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Deloitte Touche Tohmatsu

13 March 2003

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Sir David,

Exposure Draft ED 2 – Share-based Payment

Deloitte Touche Tohmatsu and its Member Firms are pleased to comment on the International Accounting Standards Board's (the "Board's") Exposure Draft, *ED 2 Share-based Payment* ("ED 2" or the "draft standard"). Given the increasing use of share-based compensation and due to the lack of any International Financial Reporting Standard addressing the recognition and measurement of share-based payments, we support the Board's decision to develop a standard that comprehensively addresses the accounting for share-based payment arrangements. Further, we support international convergence around high-quality accounting standards. As such, we encourage the Board to work closely with other national standard-setters to achieve a single, high-quality standard for the accounting for share-based payments that can be accepted globally.

FAIR VALUE MEASUREMENT

We agree conceptually with the principle behind ED 2 that the accounting for exchange transactions should be measured and recognised at fair value when the transaction involves the exchange of goods or services for an entity's own equity instruments. We believe that share-based payments to employees represent an element of compensation and that the most relevant measurement of that compensation is fair value.

ED 2 proposes that all vesting conditions be factored into the estimate of fair value having the effect of reducing the amount estimated. We are concerned about the ability to obtain reliable estimates of fair value under this approach for many of the complex share-based arrangements that exist currently in practice. As a result, preparers attempting to make reasonable estimates of fair value could be open to subsequent challenge.

We are much more concerned, however, that the proposed measurement requirements will have the unintended effect of providing an incentive to increase the complexity of a share-based payment arrangement with the goal of reducing the amount to be recognised. When complex vesting conditions are included in such an arrangement, its value will decrease, but it may not be possible to estimate the extent of the decrease reliably. If features can be identified and used to reduce significantly the estimated amount recognised, they would likely become widespread and the amount recognised will become much more difficult to interpret. As a result, users, regulators, and auditors will be disadvantaged if the results of applying the standard can be easily managed.

We believe that much complexity and subjectivity in the determination of fair value would result from including vesting conditions as an element of value and incorporating them into the fair value measurement. Our concerns lead us to propose an approach under which the fair value of a share-based payment arrangement is determined by incorporating all of the features unique to the arrangement (including lack of transferability) except for vesting conditions. Under this approach, recognition should stop when the services are no longer provided (such as an employee leaving).

In certain cases, the vesting or performance condition may not relate to a period of service, but rather a specific event, the occurrence of which may not be within the control of the counterparty. In such cases it may be unclear whether or not both parties are firmly committed to the transaction. We, therefore, believe that it is important to distinguish between those conditions that need to be satisfied before it can be determined that the parties are committed, and consequently a transaction has arisen, and those conditions that need to be satisfied prior to the counterparty being able to exercise the option. We suggest the Board differentiate between those provisions that impact the value of the award versus those provisions that impact when the award should be recognised.

While we support the measurement approach in ED 2 that incorporates features that are unique to share-based payment arrangements (other than vesting provisions) into the measurement of fair value, we recognise that the determination of fair value for share-based consideration will tend to be subjective, even under our suggested approach. Accordingly, we believe that the Board should provide additional guidance with respect to the impact of such subjective features and assumptions on fair value. To that end, we strongly encourage the Board to work with valuation professionals to assist in bringing operationality to the guidance provided in ED 2. Further, we believe that in no case should the impact of these features and assumptions result in an overall fair value that is less than the financing cost component of the time value of option granted. That is, the fair value of an award should never be less than the value of an option using a zero volatility (the "minimum value"). As a result of these differences we also believe that the use of minimum value may be an acceptable measure for unlisted entities.

Measurement Date

Conceptually, we believe that share-based payment transactions should be measured at the date both parties are firmly committed to execute the exchange transaction. As such, for transactions involving services (including employee transactions) we believe that the fair value of an arrangement should be determined when the counterparty is committed to providing the service. However, in the absence of an explicit commitment to perform, we believe that the fair value of the arrangement should be measured at the point at which substantive services by the counterparty commence. That is, we believe a service provider's commencement of substantive services demonstrates the requisite commitment to perform sufficient to establish a value for the transaction. For employee awards, the grant date usually is the measurement date because the employee is already performing services for the issuing entity.

