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Sir David Tweedie
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Dear David

AASB submission on IASB ED 2 "Share-based Payment"

In response to the IASB's Invitation to comment on its Exposure Draft ED 2 "Share-based Payment", the Australian Accounting Standards Board has prepared the attached submission addressing the specific questions asked and commenting on the proposals in IASB ED 2.

The AASB supports the IASB proposal of expense recognition where equity or equity-based instruments are provided in exchange for goods or services. We do not support the proposal to allocate an expense for stock options over their vesting period based on the number of service units expected to be received in that period.

Our concerns in relation to some proposals and support for other proposals are explained in attached submission.

The Board hopes that its comments, explaining its concerns and those of its constituents, will assist the IASB when considering amendments to the proposals in ED 2.

Yours sincerely

Keith Alfredson

Keith Alfredson
Chairman

AUSTRALIAN ACCOUNTING STANDARDS BOARD

AASB Submission to the IASB on ED 2

IASB

International Accounting Standards Board

Exposure Draft

ED 2 SHARE-BASED PAYMENT

Comments to be received by 7 March 2003

Invitation to comment

In response to the IASB Invitation to comment, the Australian Accounting Standards Board has prepared the following submission addressing the specific questions asked and commenting on the proposals in IASB ED 2.

The AASB supports the IASB proposal of expense recognition where equity or equity-based instruments are provided in exchange for goods or services. We do not support the proposal to allocate an expense for stock options over their vesting period based on the number of service units expected to be received in that period. We recommend that the IASB consider requiring one of the following alternatives:

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

The AASB also supports the IASB proposals requiring:

- no remeasurement of equity instruments following recognition;
- cashSARs to be treated as creating a liability (recognition on a constructive basis); and
- hybrids to be split; treating employee-choice as cash SARs and employer-choice as equity-settled.

[Draft] International Financial Reporting Standard IFRS X

Share-based Payment

INVITATION TO COMMENT

Question 1

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

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

The proposed application of the draft IFRS to all payments for goods or services where payment is either equity or an amount dependent on an entity's share price is supported, subject to further clarification. Clarification is needed to identify the point at which a transaction with an employee involving shares becomes a payment for services and is to be distinguished from a transaction with a shareholder (who happens to be an employee) who is acquiring more shares at a small discount to the current market price.

An exemption for discounts available under certain Employee Share Acquisition Schemes (ESAS) is permitted in the USA by the Financial Accounting Standards Board (FASB) in the Statement of Accounting Standards, SFAS 123 "Accounting for Stock-Based Compensation". A similar exemption could be incorporated in the proposed IFRS in the form of guidance explaining that such discounts fail the definition of equity-settled share-based payment transactions, because they are not essentially payment for goods or services. When the discount is low (for example, less than 5%) and employee participation in such schemes is optional, broad-based (ie. widely available to most employees), not related to an employee's salary and not dependent on future service by an employee, then such discounts do not appear to be in the nature of compensation or payment for services.

Without such guidance, it seems likely that, in addition to discounts in 'qualifying' ESASs being included, any discount available to an employee under a dividend re-investment scheme, rights issue or a 'small shareholders top-up' scheme would also be included, even when such discounts were available to all shareholders. Indeed, since it is intended that the IFRS apply to employee and non-employee alike, if a discount to an employee in a rights issue is to be included, then it would seem consistent to include the discount to other shareholders. Inclusion of discounts to non-employee shareholders seems unintended and demonstrates the need to exclude some share acquisition schemes.

It is recommended that the conclusion on the materiality of discounts (and de facto exemption for immaterial amounts) in the Basis for Conclusions (particularly paragraph BC14) be included in the IFRS.

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?

The principle of recognition of an expense is supported when the entity has received and consumed goods or services under a share-based payment transaction that obligates the entity to provide compensation to the supplier of the goods or services.

