whole.

    b. ED 2 states that an award in which the issuer has the choice of cash or share settlement is a cash-based award if the issuer's choice of settlement is not "substantive." However, there may well be differences of view as to what is "substantive," and we believe that concept should be clarified in any final IFRS to avoid diversity in practice. For example, in our view, an entity does not have a "substantive" choice of settlement alternatives if at the time of grant, the entity does not have authority to issue new shares (or does not hold shares in treasury) sufficient to settle the award.

    c. Consistent with our response to the Exposure Draft of proposed amendments to IAS 32, we do not agree that an entity with the choice of settlement for an award must account for the award as a liability if the entity has a past practice or a stated policy of settling in cash. We do not believe that the introduction of the entity's intent or past practice is appropriate in determining whether an award is a liability, unless the entity's intent or past practice legally negates the choice of the entity in such a way that, in substance, cash settlement is required.

    We realize that these issues ultimately fall within the ambit of the Board's financial instruments project rather than ED 2. Nevertheless, we believe that they must be considered before ED 2 is finalized.

- **Valuation of share options of unlisted companies** – While we believe that a concerted effort to improve valuation of employee share options will resolve our concerns regarding valuation of share options of listed companies, in our view there should be a practical exemption for share options of unlisted entities (that are not subsidiaries of listed companies) for services provided by employees. We believe that it is very difficult to determine a meaningful measurement of volatility of an unlisted entity's share price primarily due to the infrequency of market transactions in the underlying shares. To determine a meaningful measurement of volatility, an entity would need to value its underlying equity frequently, a costly endeavor that likely would result in a small estimated volatility. Accordingly, we support a model that uses a volatility of zero (that is, a minimum value approach) for unlisted entities as defined in the scope exclusions in IAS 14, *Segment Reporting,* and IAS 33, *Earnings per Share.* Our views on this issue are further expressed in our response to Question 3.

- **Inadequate definition of the reporting entity** – ED 2 implicitly defines the reporting entity to include the owner of the reporting entity and other entities controlled by the owner (a perspective not generally adopted in IFRS), and requires share-based payments among those entities to be recognized at fair value. We believe that the IASB needs to consider very carefully the implications of extending the scope of the reporting entity to include its owners and other entities controlled by them in this way. If it were applied as a general principle, it would result in significant changes in current financial reporting practices under IFRS. Conversely, the scope of ED 2 is not extended to include entities such as employee share trusts and similar bodies if those entities are not part of the reporting entity for accounting purposes. Absent such an extension, ED 2 potentially will be ineffective if those entities are used to distribute share-based payments. Our concerns about the definition of the reporting entity are discussed more fully in our response to Question 1.

- **Scope of ED 2 versus IAS 22/ED 3** – The scope of ED 2 excludes share-based payments made as part of the assets acquired in a business combination. When share-based payments are made to the previous owners of an acquired business who then remain with the acquired entity for some period following the acquisition, ED 2 does not clarify where the boundary lies between share-based payment transactions (falling within ED 2) and the cost of acquisition (falling within IAS 22, *Business Combinations,* and, potentially, ED 3, *Business Combinations*). As discussed more fully in our response to Question 1, this is a major (and increasing) area of controversy in practice, which, in our view, requires guidance that is more specific.

As noted above, we elaborate on these concerns within our responses to the Board's specific questions in the Appendix to this letter. We would be pleased to discuss our views with the Board or staff at its convenience. If you wish to do so, please contact Danita Ostling at the above address or at 0207 951 8772.

Yours sincerely,

Ernst & Young

Question 1

Paragraphs 1-3 of the draft IFRS set out the proposed scope of the IFRS. There are no proposed exemptions, apart from transactions within the scope of another IFRS. Is the proposed scope appropriate? If not, which transactions should be excluded and why?

We broadly support the scope of ED 2 so far as it is currently drafted, but believe that further clarification is required in the following areas:

- the interaction between ED 2 and IAS 22/ED 3;
- the treatment of employee share trusts and similar entities;
- the definition of "group;" and
- the treatment of inter-group funding arrangements.

In addition, we have some concerns regarding the implied definition of "reporting entity" within ED 2, which encompasses the owner of the entity and other entities under common control.

We discuss these issues in turn below.

Interaction between ED 2 and IAS 22/ED 3

Where share-based payments are made to the previous owners of an acquired business who then remain with the acquired entity for some period following the acquisition, ED 2 does not clarify where the boundary lies between share-based payment transactions (falling within ED 2) and cost of acquisition (falling within IAS 22/ED 3). This is a major (and increasing) area of controversy in practice, which, in our view, requires more specific guidance.

There is currently a clear incentive for companies to treat such costs as part of goodwill rather than employee costs, which will be even greater once the requirement for non-amortization of goodwill proposed in ED 3 comes into effect. In our view, the IASB must clarify to what extent such transactions should be treated as purchase consideration or as post-acquisition employment costs.

It seems clear that fully vested equity securities issued to employees of a target company in a business combination clearly should be included as part of the cost of the acquisition and measured in accordance with IAS 22/ED 3. However, for share-based payments granted in exchange for unvested or partially vested awards, it is not clear whether the share-based payment should be accounted for under IAS 22/ED 3 or under ED 2. In our view, when unvested share-based payments are made to employees in connection with a business combination, at least a portion of the value of the share-based payments should be accounted for under ED 2, as, presumably, the unvested share-based payments are made in exchange for the receipt of future services.