For transactions involving the exchange of goods for equity, in the absence of a commitment to perform, we believe that a measurement date does not occur until the exchange of goods for equity occurs. In the absence of a requirement in the standard for a performance commitment, we believe that a final standard will provide significant structuring opportunities in which the grant date measure will not be reflective of the commercial value of the exchange transaction.

Scope

We support the objective in the standard to provide a broad scope including employee stock option plans and employee stock purchase plans. We believe that this is consistent with the notion that standards should be based on principles with limited exceptions. However, also with respect to scope, we note that essentially all equity-settled share-based transactions are treated as equity of the issuer. This treatment may differ from the treatment that would result from the application of other standards on financial instruments. We believe that the determination of whether an instrument is a liability or is equity should not be impacted by the form of consideration given by the counterparty (whether cash, goods, or services). As such, we strongly encourage the Board to provide a consistent framework for distinguishing debt and equity transactions. If the Board decides to make exceptions to that framework, it should clearly articulate the reasons for and the extent of such exception.

Transitional Provisions

We are also quite concerned as to the transitional requirements regarding backdating to the date of exposure. We do not believe that this is appropriate, as entities should not be required to make key decisions based on moving targets. This will require them to implement proposals on which they have not an opportunity to comment and to implement proposals, based on fair value and using assumptions to determine fair values retrospectively, that will only be available once decisions have been made as to the final standard.

The attached Appendix to this letter contains our responses to the specific questions raised in the ED 2, including a detailed discussion of the matters referred to above.

We thank you for the opportunity to provide our comments. If you have any questions concerning our comments, please contact Ken Wild in London at +44 (20) 74382511.

Sincerely,

Deloitte Touche Tohmatsu

DELOITTE TOUCHE TOHMATSU

APPENDIX

Question 1
Paragraphs 1-3 of the draft IFRS set out the proposed scope of the IFRS. There are no proposed exemptions, apart from for transactions within the scope of another IFRS.

Is the proposed scope appropriate? If not, which transactions should be excluded and why?

We agree with the Board's objective of requiring recognition of share-based payments as an expense at fair value in the grantor's income statement. We believe that this principle can be broadly applied to all share based payment arrangements, and do not believe any scope exceptions should be provided for arrangements such as employee share purchase plans (ESPPs) and similar savings related schemes. ESPPs vary from country-to-country based on the unique provisions of the tax law in each respective country. Any attempt to provide a limited scope exception will introduce unnecessary complexity without conceptual merit.

We note that in some jurisdictions, local laws provide for the creation of employee share ownership plans (ESOPs) by way of separate legal entities. ESOPs may contain unique features that raise questions as to how the grant date fair value recognition model in the draft IFRS should be applied. We encourage the Board to consider providing additional guidance to supplement the general principles in the draft IFRS for these arrangements.

We also urge the Board to clarify the circumstances under which this proposed standard and when the proposed standard on Business Combinations will apply to contingent share based payments to employees or directors from whom the business has been acquired. In this regard we recommend that the Board consider the following factors:

- Is there a link between continued employment and the contingent consideration?
- Is there a link between the length of required employment and the period over which the contingent consideration is assessed?
- Does the level of compensation paid to previous owners differ from that paid to other employees?
- Is there a difference in contingent consideration conditions between previous owners who have taken up employment and those who have not?

Further guidance on these factors can be obtained from the Emerging Issues Task Force issue EITF 95-8.

IAS 32 and IAS 39 contain definitions of financial liabilities and equity instruments. In addition, these standards provide guidance as to the distinction between these categories of financial instruments and in the proposed revisions to these standards changes are proposed to these definitions and guidance. Under the proposals in ED 2, equity-settled share-based payment transactions are treated, in the main, as equity instruments of the issuer. This treatment may not be consistent with the treatment that would have resulted had the financial instrument standards been applied. We therefore believe it to be essential that there is a clear distinction between the scope of the share-based payment standard and the financial instrument standards.