However, the principle, as stated in the question, is not consistently applied in the proposals relating to cash Stock Appreciation Rights (SARs). Firstly, during the vesting period of a cash SAR, if the market price falls so much that the liability at the end of the year is less than the start of the year, services are received but no expense is recognised. Secondly, no expense is recognised in relation to services received from employees who left during the year (as is proposed for equity-settled share-based payment transactions).

It is suggested that recognition of an expense for goods or services received be restricted to those goods or services where a constructive obligation arises for the entity whereby it will be required to settle with the supplier in cash (constructive liability) or equity (constructive vesting). It seems inappropriate to recognise an expense in relation to goods or services provided by a supplier when there is no possibility of a corresponding obligation for the entity to pay the supplier (in cash or equity). It is arguable that, in these circumstances, there is no transaction under the proposed definitions of share-based payment transactions, since the entity has not incurred a liability or provided equity compensation. In the case of an executory contract, if one party does not perform, then the counterparty is not obliged to recompense that party; there is no liability to be recorded and no expense is incurred. If a party to an executory contract has performed during the period only part of what is required but is entitled to recompense only on completion (not pro rata compensation), then the position for the counterparty is the same and there is no requirement to record the same obligation or expense that would have otherwise been recorded following completion of the contract (or on pro rata entitlement).

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?*

It is uncertain whether the 'measurement principle' referred to in the question is intended to refer solely to the principle of measuring the fair value in equity-settled share-based payment transactions or whether it is intended to include in the principle, in addition, the provision of choice (and the nominated alternatives) on which fair value to use and the universal application of the principle with no exemptions (from either using fair value in measuring or permitting choice).

We support the nomination of fair value as the appropriate value to measure in all share-based payment transactions.

The provision of choice among fair values, as it is stated, seems to require acceptance of the proposition that there may be several 'fair values' for one transaction, and this seems contrary to the definition of fair value, which refers to 'the amount' (singular). We suggest that that it would be clearer and less confusing to refer to the fair value of the transaction and describe the choice as being between two alternative methods of estimating that fair value (and not a choice between fair values).

Assuming that choice as to which side of the transaction to measure is to be permitted, the choice should not depend on which fair value is "*more readily determinable*". This would permit the use of a value that was more easily calculated but less reliable than the alternative 'fair value'. The words 'reliably determinable' have been used in past standards and their meaning is better known, both theoretically through the derivation from the Conceptual Framework and practically from their past use in application. It is suggested that it would be preferable, rather than introduce a new term whose application is ill-defined and uncertain, to use the existing term, which is logically derived, consistent with other IASB standards and more certain in interpretation based on past usage.

If choice is based on "*whichever fair value is more readily determinable*", then it seems likely that many unlisted entities would consider it easier to determine the fair value of the goods or services than the fair value of their unlisted equity instruments. We do not support this outcome. Further, it is contrary to the principle of universal application of the method for measuring fair value of equity instruments expressed in paragraph 20. In the USA, SFAS 123 permits unlisted entities to use an alternative to fair value, minimum value (in which the volatility variable is omitted when valuing options with an option pricing model). The use of minimum value is rejected by the IASB in the Basis for Conclusions, BC78. However, by allowing entities to choose which side of the transaction to value on the basis as stated, the proposed IFRS effectively provides unlisted entities with an alternative that brings greater relief from the fair value rule than does the 'minimum value' alternative in SFAS 123.

The meaning of the term 'fair value' appears to shift later in the proposed standard, when the fair value of options derived from the use of an option pricing model (paragraph 20) is reduced to yet another 'fair value' (for units of service to be received), by the application of estimates made by one party as to the future actions of those employees who constitute the other party to the contract (paragraph 24). These adjustments to the 'fair value' derived from an option pricing model introduce such a significant element of subjectivity and bias to one party that it is questionable whether the result satisfies the definition of 'fair value'. It is doubtful whether the difficulties could be resolved by rephrasing the principle to state:

"an entity shall measure the fair value of the goods and services received ..... either directly by measuring the goods or services received or indirectly by reference to the equity instruments providing compensation, whichever amount is more reliably determinable"

The alternatives given in the proposals fail to identify whether the fair values to be compared (so as to decide which "*is more readily determinable*") are to be measured as at the same date, or one at date of grant and the other at expected date of receipt. Further, although the basis for choosing between the two alternatives appears to be stated unequivocally in paragraph 7, it later appears, from paragraphs 9 and 11, that the effective basis for making the choice is not the 'quality' of the fair value but the status of the counterparty, whether employee or non-employee.