Treatment of employee share trusts and similar entities

In many countries it is common to transfer shares or other assets to trusts to fund share-based payments. In such cases, it is often the trust, and not the reporting entity, that actually makes the award of a share-based payment to the employee. In practice, most such trusts are treated as "off-balance sheet" by companies reporting under IFRS, a treatment encouraged, if inadvertently, by SIC-12, paragraph 6, which specifically excludes from its scope post-employment benefit plans or equity compensation plans.

Clearly, unless such trusts are brought into the scope of paragraph 2 of ED 2, the whole draft IFRS can be side-stepped by having the trust rather than a member of the consolidated group initiate all share-based payment transactions. Accordingly, as a short-term measure, we suggest that paragraph 2 should clarify that transactions in the reporting entity's equity initiated by a trust or similar vehicle (whether consolidated by the reporting entity or not) falls within the scope of ED 2.

In the medium term, however, we believe that it is essential for the IASB to develop guidance on the accounting treatment of such trusts. Otherwise, there will be fundamentally different interpretations of the requirements of IFRS on this issue between countries whose previous GAAP required the assets and liabilities of such entities to be treated as those of the reporting entity and those whose GAAP did not.

Definition of "group"

The construction of the term "group" in paragraph 2 of ED 2 can have significant implications in determining whether a share-based payment is subject to ED 2 or, for example, should be considered a derivative financial instrument accounted for under IAS 39, *Financial Instruments: Recognition and Measurement*. We believe that it would be appropriate for the Board to define the term "group" to ensure reasonably consistent interpretation of the scope of this standard. For example, while we presume that share-based payments based on the shares of a consolidated subsidiary are subject to ED 2, it is not clear whether such payments based on the shares of an investee accounted for using the equity method or proportionate consolidation, or accounted for as a special purpose entity in accordance with SIC-12, *Consolidation—Special Purpose Entities*, would be subject to ED 2 or to IAS 39.

Inter-group funding arrangements

In many groups an employing subsidiary is required to make a cash payment to its parent (or a trust controlled by its parent) in consideration for the granting of share-based awards to its employees by the parent (or trust). In our view, it seems clear that in such cases the subsidiary should account for the transaction as a cash-settled award, the cost of which is the actual cash paid to the parent (or trust). However, as drafted, paragraphs 1 and 2 of ED 2 appear to require the subsidiary to account for the cost of the option granted to its employees in accordance with the rules in ED 2 *in addition* to any payment that may be required as a matter of group policy, giving rise to a potential "double hit" to earnings and, in some jurisdictions, distributable reserves. We assume that this was not the IASB's intention, but urge that the final IFRS should clarify this point specifically.

Implied definition of reporting entity to include owners and entities under common control

The proposals in ED 2 effectively extend the scope of the reporting entity to include the owners of the entity and other entities controlled by them – an extension which, in our view, has no basis in the IASB's current *Framework for the Preparation and Presentation of Financial Statements* ("the Framework").

In particular, paragraph 2 of ED 2 states:

> "For the purposes of this [draft] IFRS, transfers of an entity's equity instruments by its shareholders, or transfers of equity instruments of the entity's parent or of another entity in the same group as the entity, to the entity's employees, or to other parties that have supplied goods or services to the entity, are share-based payment transactions, unless the transfer is clearly for a purpose other than payment for goods or services supplied to the entity."

This has the effect that, if (as is the case in a typical group share option plan) the parent awards an option to the employee of a subsidiary, the subsidiary is required to account for the award even though it is not a legal party to it (although it has clearly benefited from it). Conversely the parent, which is a legal party to the award, is not required to account for it under ED 2, because the parent (as opposed to the group) has arguably not received services from the beneficiary of the award, which would be necessary in order for the transaction to fall within the scope of paragraph 1 of ED 2.

We believe that the IASB needs to consider very carefully the implications of extending the scope of the reporting entity to include its owners and other entities controlled by them in this way. For example, it is common for group companies to provide services to other members of the group free of charge, or to transfer assets or sell goods at other than their open market value. Companies may also undertake similar transactions with their owners. If the principles in ED 2 were applied, all such transactions (generally recorded under current IFRS at the actual amount paid, if any – a treatment implicitly permitted by IAS 24, *Related Party Disclosures)* would be recorded at market value, with the difference from the amount paid recorded as an imputed capital contribution.

Question 2

Paragraphs 4-6 of the draft IFRS propose requirements for the recognition of share-based payment transactions, including the recognition of an expense when the goods or services received or acquired are consumed. Are these recognition requirements appropriate? If not, why not, or in which circumstances are the recognition requirements inappropriate?

We agree with the provisions described in paragraphs 4-6 of the draft IFRS.

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?

While we agree with the draft IFRS's principle that an entity should measure goods and services received in exchange for share-based awards at fair value, we believe that there should be a practical exemption for share-based payments by unlisted entities (other than subsidiaries of listed entities) for services provided by employees. We observe that it is very difficult to determine a meaningful measurement of volatility of an unlisted entity's share price primarily due to the infrequency of market transactions in the underlying shares. To determine a meaningful measurement of volatility an entity would need to frequently value its underlying equity, a costly endeavor. As a result, we do not believe that the cost of requiring fair value measurement outweighs its benefits and therefore we support a model that uses a volatility of zero for unlisted entities (that is, a minimum value approach). Given the infrequency of the valuation of unlisted entities, it is likely that the volatility determined in such cases will be a small amount and, therefore, fair value should not differ greatly from the value derived using the minimum value approach.

A further issue in the case of options on unlisted shares is that the approach required by ED 2 (that is, to measure the options at a fair value in all cases) is inconsistent with IAS 39, paragraph 69(c), which requires an investor to recognize such an instrument at fair value only if fair value can be reliably measured. We note that paragraph BC 139 states that, "an unlisted entity that regularly issues shares or options to employees (or other parties) might have an internal market for its shares." However, we believe that this is a relatively rare situation, and observe that in many jurisdictions, the creation of a market in the shares of an unlisted company potentially would breach securities laws.