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 that, consistent with other standards, transactions involving goods should be recognised when the risks and rewards of ownership pass. We also agree that for transactions involving services an expense should be recognised over the period of service, or where no period is specified, over the period that the service is expected to be received. We note, however, that there may be cases where it is unclear if the award relates to any service or it is unclear when or over what period the service will be received. This is particularly true where the transaction relates to a specific event *e.g.* share options granted that may be exercised upon the occurrence of an initial public offering of the entity.
We also agree that the goods acquired or services received should be recorded as assets or expenses, as the case may be, based on other relevant standards.

Further comments with respect to the recognition requirements of the draft IFRS are included in other comments.

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?

Conceptually we disagree with paragraph 7 of ED 2. As a general principle, we believe that the entity should measure the share-based transaction at fair value based on the fair value of the financial instrument issued. In practice this can be done either by directly measuring the fair value of the equity instrument issued or indirectly by measuring the fair value of the goods or services received. While ED 2 proposes to use whichever measure is more readily determinable we believe that the principle should be to use whichever measure is more ***reliably*** determinable. Using the phrase "readily determinable" appears to require the use of the fair value "easiest" to determine—especially in translation to other languages. We note that reliability is a cornerstone in the IASB framework, and should be the measurement basis.

We believe conceptually that there should be no exceptions to the fair value principle. However, we believe that there may be circumstances where it may be difficult to obtain the necessary information to estimate the fair value of share options in unlisted entities. We encourage the Board to develop additional guidance for determining fair value for these entities. Although we understand the comments made in ED 2's Basis For Conclusions, we believe that for unlisted entities the minimum value approach would be an acceptable compromise.

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 the general measurement principle is that the share-based payment transaction should be measured at the date both parties are firmly committed to the transaction. This is the date we believe a financial instrument comes into existence. We believe the draft IFRS should be clarified to include further guidance for determining the measurement date of a transaction in which services are delivered over an extended period of time. We believe that this should occur when the counterparty is committed to providing the service. In the absence of a commitment to perform, we believe that the value should be measured at the point at which substantive services by the counterparty commence.

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?

As discussed in our response to Question 4, we believe that the appropriate measurement date is when both parties are firmly committed to the transaction. If the two parties to the arrangement have negotiated a firmly committed contract, under which both parties are committed to perform and a significant penalty is present in the event of non-performance, we believe a grant date measurement is appropriate. At that date, both parties are committed to perform, providing evidence that each party believes the consideration paid and consideration received are equal. We believe that the notion of a firm commitment would be consistent with that as discussed in IAS 39.

In other circumstances, both parties to an arrangement are not firmly committed. Rather, the arrangement consists of an offer by one party to deliver equity instruments if the other party chooses to perform. A grant date measurement, as defined in the draft standard, for such an arrangement may result in a significant understatement of the recorded expense.

In the absence of a firm commitment, we believe the measurement date has not been established at what ED 2 considers to be the grant date. However, we do not believe the measurement date should be delayed until the award vests. We share the Board's concern that a vesting date measurement date introduces undesirable volatility in an entity's share price into the determination of the value of the goods or services received. Rather, we believe the measurement date should occur when both parties have accepted an obligation to perform under the contract. We believe that this should occur when the counterparty is committed to providing the service, which would, at the latest, be when substantive performance by the counterparty begins. At that point, the previously uncommitted counterparty has demonstrated its willingness to perform in exchange for the consideration offered.

Question 6

For equity-settled transactions with parties other than employees, the draft IFRS proposes a rebuttable presumption that the fair value of the goods or services received is more readily determinable than the fair value of the equity instruments granted (paragraphs 9 and 10).

Do you agree that the fair value of the goods or services received is usually more readily determinable than the fair value of the equity instruments granted? In what circumstances is this not so?