We support universal application to all reporting entities and the provision of more guidance and direction on application for unlisted entities.

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?

Setting up two different dates, grant date and receipt date, for the measurement of the fair value of equity-settled transactions, effectively based on whether the transaction is with an employee or non-employee, appears contrary to the principle stated in the Basis for Conclusions, BC122:

> *"The Board saw no reason to draw any distinction between share-based payment transactions with employees and other parties. The basic transaction is the same, namely the receipt of goods or services as consideration for the issue of shares or share options. Therefore, any conclusions about which measurement basis and measurement date should be applied are, in principle, equally applicable to share-based payment transactions with parties other than employees."*

This principle is reinforced by the IASB's conclusions in BC104 and BC128. With respect to share-based payment transactions with employees, the fair value is not measured at the date the services are received, because services are received either before grant date (vested grants) or after grant date (during the vesting period). This inconsistency needs to be clarified.

With respect to share-based payment transactions with non-employees, we note the current discussion in relation to the proposed IFRS on Business Combinations, on whether to use 'date of contract' or 'date of receipt'. We consider whatever basis is adopted the two standards need to be consistent. If 'contract date' is adopted in the forthcoming standard on Business Combinations, then 'contract date' and not 'date of receipt' should be prescribed in this proposed standard.

The proposals do not contain sufficient guidance as to how to 'measure directly' the fair value of either goods or services supplied by a non-employee. Paragraph 10 refers to the existence of an established market, using this to justify the 'direct' method but not restricting the choice of the 'direct' alternative only to the circumstances where a market exists. Where there is no established market, there is no guidance. The need for more explicit guidance is reinforced by the proposed change to the definition of 'cost' in IAS 16 "Property, Plant and Equipment", IAS 38 "Intangible Assets" and IAS 40 "Investment Property" (Appendix E, paragraph E7).

The extent to which equity-settled transactions with non-employees will be covered by the proposed standard is somewhat uncertain, as the exemptions based on IAS 22 appear subject to change with the introduction of the proposed new IFRS on Business Combinations and associated revisions to IAS 36 and 38. Despite the wide-ranging description of goods in paragraph 3, it is not clear whether the term 'goods' can or does include real property (for example, land), since its more common legal meaning is restricted to 'movable personal property'. We suggest that the terms 'goods' and 'services' should be defined, at least for the purposes of the proposed IFRS.

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 noted in relation to Question 4, specifying different dates for measuring the fair value of a transaction depending on the status of the counterparty is not consistent with the principle expressed in the Basis for Conclusions (BC104, 122 and 128). The proposed system appears to result in the recognition of amounts that do not relate to the fair value of equity instruments at the time of recognition. Such amounts are less relevant than amounts measured at the time of recognition, based on current fair values. The earlier-measured amount is inherently less reliable than one measured at the date of recognition because at least some of the uncertainties involved in the earlier estimation will have been resolved by the later date.

The AASB considers that the same date should be used for valuation of equity instruments, irrespective of the counterparty, and that date should be same as adopted in the forthcoming IFRS on Business Combinations.

A particular example of circumstances in which grant date would seem inappropriate is described as follows. In situations where an entity permits an employee to take part of their salary (or director's fees) in the form of shares, it is common for the entity to require the employee to nominate the 'salary sacrifice' amount at the start of a period and to issue or transfer to them on each 'pay day' a number of shares determined by dividing the current market price per share into the dollar amount that would otherwise have been paid. In such cases, it would seem inappropriate to record the remuneration expense using a 'deemed fair value per service unit' based on the market price at the start of the period. The use of grant date may result in recording an expense that is difficult to reconcile with the value (and number of shares) determined under the terms of the contract.