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 believe that the grant date is the most appropriate date to measure the fair value of the goods or services to be received in all circumstances. We see no compelling reason to have different measurement dates for transactions with employees and those with non-employees. Further, with regard to nonemployee transactions, we see no conceptual basis for measuring the transactions at different dates depending on whether the value is based on the equity instrument issued or the goods or services received.

Presumptively, the value of the equity instruments is equal to the value of the goods or services received on the date the arrangement is entered into—that is, the grant date (consistent with the Board's conclusion in paragraph BC90 of ED 2). We believe that measurement on that date, without regard to the method of measurement, is appropriate and provides the added benefit of avoiding having the determination of the measurement date for the transaction based on a subjective conclusion about which side of the transaction is more reliably measurable.

The approach in ED 2 could be compared to a requirement to measure inventory at its current price at the date of delivery rather than the price actually paid as agreed with the supplier at the time that the original order was placed. Such a recognition of changes in the value of the goods or services received is, in effect, the recognition of gains and losses on an executory contract that are not normally recognized in a similar cash transaction.

Measurement at grant date also is more consistent with the concept of equity described in the Framework. The Framework does not provide for recognition of gains or losses on equity transactions. Benefits to the suppliers or service providers that result from changes in the value of an equity security after the grant date (which are captured in a "service date measurement" model) represent benefits received as an equity holder, not as a supplier or service provider.

The Board's conclusion to measure the value of goods or services when received for certain transactions also is inconsistent with its conclusion in paragraph BC104 (similar points of view also are described in paragraphs BC 122 and BC 128):

> "The Board therefore concluded that, no matter which side of the transaction one focuses upon (the receipt of resources or the issue of an equity instrument), grant date is the appropriate measurement date under the Framework, because it does not require remeasurement of equity interests and it provides a reasonable surrogate measure of the fair value of the services received."

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?

For the reasons described in our responses to Questions 3 and 4 above, we believe that the grant date is the appropriate date to measure all equity instruments granted to both employees and non-employees.

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?

Please note also our responses to Questions 3 and 4 above.

From a practical point of view, we agree with the approach proposed in ED 2 that there should be a rebuttable presumption that the fair value of the goods or services received is more readily determinable than the fair value of the equity securities granted in transactions with parties other than employees. However, it is quite clear that reliability of measurement actually depends on the nature of the entity making the awards (that is, whether the entity is quoted or not) and the nature of the goods or services received (that is, whether market prices of the goods or services are readily available) rather than on the identity of the recipients (that is, whether the recipients are employees are not).

For this reason, we believe that this presumption may be appropriately rebutted in a number of circumstances. For example, many services provided by nonemployee consultants are similar to services that are or could be provided by employees. The consultants may be compensated with a combination of cash, equity securities, and other benefits, which would make the measurement of the fair value of the services received just as problematic as when such services are provided by employees.

The fair value of publicly traded shares may be more readily determinable than items such as acquired in-process research and development, advertising services provided on a new internet website, or other unique goods or services. In these cases, we believe that the presumption that the fair value of the goods or services is more readily determinable than the equity instruments granted may be rebutted.

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 generally support this approach, although we can envision some situations in which the contrary position would be true. As noted in our response to Question 6 above, we believe that reliability of measurement depends on the nature of the awards rather than on the identity of the recipient (that is, whether the recipient is an employee or not).

For this reason, we believe that this presumption may be appropriately rebutted in certain circumstances. For example:

- There are situations in which, after an employee's total cash remuneration has been determined, it is mutually agreed (for example, for tax reasons) to satisfy some part of that remuneration in shares. In such cases the value of cash remuneration transmuted into equity may provide the more reliable measurement.
- In some jurisdictions there are situations (for example, on flotation of previously publicly-owned entities) where share-based awards are made as a matter of law. In such cases it is unclear whether any specific service has been rendered in return for the award and therefore whether it is appropriate (on the logic in the ED) to recognize any cost.

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 that it is appropriate to presume that services received in exchange for the equity instruments granted are received during the vesting period. We believe that this approach best reflects the economics of the transaction—that service is required during the vesting period to earn rights to the equity instrument.

Many employee share options provide that the term of vested options truncate if the grantee's employment is terminated. While this suggests that the employee continues to earn additional time value even after the stock option is vested, we believe that the bulk of the value of the share option is earned during the vesting period and the Board has taken a reasonable approach to this issue in ED 2.

Question 9

If the services received are measured by using the fair value of the equity instruments granted as a surrogate measure, the draft IFRS proposes that the entity should

determine the amount to attribute to each unit of service received, by dividing the fair value of the equity instruments granted by the number of units of service expected to be received during the vesting period (paragraph 15). Do you agree that if the fair value of the equity instruments granted is used as a surrogate measure of the fair value of the services received, it is necessary to determine the amount to attribute to each unit of service received? If not, what alternative approach do you propose? If an entity is required to determine the amount to attribute to each unit of service received, do you agree that this should be calculated by dividing the fair value of the equity instruments granted by the number of units of services expected to be received during the vesting period? If not, what alternative method do you propose?

We broadly agree with a "unit of service" approach, although we believe the approach can be complex, and the IASB should consider simpler alternatives. However, we do not support the detailed application of this approach in ED 2 to the extent that it results in an income statement charge for services rendered for share-based awards that do not vest through forfeiture or cancellation. Please see our responses to Questions 10 through 14 below.