We do not support the Board's decision to establish a rebuttable presumption that certain transactions should be valued by reference to the fair value of the goods or services received, while other transactions should be valued by reference to the fair value of equity instruments granted. Rather, we believe that the general principle should be that the fair value of the transaction is determined by valuing the financial instrument issued as detailed in our response to Question 3.

Conceptually, we believe certain transactions with non-employee service providers are economically identical to transactions with employees. As a result, we do not believe that there should be a presumption based on whether the transaction is with an employee or non-employee.

We note that in jurisdictions such as the United States that require different accounting for employee and non-employee transactions, extensive interpretative guidance has been needed to determine whether a service provider is an employee or a non-employee. The following are examples of situations that have required extensive guidance.

- Instruments granted by an investor to employees of an equity method investee or a joint venture.

- Instruments granted to members of an entity's Board of Directors.

- λ Instruments granted by a subsidiary based on the equity of its parent, and instruments granted by a subsidiary based on the equity of a different consolidated subsidiary of the same parent.

- λ Circumstances in which a change in status from employee to non-employee or non-employee to employee occurs.

Question 7
For equity-settled transactions with employees, the draft IFRS proposes that the entity should measure the fair value of the employee services received by reference to the fair value of the equity instruments granted, because the latter fair value is more readily determinable (paragraphs 11 and 12).

Do you agree that the fair value of the equity instruments granted is more readily determinable than the fair value of the employee services received? Are there any circumstances in which this is not so?

As indicated in our response to Question 6, we do not believe there should be a rebuttable presumption that certain transactions be valued by reference to the fair value of the goods or services received, while other transactions should be valued by reference to the fair value of equity instruments granted. As also indicated in that response, we do not believe that a distinction should be made between transactions with employees and parties other than employees.

Question 8
Paragraphs 13 and 14 of the draft IFRS propose requirements for determining when the counterparty renders service for the equity instruments granted, based on whether the counterparty is required to complete a specified period of service before the equity instruments vest.

Do you agree that it is reasonable to presume that the services rendered by the counterparty as consideration for the equity instruments are received during the vesting period? If not, when are the services received, in your view?

We concur that in general the services in respect of which the equity instrument is issued are received during the vesting period. As previously mentioned in our response to Question 2, we also believe that where the services relate to a period that can be reasonably determined from the terms of the grant this period should be used.

We observe that there may be situations where it is not clear what the vesting period would be. For example if the vesting period is shortened in the event the employee leaves employment. We encourage the Board to provide guidance in these situations where particular circumstances built into the share option conditions could cause the vesting period to be variable.

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 agree that the fair value of equity instruments granted in exchange for services received should be recognised over the service period. However, we do not believe that it is necessary to determine the amount to attribute to each unit of service received. We believe that, in theory, once the value of the transaction is determined based on the equity instruments issued, no change to this amount should be allowed based on a change in the amount of service actually received. Consequently, the amount determined should be expensed on a systematic and rational basis over the vesting period irrespective of any changes in circumstances and in particular whether the options vest or not. This however is dependent upon the fair value taking all vesting conditions into account, which, we do not believe can be done.

We consequently suggest that the Board does not permit vesting conditions to be incorporated into the fair value of the share options issued. Instead, we believe that if the counterparty stops providing services, any unexpensed portion of the value originally attributable to the share option should not be expensed. In all other cases we believe that expensing should continue over the period the service is provided.

As previously noted in our response to Question 4, we believe that the fair value of the share options should be determined once the parties are committed to the transaction. We therefore believe that it is important to distinguish between those conditions that need to be satisfied before it can be determined that the parties are committed, and consequently a transaction has arisen, and those conditions that need to be satisfied prior to the counterparty being able to exercise the option. We suggest the Board differentiate between those provisions that impact the value of the award versus those provisions that impact when the award should be recognised.

Question 10
In an equity-settled share-based payment transaction, the draft IFRS proposes that having recognised the services received, and a corresponding increase in equity, the entity should make no subsequent adjustment to total equity, even if the equity instruments granted do not vest or, in the case of options, the options are not exercised (paragraph 16). However, this requirement does not preclude the entity from recognising a transfer within equity, ie a transfer from one component of equity to another.