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?

While it is easy to find many instances of equity-settled share-based payment transactions with non-employees where the fair value of the transaction is more easily measured by reference to the goods or services received rather than to the equity instruments forming the payment, it is also easy to find examples of such transactions where the fair value of the transaction is more easily determined from the equity instruments. It is uncertain whether the balance is so strongly weighted in favour of the first that it is sufficient to justify a rebuttable presumption for non-employee transactions.

As noted above in relation to Question 4, it is not clear whether the term 'goods' includes real property (for example, land) or non-physical rights (for example, a financial asset comprising an interest in an associate, not covered by another IFRS). Where a transaction involves a unique good (or service) or one that is rarely traded, and the compensation is exchange-traded shares, it seems clear that the fair value of the equity is likely to give a more relevant and reliable amount for recognition. The choice between valuing what is received or what is given in return would be more justifiable if based on the quality of the market for each side, not the status of the counterparty.

Question 7

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

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

We agree that in almost all cases of equity-settled transactions with employees it is not only more difficult to determine the value of services 'directly' but that it is virtually impossible to determine a value independently of the compensation provided.

These proposals appear to assume that agreement (accepting that the fair value of an equity-settled share-based payment transaction is more likely to be reliable if based on the fair value of the equity instruments granted by the entity and not the services provided in return by the employee) provides logical support for the proposed system of recording expense based on the services received and not the number of equity instruments provided as compensation. We agree with the principle of using the fair value of equity instruments and believe it is not applied correctly in the proposed system. From the examples supplied in Appendix B, it appears a consequence of the proposed system that the amount recorded per option varies in each period pre vesting and rarely equates to the original 'fair value of the equity instruments granted'. We have concerns about such an approach.

There are some circumstances when a reliable value exists independent of the fair value of equity instruments. In salary sacrifice plans, as described above in relation to Question 5, it would appear easier to determine the value of the transaction as the amount of salary foregone at each 'pay day' rather than attempt to estimate the number of shares that will be transferred during the nominated period and the value of this parcel of shares at the date of grant (when the employee agrees to the entity's offer and nominates the dollar amount of salary to be sacrificed). Further, requiring that the value of a salary sacrifice 'grant' be expensed using the proposed 'deemed fair value per unit of service' method is likely to result in an expense (and notional number of shares) that is different from the cost under the terms of the contract. The need to clarify the treatment of dividends in salary sacrifice plans is explained in relation to Question 11.

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?

Paragraphs 13 and 14 describe only two situations:

- vest on grant; and
- vest on satisfying service condition.

There is no mention of 'vest on satisfying performance condition', whether that performance is by the employee or the company. For example, there is no mention of how to treat option plans where an option becomes exercisable (vests) when the share price reaches a particular target. These plans are common in Australia.

In relation to options that vest on grant, the directions refer to recognising 'services received'. It may be preferable to describe this as a bonus since, presumably, the cost of the services already received has already been recognised. Further, if the grant is made at the start of a year, the services would have been received in the prior period. In this situation, it appears impossible to follow the directions in paragraph 15 as to how to determine the amount to attribute to each unit of services received and how to use this to account for what is received in each accounting period.

If a cash bonus were granted and paid immediately, then the amount would obviously be recognised in full and it would not be required to be related to particular services received over some unidentified period in the past. There may be no nexus between a grant and any specific services or length of employment and it seems not only unnecessary but also counterproductive to require creation of some arbitrary relationship in these circumstances in order to comply with the requirement in paragraph 13 that the entity "*shall recognise the services received in full*". It would be sufficient for paragraph 13 to require that the bonus be recognised as an employee expense with a corresponding increase in an equity account.