Question 10

In an equity-settled share-based payment transaction, the draft IFRS proposes that having recognized 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 recognizing 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 disagree with the key principle of ED 2 that there should be no adjustment to the expense for equity-settled options once the relevant service has been rendered. The stated objective of ED 2 is (emphasis added):

> "to ensure that an entity recognizes all share-based payment transactions in its financial statements, measured at fair value, so as to provide *high quality, transparent and comparable* information to users of financial statements."

Suppose that two companies grant identical performance related options to their employees. In both cases, identical units of service are rendered. However, with respect to the first company all eligible employees leave before the awards vest, whereas with respect to the second company, all employees remain to collect their awards. Assuming that each company accurately estimates the number and timing of forfeitures, ED 2 draws no distinction between the reported earnings of the two companies, although no equity instruments ultimately are issued to employees of the first company. Thus, in our view, ED 2 fails to meet the stated objective.

Another consequence of the methodology in ED 2 is that it can produce different charges to the income statement for the same number of units of service, according to whether that number is the same as, greater than, or less than the number assumed in the initial valuation of the award. This puts considerable pressure on the ability to accurately estimate forfeitures on the grant date and, potentially, could provide an incentive for inappropriate adjustment of those estimates.

We acknowledge that the services received have value. However, in our view where the share award does not actually vest, no equity instrument is in fact issued, such that the grantor has not paid for that value. Essentially, upon forfeiture the grantee has transferred the equity instrument back to the grantor for no consideration, such that the grantee has effectively contributed, for no consideration, either (a) the equity instrument or (b) the services recognized. As a result, it could be argued that, conceptually, the grantor should recognize a gain for the contribution in an amount equal to the services recognized in exchange for the equity instrument. Rather than grossing up the statement of operations for the compensation cost and the gain recognized upon forfeiture, we believe that the gain is most appropriately recognized by reversing any compensation amounts previously recognized.

For all these reasons, we believe that amounts recognized for goods or services received in exchange for equity instruments that are forfeited because service or performance requirements are not met should be reversed.

Question 11

The draft IFRS proposes that the entity should measure the fair value of equity instruments granted, based on market prices if available, taking into account the terms and conditions of the grant (paragraph 17). In the absence of a market price, the draft IFRS proposes that the entity should estimate the fair value of options granted, by applying an option pricing model that takes into account various factors, namely the exercise price of the option, the life of the option, the current price of the underlying shares, the expected volatility of the share price, the dividends expected on the shares (where appropriate) and the risk-free interest rate for the life of the option (paragraph 20). Paragraph 23 of the proposed IFRS explains when it is appropriate to take into account expected dividends. Do you agree that an option pricing model should be applied to estimate the fair value of options granted? If not, by what other means should the fair value of the options be estimated? Are there circumstances in which it would be inappropriate or impracticable to take into account any of the factors listed above in applying an option pricing model?

We have significant concerns about the subjectivity and reliability of employee share option values derived from option-pricing models. We believe that such models were not designed for employee share options and as a result, the model assumptions are arbitrarily modified to derive a value that is asserted to take into account the unique aspects of employee share options (that is, non-transferability, vesting requirements, and numerous other characteristics). We are also concerned that the subjectivity of certain assumptions that have a dramatic impact on option values (e.g., volatility and expected life of the option) significantly reduces the reliability and comparability of estimated values for employee share options.

Despite our concerns about valuation, we are supportive of the efforts of the IASB to promote a worldwide accounting standard requiring the recognition of the cost of share-based payments based on the fair value of those awards on the grant date. However, we believe that the IASB, in cooperation with the FASB, valuation experts, preparers and users, should carefully deliberate the valuation issues associated with employee share options and determine that the promulgated approach is capable of reliably valuing such awards within a reasonable degree of precision. Paragraphs 24 and following of the Framework require that, in order for an item to be recognized in the financial statements, it must satisfy four fundamental recognition criteria. Those criteria include reliability. In particular, the Framework (paragraph 32) states:

> "Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading."

The Framework further requires that information must be representationally faithful and neutral. We believe that it is critical that the measurement of the fair value of employee share options be viewed as meeting those objectives.

In our view an intrinsic value measurement approach for employee share options consistently and clearly understates the value of those options and biases equity-based compensation decisions towards the use of certain forms of share options. However, if the IASB mandates a fair value approach that is perceived consistently and materially to overstate the value of employee share options, the approach will introduce a new, but equally inappropriate, bias against the use of share options to compensate employees.

We understand that many users of financial statements frequently adjust reported financial information to derive information that benefits their analysis. If the amounts recognized for employee share options are perceived to be misstated or highly unreliable, this likely would induce many users to make one more adjustment to reported financial information, which would not represent any meaningful progress in achieving the fundamental objective of financial reporting as set out in paragraphs 12 and following of the Framework.

We understand that valuation experts and others continue to work to develop option-pricing models that result in better estimates of value for employee share options. We support these efforts and believe it is essential that the IASB (together with the FASB and other interested national standard setters) work with these experts and others to develop a valuation methodology suited to the unique characteristics of employee share options. We believe that in finalizing an IFRS, the IASB and others should devote significant additional effort to improve valuation methodologies and to provide additional valuation guidance. The development of such methodologies (which may include a refinement of existing option-pricing models if such refinements sufficiently reflect the differences between employee share options and the type of options that such models were designed to value) will require considerable effort. However, we are optimistic that the appropriate, concerted effort will lead to the development of better option-pricing methodologies in time for the IASB to issue a final standard in time for adoption of IFRS by European Union companies in 2005.

In addition, we believe that additional guidance regarding the appropriate application of option-pricing models would be an important step towards achieving greater comparability of estimates and a better approximation of fair value.

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?