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

We believe, except as noted in our response to question 9, that there should be no subsequent adjustment if the options do not vest or are not exercised.

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 believe that the valuation approach required by the draft standard should be consistent with the IASB's fair value hierarchy. In the event the option is traded in a market, the market price should be used. In the absence of a market price, we believe there are circumstances in which comparable transactions can be observed that may form the basis for the measurement of fair value

In the event that market data and similar transactions are not available, we concur that an option-pricing model should be applied to estimate the fair value of options granted. Except as noted previously in our responses to Questions 9 and 13 we do not believe there are any circumstances in which it would be inappropriate or impracticable to take into account any of the factors listed in the draft standard.

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?

We agree that the use of an option's expected life rather than its contractual life when applying an option-pricing model is an appropriate means of adjusting the option's fair value for the effects of non-transferability.

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 do not agree that vesting conditions should be taken into account when estimating the fair value of options or shares granted. We, however, are concerned about the ability to obtain reliable estimates of fair value under this approach for many of the complex share-based arrangements that exist currently in practice.

We are even more concerned, however, that the proposed measurement requirements will have the unintended effect of providing an incentive to increase the complexity of a share-based payment arrangement with the goal of reducing the amount to be recognised. When complex vesting conditions are included in such an arrangement, its value will decrease, but it may not be possible to estimate the extent of the decrease reliably. If features can be identified and used to reduce significantly the estimated amount recognised, they would likely become widespread and the amount recognised will become much more difficult to interpret. As a result, users, regulators, and auditors will be disadvantaged if the results of applying the standard can be easily managed.

We believe that much complexity and subjectivity in the determination of fair value would result from including vesting conditions as an element of value and incorporating them into the fair value measurement. Our concerns lead us to propose an approach under which the fair value of a share-based payment arrangement is determined by incorporating all of the features unique to the arrangement (including lack of transferability) except for vesting conditions. Under this approach, recognition should stop when the services are no longer provided (such as an employee leaving).

In certain cases, the vesting or performance condition may not relate to a period of service, but rather a specific event, the occurrence of which may not be within the control of the counterparty. In such cases it may be unclear whether or not both parties are firmly committed to the transaction. We, therefore, believe that it is important to distinguish between those conditions that need to be satisfied before it can be determined that the parties are committed, and consequently a transaction has arisen, and those conditions that need to be satisfied prior to the counterparty being able to exercise the option. We suggest the Board differentiate between those provisions that impact the value of the award versus those provisions that impact when the award should be recognised.

While we support the measurement approach in ED 2 that incorporates features that are unique to share-based payment arrangements (other than vesting provisions) into the measurement of fair value, we recognise that the determination of fair value for share-based consideration will tend to be subjective, even under our suggested approach. Accordingly, we believe that the Board should provide additional guidance with respect to the impact of such subjective features and assumptions on fair value. To that end, we strongly encourage the Board to work with valuation professionals to assist in bringing operationality to the guidance provided in ED 2. Further, we believe that in no case should the impact of these features and assumptions result in an overall fair value that is less than the financing cost component of the time value of option granted. That is, the fair value of an award should never be less than the value of an option using a zero volatility (the "minimum value").

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 believe that a reload feature should be factored into the fair value of an option grant if its fair value could be determined. However, we believe that this may be difficult and request the Board to provide additional guidance with respect to the method that entities should use to value the reload feature of an option grant.

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 there are numerous features that may be inserted into an employee share option which are not reflected in traditional option pricing models. Examples of these features are tax gross up arrangements in which the grantee is paid cash in an amount sufficient to fund any tax liability incurred upon exercise, non-compete agreements, and transferability restrictions on shares received upon exercise. As previously mentioned, we believe that features that represent performance or vesting conditions should not be incorporated into the determination of the fair value of the award. Where however these features stand apart from the award and result in an additional liability we believe that they should be treated as any other liability. With respect to each of the three features listed above, we believe the following accounting is appropriate:

- Tax gross up- This provision should be accounted for as a separate element of compensation expense apart from the option award. A tax gross up provision represents a liability.