The 'unit of service' is a very important term in the proposed process of recognising an expense but it is not clearly defined as to whether the 'unit' should be taken as a year, a month, a day or an hour of service by an employee. The illustrations in the Appendices take it to be a year, which is computationally convenient but fails to distinguish between an employee who works the bare minimum of hours and an employee who consistently works overtime (for example, an entity would receive 25% more services from an employee who regularly worked 25% more hours than the bare minimum).

It is a weakness in the proposed system that, while it purports to be based on recognising the expense of 'services received' from employees, the unit of service is really a chronological measure of the progress in time between grant and vesting. Working overtime does not reduce the remaining time to vesting by an equivalent amount, nor increase the number of instruments to vest. The additional 'services received' from an employee, who in one year worked 25% overtime and provided 25% more services to the entity, would not be recognised in the expense recorded for that (or any) year. The system does not appear to satisfy the Board's objective, as stated in the Basis for Conclusions, BC 200, "*to account for the services subsequently received, not the fair value of the options granted.*"

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 do not agree that it is necessary to determine the amount to attribute to each unit of service received (or expected to be received). ED 2 justifies the use of the fair value of the equity instrument side of the transaction to value a transaction on the grounds that this value is 'more readily determinable' than the value of the goods or services side. It seems unnecessarily complicated and circular to attempt to twist the valuation back to the services side of the transaction. Further, the transformation is achieved at the expense of introducing further subjective expectations and estimations into the valuation process. The additional subjective estimations must inevitably reduce the reliability of the value so derived (per service unit) to a level below that of the initial 'fair value of the equity instruments'. Accordingly, the arguments used in the Basis for Conclusions to support the method of measuring the fair value of equity instruments at grant date cannot be taken as providing equal support for the deemed value per service unit.

It is a particular weakness of the transformation of the fair value of equity instruments into a deemed value per service unit that it results in the 'value' to one employee being dependent on the expected future actions of other employees. This seems contrary to the definition of fair value, where the value of a transaction between willing parties is not determined by reference to the possible actions of third parties. In circumstances where there is a grant of equity instruments to a small number of senior executives, it seems inappropriate to reduce the amount attributed to the remuneration of one executive because another executive might leave.

We consider it is unnecessary to refer to the fair value of equity instruments as a 'surrogate measure' for the value of services expected to be received. Paragraph 7 establishes that the fair value for the transaction is to be determined from the equity side. The justification for choosing to value the equity side is undermined if the method for recording expense is based on the services side of the transaction.

It would simpler and more consistent with the principle of using the fair value of the equity side of the transaction to base the recording of the expense directly on the fair value of equity instruments. The use of the 'fair value' concept and the date of measurement are justified in the Basis for Conclusions. These arguments apply with full force to a system of recording expense based on the constructive vesting of equity instruments, unlike the proposed system, where support is reduced by the increased subjectivity and shifting away from equity instruments to the artificial construct of 'units of service received'.

It should also be remembered that various jurisdictions have requirements for the disclosure of the remuneration of directors or executives on an individual basis. The methodology adopted in the proposed standard should facilitate the calculation of the share-based payment component of the remuneration disclosed for an individual for the reporting period.

We recommend the IASB consider adopting one of the following three methods mentioned in submissions from our constituents as alternative approaches to recognising an expense for unvested share options:

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

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 agree that once an expense has been recognised for an equity-settled share-based payment transaction with an increase in an equity account, then total equity should not be increased or decreased again in respect of that equity instrument as long as it exists.

We believe that the exercise of a share option and payment of the exercise price should cause an increase in total equity but that this increase is properly associated with the issue of the share underlying the option, an equity instrument separate from the option itself. When the option is exercised, the option instrument ceases to exist since the conditional rights to an interest in the residual net assets of the entity cease to exist, having been transformed into rights attaching to the share. The amount initially recorded in respect of the option (the option premium) recognised the consideration or resources received by the entity from employees and these resources remain with the entity on exercise. The conditional rights are expunged but this does not reduce the net assets of the entity by an amount equivalent to the option premium, since no liability (or obligation to part with resources in any form) arises from exercise.