As discussed in our response to Question 11, the lack of transferability is one of many unique characteristics of employee share options. We agree that the reason that many employees exercise options before the expiration of their term is because the options are not transferable, whereas the shares obtained on exercise normally are. However, it is not clear whether the reduction in estimated value resulting from the use of an expected life rather that the maximum term of the option approximates to the diminution in value resulting from the non-transferability of typical employee share options. We believe that, in the absence of another accepted method to estimate the diminution in value resulting from the non-transferability of employee share options, the use of an expected life should be permitted. However, we believe that this approach should not be prescribed as the only means to achieve that end. We also encourage the Board to explore with valuation specialists other means of estimating the diminution in value resulting from the non-transferability of employee share options.

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, whether based on continuous employment or performance, should be incorporated into the estimate of fair value of an equity instrument granted in exchange for goods or services because a share option normally is not exercisable during the vesting period (that is, exercise is restricted during the exercise period).

However, consistent with our response to Question 10, we believe that forfeitures, whether a result of termination of employment or the failure to achieve performance conditions, should not affect the *measurement* of an award. Rather, forfeitures should affect the *recognition* of an award. In addition to the reasons we discussed in our response to Question 10, we believe that the valuation challenges presented by employee share options are great enough without adding in estimates of forfeitures that will in some circumstances be very difficult to estimate. For example, estimating the likelihood that a single executive will satisfy employment requirements to vest in an award, or whether a performance condition that is not based on relatively straightforward performance metric will be achieved, is exceedingly difficult. We are not confident that valuation experts would agree on estimates (within a reasonable range) of the likelihood of achieving many of the performance conditions that will be embedded in share-based payments to employees.

Some may argue that if estimates regarding the recognition of an award are adjusted to actual, then all assumptions required to measure an award should be adjusted to actual through the vesting date (or perhaps even the exercise date). We disagree with that view because, again, we view the vesting of an award as a recognition issue, not a measurement issue. Further, we do not believe that it is appropriate that a grantor recognize expense (or income) subsequent to the grant date based on changes in the value of its own shares underlying an option.

Question 14

For options with a reload feature, the draft IFRS proposes that the reload feature should be taken into account, where practicable, when an entity measures the fair value of the options granted. However, if the reload feature is not taken into account in the measurement of the fair value of the options granted, then the reload option granted should be accounted for as a new option grant (paragraph 25). Is this proposed requirement appropriate? If not, why not? Do you have an alternative proposal for dealing with options with reload features?

We agree with the proposed accounting for reload features described in paragraph 25 of ED 2. We believe that the benefit of future reloads is provided in the original grant that contains the reload feature and, therefore, should be measured and recognized with that original grant. To the extent that the Board has views on when it would or would not be practical to incorporate the value of a reload feature into the grant date measurement of a share option, it would be helpful to provide examples of such circumstances.

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 draft IFRS has appropriately identified many of the most common employee share option features that would impact their valuation. However, we also believe that the Board should explore the impact of other restrictions on exercise of options and sale of shares that often are imposed by securities regulations. For example, in some jurisdictions public companies are subject to periods surrounding publication of financial results and, potentially, other events, during which executives are prohibited from transacting in the company's shares. This further limits the employee's flexibility to realize the value of an option and, in our view, further reduces the value of that option.

In connection with the study of valuation issues we suggest in our response to Question 11, we believe the IASB and FASB should work with valuation experts, option issuers and recipients to identify all of the differences between employee share options and traded share options that have valuation implications, and incorporate all those differences into its valuation guidance. Also, as more fully discussed in our response to Question 11, we believe that some guidance would be useful to the extent that the IASB believes current models are not well-suited to the valuation of employee share options generally, or to specific types of employee share options. We believe such guidance would enhance the consistency and comparability of fair value estimates, while still leaving room for future improvements in option valuation.

Question 16

The draft IFRS does not contain prescriptive guidance on the estimation of the fair value of options, consistently with the Board's objective of setting principles-based standards and to allow for future developments in valuation methodologies. Do you agree with this approach? Are there specific aspects of valuing options for which such guidance should be given?

We agree with the Board's approach not to provide prescriptive guidance regarding the determination of the fair value of options, primarily because it permits potential future developments in option pricing to be incorporated into valuation methodologies without requiring a change to the IFRS. However, as noted in our response to Question 12, the Board has prescribed the method to estimate the diminution in value resulting from the non-transferability of employee share options. We recommend that the described approach be provided as an example of a method to estimate that diminution in value, and other reasonable valuation approaches should be permitted, provided that the approach used is consistent with accepted valuation techniques. Please also see our responses to Questions 11 and 16.

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 recognize additional amounts for services received during the remainder of the vesting period, i.e., additional to the amounts recognized 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 our view, such a transaction represents the cancellation of one option and the granting of another. In our analysis, it is inappropriate to account for an award that effectively no longer exists, particularly as the main argument in the Basis of Conclusions (BC 219) appears to be anti-avoidance (that is, to prevent companies from reducing compensation cost by remeasuring that cost when the fair value of options declines). Accordingly, consistent with our response to Question 18 below, we believe that an entity should cease recognizing the cost of the award originally granted and instead recognize the full fair value of the amended award, less any amount already charged in respect of the original award, over the remaining vesting period. However, we do not believe that it would be appropriate for companies to recognize a credit in cases where the fair value of the revised award is less than the amount already charged.

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 recognize 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 disagree with the approach set out in ED 2. We think it is wrong in principle for an entity to continue to recognize a cost for an award that can never vest, since the entity is clearly receiving no service for such an award. Some might argue that this approach draws an artificial distinction between an option which becomes “out of the money” at some point during the vesting period but is allowed to run its course and one which is formally cancelled. In our view, however, there is sufficient difference between an option that might recover its value and one that simply does not exist any longer to justify the different accounting consequence.