- Non-compete agreement- A non-compete agreement represents an additional vesting provision. Consistent with our prior comments, we believe vesting provisions should not impact the value of the award.

- Transferability restriction- A restriction on the transferability of shares received upon exercise may be best reflected in an option pricing model by adjusting the current market price of the shares, which reflects a fully liquid instrument, for an illiquidity discount. This discount would conceptually be equal to the amount a grantee would need to expend to hedge its market risk during the period of illiquidity, and often will not result in a significant adjustment.

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 concur with the approach proposed in paragraph 20 of the draft standard, requiring the use of a valuation technique that takes into account the six listed factors. As stated previously, we believe that additional guidance in certain areas may be useful.

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 of the original option grant. Example 3 in Appendix B illustrates this requirement. As shown in that example, the incremental value granted on repricing is treated as a new option grant, in addition to the original option grant. An alternative approach is also illustrated, whereby the two grants are averaged and spread over the remainder of the vesting period.

Do you agree that the incremental value granted should be taken into account when measuring the services received, resulting in the recognition of additional amounts in the remainder of the *vesting period? If not, how do you suggest repricing should be dealt with? Of the two methods illustrated in Example 3, which is more appropriate? Why?*

We concur with the requirement of the draft standard that any incremental value conveyed to an employee through an option modification should be expensed over the remaining vesting period.

Question 18
If an entity cancels a share or option grant during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied), the draft IFRS proposes that the entity should continue to recognise the services rendered by the counterparty in the remainder of the vesting period, as if that grant had not been cancelled. The draft IFRS also proposes requirements for dealing with any payment made on cancellation and/or a grant of replacement options, and for the repurchase of vested equity instruments.

Are the proposed requirements appropriate? If not, please explain why not and provide details of your suggested alternative approach.

We believe that the cancellation of an option without a new grant (or some other form of compensation) would be rare, as companies do not normally have the unilateral right to rescind a previous option grant. If the entity is able to link the cancellation with a new grant, we concur with the requirement in the draft standard to record the transaction as if the original equity instrument was modified. In the rare event that an entity cancels a grant of shares or options and the event cannot be linked with a new grant or some other form of compensation, we do not believe that the entity should continue to account for services rendered by the counterparty during the remainder of the vesting period as if that grant had not been cancelled. We believe such a transaction should be accounted for as if cash compensation was forfeited. Similar to our comment above with respect to the accounting for cancellations, we believe that the repurchase of an unvested equity instrument should result in the recognition of any remaining unrecognised compensation expense at the repurchase date. After recognising such expense, we concur with the requirements of paragraph 29 (b) of the draft standard that the repurchase should be accounted for as a deduction from equity (unless the repurchase is at an amount above or below fair value, in which an expense or income, respectively, should be recognised).

We concur with the requirements of paragraph 30 of the draft standard with respect to repurchases of vested 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 recognised in the income statement.

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

As discussed in our response to Question 3, we support the principle that share-based payment transactions should be measured at the fair value of the financial instrument issued. Consequently, we support ED 2's proposals in respect of cash-settled share-based payment transactions subject to our previous comments in respect of vesting conditions.

Question 20
For share-based payment transactions in which either the entity or the supplier of goods or services may choose whether the entity settles the transaction in cash or by issuing equity instruments, the draft IFRS proposes that the entity should account for the transaction, or the components of that transaction, as a cash-settled share-based payment transaction if the entity has incurred a liability to settle in cash, or as an equity-settled share-based payment transaction if no such liability has been incurred. The draft IFRS proposes various requirements to apply this principle.

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

We believe that the requirements for presentation of equity-based awards as liabilities or equity should be consistent with the liability and equity guidance in IAS 32 and IAS 39.