When an option expires unexercised, the same reasoning applies to the option premium as applicable when exercise occurred. There is no liability or obligation on the entity arising from expiry that can be construed as causing net assets to be reduced by the amount of the option premium.

When an option is forfeited at or before vesting date, the entity does not incur any liability or obligation to part with an amount equal to the option premium in respect of that option, representing the resources recognised in a prior period. If an employee left the entity before any amount had been recognised in respect of share options granted (and not vested), then the options would be forfeited but there would not be any option premium to adjust.

Accordingly, we support the proposed requirement that total equity should not be reduced as a consequence of the exercise, expiry or forfeit of a share option. Further, as noted in relation to Question 13, we believe the effect of forfeiture on the entity would be more accurately represented if the expense recorded in one period does not include any amount in respect of options that are forfeited in that period, either directly (through including the deemed value for service units received from employees who left in the period) or indirectly (through including the expected departure rate in the initial calculation at grant date).

However, we consider that all forms of capital reductions, capital returns and 'buy backs' of equity instruments should be recognised with adjustments to total equity. We consider this extends to the cancellation of share options when that action obliges the entity to recompense the option holders, whether with cash or with the issue of (valuable) equity instruments.

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 support the use of an option pricing model, using the six variables (factors) nominated in the above description, as providing a sufficiently reliable estimate of the fair value of an option. We believe the reliability of a fair value generated by an option pricing model is diminished by the proposed adjustment (reduction) of that value based on subjective estimates of the future forfeit rates. We believe that the use of these estimates constitutes a substantial devaluation of the results from models and partial duplication of some factors already accounted for in the models. The robustness of the models cannot be transferred to support the proposed 'deemed fair value of service units at grant date' since their use in this calculation is degraded by the vesting estimates. We comment further in Question 16 on the devaluation of the use of option pricing models and in Question 13 on the inappropriateness of including vesting estimates in the calculation.

The above description refers only to the life of an option. When the term is not qualified, it refers only to the contractual life of the option. We note that contractual life is an objective term evidenced by the expiry date (stated in the terms of the option instrument) and its use in any option pricing model will generate a value that is inherently more reliable than a value based on expected life. We comment further on the use of expected life in relation to Question 12.

We note that the questions refer to the measurement of share options but the preceding 'situation description' refers to paragraph 23 and dividends in relation to measuring shares. We consider that the intention in paragraph 23 is not clearly stated and could be misconstrued to read that when dividends are to be received, they are to be excluded from the valuation. In the case of shares to be issued in 'salary sacrifice' share plans, the position of dividends on shares before and after vesting should be clarified.

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 do not agree that it is appropriate to adjust for non-transferability by mandating the use of expected life instead of the contractual life of an option. We have seen no evidence to demonstrate that the use of expected life is an acceptable surrogate for the effect of non-transferability and neither have the actuaries with which we have discussed the matter.

The use of expected life instead of contractual life is supported only when this can be reliably determined. Where no reliable estimate of expected life can be determined, contractual life should be required, irrespective of transferability.

The use of expected life is justified elsewhere (Implementation Guidance IG10 – IG13) for other reasons and, therefore, it is doubtful whether mandating its use in the circumstances described could have the desired effect, since it can also be used when options are transferable (and it cannot be applied twice). In the Basis for Conclusions, BC157 refers to the use of expected life being required for non-transferable options in "*recent accounting standards and proposed standards issued by other* *standard-setters*". We are uncertain as to which standards are referred to, as we are not aware of requirements to use expected life for (and only for) non-transferable options (and contractual life for all transferable options), or that such requirements are justified on the basis that expected life is a surrogate for non-transferability.