Moreover, as the Basis for Conclusions points out, it is unlikely that an option with real value could be cancelled without compensation. In cases where such compensation is made in cash, the presumption must be that the cash compensation represents the fair value of the award at the point of cancellation. There would therefore be an element of double counting if an entity were to recognize an expense both for the cash compensation and for the now cancelled award.

ED 2 as drafted avoids this problem by the requirement in paragraph 29(b) that any cash paid on cancellation be charged to equity (with any excess over the fair value of the award cancelled being recognized as an expense). However, we do not agree with this requirement as drafted. In our view, it is the excess over the amount already credited to equity that should be recognized as an expense.

We take this view because, consistent with our response to Questions 10 through 14, we disagree with the analysis underlying the approach proposed in ED 2 that such payments represent the redemption of an equity instrument. An unvested equity award, whether an option or a share, does not in our view represent an equity instrument but an equity instrument yet to be issued. Moreover, it is not clear how the treatment proposed in the ED fits in with the general rules discriminating between equity-settled and cash-settled awards, and in particular the rules governing options where the issuer has a choice of settlement. As drafted, paragraph 29(b) could produce an anomalous result if, for example, an entity decides to cancel an award in return for a cash payment and charge the payment to equity, thus avoiding the full charge to income that would be required for a cash-settled award if the value of the award increased after the grant date.

However, irrespective of whether the IASB is persuaded of this view, or decides to adhere to the approach set out in the ED, we suggest that the Board amend paragraph 29(b) to refer to any payment made *or promised* in exchange for cancellation of an award. This change would clarify that the timing of the transfer of consideration does not necessarily determine whether the payment is the acquisition of an equity interest, which we assume is consistent with the Board's intent in this regard.

For the avoidance of doubt, we support the approach proposed in paragraph 30 in respect of cancellation of awards that have already vested, since, in our view, these do represent equity instruments.

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 recognized in the income statement. Are the proposed requirements appropriate? If not, please provide details of your suggested alternative approach.

We presume that the proposed approach for accounting for cash-settled share-based payments was proposed on the grounds that it remeasures the liability at fair value, consistent with the accounting for a net cash-settled derivative under the proposed amended versions of IAS 32 and IAS 39. However, the consequent treatment of the gain or loss on such remeasurement under IAS 39 (that is, immediate recognition) is very different from that proposed in ED 2 (that is, spreading until the end of vesting period, and immediate recognition thereafter). Moreover, under the IAS 39 model, the services rendered, like cash consideration, would be added to the carrying value of the derivative (which would then be remeasured) rather than expensed, thereby calling into question whether IAS 39 is in fact the appropriate model.

Moreover, we note that the ultimate payment under such transactions (for example, a cash-settled share appreciation right) typically is based on the intrinsic value of the award at maturity. Accordingly, amounts recognized for units of goods or services that result from the time value of the award eventually will be reversed. We see little merit in an approach that results in the recognition of cost that is assured of reversal, particularly when that approach also requires the use of an option-pricing model to value the award at each reporting period, and not just at the outset as in the case of an equity-settled award. As a result, we believe that a simpler approach is warranted and such awards should be measured, and remeasured, at intrinsic value, rather than at fair value.

We also have a much more pervasive concern that ED 2 assumes that IAS 32 and IAS 39 provide clear guidance on the differentiation of equity-settled from cash-settled transactions. We are not convinced that this is always the case.

To take a simple, and very typical, example, if a company grants options which are to be cash-settled, ED 2 clearly requires the total cash paid to the employee to be charged to income. If, however, the option is equity settled, the income statement charge is based on the fair value of the option at grant date, even if the company is compelled to obtain the shares by market purchase at exercise date rather than by a fresh issue of shares. Such compulsion might be for legal reasons or other reasons (for example, the company might lack the legal capacity to issue fresh equity at the relevant time).

In both cases, the company has suffered a net cash outflow of the difference between the fair value of the shares at vesting and the option proceeds. The accounting treatment under ED 2 is apparently driven solely by the name of the payee on the check – if it is the option holder, the option is a liability; if it is a market counterparty, the option is an equity instrument.

This apparent anomaly arises from the fact that IAS 32 and IAS 39, both in their current form and as proposed to be amended, classify a financial instrument as a liability by reference only to the rights of the holder *of that instrument*. In this example, the option holder has no right to receive cash, and the current equity shareholders whose shares are bought in the market to satisfy the option have no right for their shares to be redeemed. Therefore, neither is treated as a liability even though the company will be compelled to suffer a cash outflow as a result of its commitments taken as a whole.

Similar concerns arise in respect of the proposed treatment of awards where the issuer or the holder has a choice of settlement alternatives, and that of payments in consideration for cancellation of awards (please see, respectively, our responses to Question 20, below, and Question 18, above). We realize that these issues ultimately fall within the ambit of the Board's financial instruments project rather than ED 2. Nevertheless, we believe that they must be considered before ED 2 is finalized.

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.

The accounting approach described in ED 2 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 has the merit of consistency with IAS 32 (as proposed to be amended). However, we believe that the issues associated with bifurcating an award into equity and liability components can be complex and that the IASB has somewhat underestimated their difficulty. There is an implication in paragraph 38 of ED 2 that this is not difficult, on the argument that the fair value of the cash and share alternatives is generally the same. In our view, such an assumption is highly questionable. In many cases awards are in fact structured specifically in order to give higher value to the share alternative. For example, the employer may give free additional shares to an employee who chooses the share alternative rather than cash and agrees to retain the shares for a minimum period.