The draft standard requires recognition of equity-settled share-based payments based on a grant date valuation. We believe the draft IFRS should clarify whether a grant date measurement without remeasurement is appropriate for instruments that do not meet the Board's definition of equity under IAS 32 due to indexation to factors other than the entity's own stock. For example, some entities grant options with an exercise price indexed to a broad stock market index. Would such instruments be considered equity under the draft standard?

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 generally agree with the disclosure requirements of the draft standard.

Question 22

The draft IFRS proposes that an entity should apply the requirements of the IFRS to grants of equity instruments that were granted after the publication date of this Exposure Draft and had not vested at the effective date of the IFRS. It also proposes that an entity should apply retrospectively the requirements of the IFRS to liabilities existing at the effective date of the IFRS, except that the entity is not required to measure vested share appreciation rights (and similar liabilities) at fair value, but instead should measure such liabilities at their settlement amount (ie the amount that would have been paid on settlement of the liability had the counterparty demanded settlement at the date the liability is measured).

Are the proposed requirements appropriate? If not, please provide details of your suggestions for the IFRS's transitional provisions.

As a general principle we believe that changes in accounting policies should apply retrospectively. However, there are exceptions to this general principle that may be necessary in particular if the information to determine the prior effect of the changes is not available. If the latter applies we strongly believe that the requirements of a new standard should only be applied prospectively. In all cases we would however allow retrospective application provided the requirements can be reliably applied.

We believe that in most cases, the information to determine reliably the fair value of share-based payments that have occurred in the past would not be available and therefore disagree strongly with the proposals in ED2 that the requirements should be applied from the date of exposure. We believe that the draft standard should apply only to equity instruments granted after the effective date of the standard. We agree however with the draft standard's proposals in respect of liabilities. We also believe that entities should disclose the fact that the amount of share-based compensation expense recognised in the financial statements may not be representative of future share-based compensation expense, as the amount of expense will "ramp up" in the period after adoption.

We would also request the Board to provide additional guidance as to the application of the Standard to repricings that occur after the effective date. In addition we believe it would be useful for the Board to provide guidance on the requirements of ED 1 on First time Application of IFRSs considering our comments above on transitional provisions.

Question 23

The draft IFRS proposes a consequential amendment to IAS 12 (revised 2000) Income Taxes to add an example to that standard illustrating how to account for the tax effects of share-based payment transactions. As shown in that example, it is proposed that all tax effects of share-based payment transactions should be recognised in the income statement.

Are the proposed requirements appropriate?

We believe that valid arguments can be made in support of recognising all tax effects of share-based payments in the income statement. We do, however, encourage the Board to work with the liaison standard setters to achieve one common approach.

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.

Our comments are included in the answers to specific questions above.

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

Equity-settled share-based transaction" is defined as a share-based payment transaction in which the *entity* receives goods or services as consideration for equity instruments of the *entity* (including shares or share options). This suggests that if a listed parent gives an option to an employee of a subsidiary and the subsidiary makes no payment to the parent, (or pays only the nominal value of the shares to the parent) there should be no charge in the subsidiary's own accounts (or the charge should equal just the nominal value of the shares). However, paragraph 2 of ED 2 states that share-based payments include transfers of equity instruments of the entity's parent to the entity's employees. We would therefore recommend that the definition be amended to avoid any confusion by changing the end of the definition to read "…as consideration for equity instruments (including share or share options) of the entity or any other party."

Paragraph 1 states: 'The objective of [draft] IFRS X *Share-based Payment* is to ensure that an entity recognises 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." Transactions in which company transfers its stock along with the transfer of its goods or the rendering of its services are not under the scope of ED 2. As such transactions are not included within the scope of ED 2, there is no guidance as to when to measure and how to record the exchange. We would therefore urge the Board to consider adding the accounting for these transactions to its agenda.

We believe that it would be useful to have guidance on the appropriate volatility of Beta. Our understanding is that in practice institutions that provide valuations based on the Black Scholes model tend to amend the beta by some formula that results in a beta in the range of 50% to 95% of the raw beta. Guidance or at least an acknowledgement of this practice should be included in the final standard.