Further, we question whether there is any need to find a 'surrogate' for the effect of non-transferability, as it seems inappropriate to include this as a factor in determining the fair value of a share option. It appears to introduce an undesirable level of subjectivity into the estimations. It also appears to assume the existence of transferable, non-vested options. Despite many differences between various legal jurisdictions, we find it difficult to understand how it would be possible in any jurisdiction for a person to transfer beneficial rights to which they are not yet entitled. In the Basis for Conclusions (BC158 and 159), reference is made to some employees being able to use hedging to "*mitigate the effects of non-transferability*". We can understand how hedging might be used when vested options are not transferable but we find it difficult to understand why an employee would increase their risk by 'selling' that to which they are not yet entitled (short selling). As noted in BC148, the Black-Scholes option pricing model already presumes that the option cannot be exercised during its life. If an option can be exercised before its expiry date, then the Black-Scholes model is not appropriate, even if the option cannot be exercised or transferred until after it vests.

We agree with the statement in BC164 that "*the question is the value of the option from the entity's perspective, not the employee's perspective*". We disagree with the logic in BC 156 that implies that it is non-transferability (and that alone) that causes the life of an option to be less than its contracted life. Early exercise is just as likely for transferable vested options that are unquoted securities.

If the use of expected life were permitted only in conjunction with the use of a Black-Scholes type model, then the question of capacity to transfer pre-vesting is practically irrelevant. However, if expected life is allowed to be used in a binomial or other model that incorporates exercise prior to expiry date, this appears to contradict the justification for using expected life. 'Expected life' is a rough average of the expected early, middle and late exercises. Using it in a binomial model would lead to 'double-counting' of the reductive effect of shorter life (since this incorporates the possibility of exercise before the end of the nominated expected life).

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?

The majority of submissions from our constituents supported reductions in the 'fair value' of option grants based on the expectations that some employees will fail to meet the service and performance conditions for vesting and that, where performance does not depend on the personal exertions of an employee, forfeit may occur because the performance of the entity is below the required level for vesting. However, it would be inappropriate to permit such reductions where the terms of the grant allow (or give discretion to the Board of Directors to allow) vesting to occur without satisfaction of the vesting conditions when an employee leaves the entity before the vesting date.

We are concerned that divergent and unacceptable practices may arise in the determination of the adjustments made for vesting conditions. The lack of guidance in the proposed IFRS means there is considerable scope for undesirable manipulation of the outcomes. We believe the IASB should consider the following problems and difficulties associated with the proposed reductions in fair values of options based on vesting conditions.

In cases where vesting depends on the market price of the underlying security reaching a particular level, adjustment for this appears to either double-count or negate the influence of the variable (factor), expected volatility of share price, already included in the option pricing model.

As noted earlier in relation to Question 9, the introduction of expected forfeit rates reduces the reliability of the results and decreases any claim to represent a 'fair value'. The value to one recipient should not be so dependent on the (expected) actions of others. The fair value of an option in a grant should not be reduced so that those options that do vest are recorded at less than their fair value, based on the number of options in the grant the entity expects will never vest (ie the equity compensation that the entity expects it will not have to 'pay'). This appears inconsistent with the reasoning in the Basis for Conclusions (BC205 to BC207) supporting the proposals that once an amount has been recorded in respect of an option, that amount should not be adjusted subsequently because of lapse or forfeit. It seems contradictory to require that the amount recorded should already include a reduction in fair value because of expected forfeit.

If the initial estimate of departure rate is shown in later periods to be incorrect, there is no capacity for the estimate to be revised at any point, or for any 'truing-up' to occur. The 'deemed value per service unit', initially determined on one level of forfeit, continues to be applied, irrespective of the actual departure rate, to options in respect of those employees still employed as well as including in the expense a pro-rata amount for services received during the year from employees who have left before the end of the year (and forfeited any possible rights to options). In the Basis for Conclusions (BC196 – BC200), the references to the numerical illustrations presented in the Appendices do not point out the difference, if no employees leave, between:

- the amount expensed when the departure rate of 20% is used, $666,667; and
- the amount that would have been expensed if the fair value of options had not been reduced by 20%, $750,000.