Accordingly, the Board should provide additional examples in ED 2 to reduce the potential for diversity in practice. It would be useful to provide examples of at least the following:

- An employee share option that requires physical settlement, but allows the grantee or the grantee's estate to require cash settlement at fair value only if a specified event occurs (e.g., death or disability of the grantee, a change in control of the grantor).

- A share or option award granted to an employee that requires physical settlement but permits the grantee to put the shares or options back to the grantor for a fixed price.

- A share or option award that permits the grantee to put sufficient shares back to the grantor to satisfy the grantee's tax withholding obligation.

- A share or option award that allows the employee to choose share or cash settlement but provides an incentive (in the form of additional free shares) to take shares rather than cash and hold the shares for a minimum period.

The treatment of awards where the issuer has a choice of settlement alternatives is set out in paragraphs 42 through 44 of ED 2. These make it clear that an award where the issuer has the choice of cash or share-settlement is a cash-based award if the issuer's choice of settlement is not "substantive." However, there may well be differences of view as to what is a "substantive" choice, which any final IFRS must clarify.

In our view, an entity does not have a "substantive" choice of settlement alternatives if at the time of grant the entity does not have authority to issue new shares (or hold own shares in treasury) sufficient to settle the award. If no such shares were available for settlement of the award, the entity would be required to repurchase shares in the market to deliver to the employee. As such, this instrument is actually a cash-based award because the entity was required to pay cash to settle the award regardless of its settlement choice.

In addition, consistent with our response to the exposure draft of proposed amendments to IAS 32 and IAS 39, we do not agree with the requirement of paragraph 42 of ED 2 that an entity with the choice of settlement for an award must account for the award as cash-settled (that is, as a liability) if the entity has a past practice or a stated policy of settling in cash. We do not believe that the introduction of the entity's intent is appropriate in determining what is an equity award versus a cash-based award. It is our belief that the only relevant difference between equity contracts and other contracts is if the entity truly has a legally enforceable option to settle the contract by delivering equity as opposed to delivering a financial asset or assuming a financial liability.

Past practice and stated policy are only meaningful if they legally negate the choice of the entity and in such a way, in substance require cash settlement. We therefore propose that paragraph 42 be amended to reflect this rather than requiring past practice or stated intent to be treated as giving rise to a liability in all cases.

Another area where the interaction of the proposals in ED 2 with IAS 32 (as proposed to be amended) may not be producing the most appropriate result is that of hedging of share-based awards. For example, if an option is to be either equity-settled using a market purchase of shares at the relevant time, or cash settled, the company can hedge its exposure to share-price movements by purchasing an option from a third party In economic terms, the company is indifferent as to whether such a hedging option is settled gross or net (since it can use any cash received to buy shares or sell any shares received for cash as required).

However, the interaction of ED 2 with IAS 32 and IAS 39 (in particular the new paragraphs 29A to 29G of IAS 32 on transactions in own equity proposed in the exposure draft of changes to IAS 32 and IAS 39 issued in 2002), generally makes it more difficult to reflect this hedging in the financial statements.

If the employee option is accounted for as an equity-settled transaction under ED 2, any form of hedge accounting is precluded by IAS 39, which allows for hedges of assets and liabilities, but not of equity Moreover, amounts reflected in the income statement for the employee option (essentially the cost of the relevant number of "units of service" for the particular option) will not be offset by the amounts recorded in respect of the external bought option, which will (assuming that the proposed changes to IAS 32 are made) be either:

- an interest cost on the amount payable to the counterparty, initially recorded at its net present value (if the option is to be gross-settled); or
- changes in the fair value of the option as they arise (if the option is to be net settled).

When the employee option is accounted for as a cash-settled transaction under ED 2, the problem is slightly different. If this is hedged with a gross-settled option, hedge accounting is apparently precluded by the accounting treatment required for the hedging option under the proposed changes to IAS 32. However, where it is hedged with a net-settled option, IAS 39 would appear in principle to allow hedge accounting.

Question 21

The draft IFRS proposes that an entity should disclose information to enable users of financial statements to understand:
(a) the nature and extent of share-based payment arrangements that existed during the period,
(b) how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined, and
(c) the effect of expenses arising from share-based payment transactions on the entity's profit or loss.
Are these disclosure requirements appropriate? If not, which disclosure requirements do you suggest should be added, deleted or amended (and how)?

We believe that the proposed disclosures are excessive. The disclosure requirements for a company that uses share-based payments extensively in its operations would be voluminous and it is not clear whether that volume of information would benefit most investors. The Board should carefully assess the need for each disclosure and make every effort to eliminate those disclosure requirements that do no significantly enhance the user's understanding of the financial statements. However, we believe that the extent of disclosure will depend to some extent on the ultimate valuation approach required by any final standard, and the flexibility in that approach. Clearly, the greater the flexibility allowed in the choice of valuation methodologies and assumptions, the more disclosures likely will be required to provide financial statement users with sufficient information to assess the reasonableness of what inevitably will be a subjective valuation.

Regarding disclosures intended to enable a user to "understand the nature and extent of share-based payment arrangements" that existed during the period, we believe the Board should carefully examine the disclosures to determine whether they are necessary for an understanding of the financial statements or instead provide a perceived corporate governance benefit. If that analysis suggests the latter, we would respectfully suggest that mandating such disclosure is more appropriately the role of securities regulators. For example, it appears that the disclosures required by paragraph 46(a)(iii) relate more to corporate governance than to gaining an understanding of the financial statements.

Regarding the disclosures intended to enable a user to "determine how the fair value of the goods or services received, or the fair value of the equity instruments granted, was determined," we believe that some limited disclosure in this area is warranted. However, the proposed level of disclosure appears to suggest that the fair value of share-based payments is not reliably determinable within a reasonable range. Further, some of the disclosures appear to be examples of audit evidence that go far beyond what companies normally are required to disclose. For example, paragraph 48(a)(i) requires disclosure of all inputs into the option-pricing model, even though several of the inputs (share price, exercise price, risk-free interest rate) are objectively determinable. We suggest that the disclosure requirements in paragraph 48 be limited to the most subjective assumptions used in option-pricing models, namely, expected life (or other means used to discount for vesting requirements), dividend yield and volatility. Further, we believe the reconciliation between historical volatility and expected volatility required by paragraph 48(a)(ii) is not particularly useful. While historical volatility is a consideration when determining expected volatility, it is not the only consideration.

Regarding the disclosures intended to enable a user to determine the "effect of expenses arising from share-based payment transactions on the entity's profit or loss," we believe that a simple disclosure of expense resulting from the grant of equity instruments and the expense resulting from the grant of liabilities is sufficient. We do not believe it is appropriate to require additional disclosure analyzing the expenses resulting from the grant of liabilities into those that were recognized and those that hypothetically would have been recognized if the awards had been equity awards.

Because of the above views, we would recommend deleting the disclosure requirements described in the following paragraphs:

Paragraph	Additional Comments
46(a)(iii)	
46(c)	
48(a)	Except for the disclosure about expected life of the option or other manner in which vesting conditions are incorporated into the value of the option, expected volatility, and

	recognition of reload features.
48(b)(ii)	This disclosure appears to repeat the information required to be disclosed in paragraph 48(a)(iv).
48(b)(iii)	We support the requirement to disclose "whether," but not the requirement to disclose "how," dividends were included.
48(e)	
50	
52(b)	Except for gross expense resulting from share-based liabilities.

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.

We disagree with the proposed transitional requirements in ED 2 with respect to equity-settled awards. We believe that the two-step transition approach to equity-settled awards (i.e., to awards granted after the publication of ED 2 that have not vested before the effective date of the IFRS), is unnecessarily complex and suggests that ED 2 should essentially be viewed as authoritative, notwithstanding the fact that the Board has published the draft for comment with the view that it may make changes to the proposal in response to constituent comments.

We recognize that, as a rule, the Board takes the view that there should be full retrospective adoption of new standards, and, to that extent, the proposals in ED 2 could be argued to be a concession. However, there are instances in which the Board has taken the view that past transactions should not be reopened—for example, the proposal in ED 1 that previous business combinations should not be "reopened" upon first time adoption of IFRS. The reasons underlying the Board's decision with regard to business combinations—the impracticability of performing the necessary calculations combined with the risk of the inappropriate use of hindsight to determine fair values—are, in our view, equally applicable in the case of pre-existing share awards.

In our view, the requirements of ED 2 should be applied:

- By existing users of IFRS to share awards granted on or after the publication date of the final IFRS; and
- By first-time adopters of IFRS to share awards granted on or after the later of (i) the transition date to IFRS or (ii) the publication date of the final IFRS.

As drafted, ED 2 would require an entity that does not adopt IFRS until (for example) 2010 to apply it retrospectively to all awards made since November 2002. We consider this an unreasonable burden. Our approach outlined in the preceding paragraph would satisfactorily address this issue.

If the Board does not accept this as an overall approach, we suggest that the proposals in ED 2 regarding the transitional arrangements for cash-settled awards must be reconsidered. In our view, it is inconsistent to require retrospective transition for cash-settled, but not share-settled, awards. We recommend that the final IFRS be applied to liabilities by recognizing the cumulative effect of any adjustment to adjust the liability to fair value (or intrinsic value if the Board sees fit to change the requirements for share-based liabilities, as we suggest in response to Question 19 above) as a charge to retained surplus on the date of adoption.

We also believe that in any event the final IFRS needs to clarify the position of modifications made after the effective date to previous awards that do not fall within the scope of the IFRS.

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 recognized in the income statement. Are the proposed requirements appropriate?

We believe that this issue should be dealt with in general terms and not simply through a single worked example.

We are not convinced that the proposed amendment in fact complies with IAS 12, *Income Taxes*. In the first instance, it seems to have the effect of recognizing a temporary difference on equity, whereas IAS 12 requires deferred tax to be recognized on temporary differences arising from assets and liabilities. We note the analogy with R&D drawn in paragraphs BC 296-7, but in our view the treatment of R&D under IAS 12 (which implicitly relies on the idea that the R&D is recognized as an asset for a split second and then expensed) is itself questionable. We stress, however, that we see this as a defect in IAS 12, not in ED 2, and do not support "flow through" accounting for the tax relief on options.

We question the proposal that all the tax benefits should be accounted for within the income statement. While this has the benefit of simplicity, we believe that the approach described in paragraph BC 300 of ED 2 would be more appropriate and, moreover, more consistent with the requirements of paragraph 61 of IAS 12. The conceptual basis for this view is described in paragraph BC 302 of ED 2. Essentially, we believe that payment for goods or services with an equity instrument encompasses two transactions, a compensatory transaction and an equity transaction. The recognized tax benefit of the compensatory transaction should be based on the accounting measurement of the compensatory transaction. Other tax benefits should be viewed as resulting from the equity transaction and, therefore, should not be recognized in the income statement.

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…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.)

Differences between ED 2 and Statement 123 were considered in our responses to the above questions.

Question 25

Do you have any other comments on the Exposure Draft?

We have dealt with concerns on issues not specifically raised in the Invitation to Comment at appropriate points in the responses to the above questions.