If an entity incorrectly estimates a high departure rate, the reduction in the expense is permanent. The only disclosure providing an indication of errors in estimates is that required (after the event) by Paragraph 48(e), comparison of the estimate at grant date with the actual percent vesting during the period. It is uncertain whether most users of an annual report would realise the significance of this disclosure, even if there were a substantial discrepancy. It is likely to be impossible to calculate from the disclosures the amount of the reduction or, when the vesting conditions include performance, to isolate the difference between expected and actual rates of departure.

The effect of expected forfeiture for failing the service conditions (ie, the departure rate of employees pre vesting) is applied not only to reduce the value of the options at grant, it is used to reduce the number of service units expected. If the rate were applied equally to both numerator and denominator, it would have nil effect and thus be redundant to the calculation. However, as explained in a footnote (to BC199) in the Basis for Conclusions, inclusion in the calculation of the 'deemed value of service unit' of units for services expected to be received during a period from employees who leave before the end of the period means the effect of the same rate on denominator and numerator is not identical. The explanation fails to point out that substantial partial cancellation occurs (weakening the case for including the rate). In BC199, the Board justifies the proposed dual application of the expected departure rate because "*the same event, the departure of employees, affects both sides of the transaction – the number of options that vest and the quantity of services received by the entity in return for the options*". There is no explicit justification for the differential application of the same rate. It appears to incorporate deliberately into the calculation an amount in respect of equity instruments that are expected to be forfeited. This contradicts the earlier justification in BC197 for applying the departure rate to reduce the fair value of the grant by an amount representing the value of equity instruments expected to be forfeited.

The effect of forfeiture on the entity would be more accurately represented if the expense recorded in one period did not include an amount in respect of options that are forfeited in that period, either directly (through including the deemed value for service units received from employees who left in the period) or indirectly (through including the expected departure rate in the initial calculation at grant date).

Question 14

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

The proposal to include a reload feature in the initial calculations where practicable is supported. While the 'where practicable' qualification is often considered to provide an inappropriate means for avoiding some requirements, it is not opposed in this instance because any entity that fails to include the value of a reload feature at grant date will be required to include a value for this eventually (as a new grant, measured at the reload date). It is suggested that clarification be added to ensure that when a reload occurs after the vesting date of the initial grant, its value is expensed at the date of the reload.

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 there are other features common to employee share plans that should be specifically addressed in the proposed IFRS to ensure that their treatment is clear, unambiguous and applied consistently. Some of these features have been noted earlier (eg. 'vesting on performance', Questions 8 and 13), but are included with other features in the following list (which relates to both shares and options unless one or the other is clearly indicated).

- Vesting based on performance criteria alone
- Vesting after a specified number of years but exercise only possible when the market price reaches or exceeds a predetermined level (or level determined in accordance with parameters set at grant date)
- Vesting conditions related to performance that result in variable numbers of options being earned at different points over the performance period (or other forms of 'rolling' entitlements)
- Plans where the number of options granted (or issued) depends on performance (or service) *prior* to the grant and where, in some cases, further service or performance is necessary for vesting to occur
- Salary sacrifice plans (for example, where the number of shares to be earned each month equals the amount of salary foregone divided by the current market price of the shares)
- 'Performance Rights': similar to share options but, not having an exercise price, excluded by the proposed definition of share option (various other names may be used: 'Deferred Shares', 'Restricted Shares', 'Share Rights')
- Recurrent 'grants' of equity instruments to an employee under an individual contract of employment (are these separate grants, or must the date of signing the contract be taken as grant date?)
- Recurrent grants to ongoing or new employees under a generic 'Employment Award' (similar to problems for individual noted above)

- Share plans or share option plans where the entity is unable to issue any more of its own equity (for example, restrictions in some privatisation arrangements) and must buy on market to settle with shares or provide shares for exercise of options: these arrangements appear to be the same in substance as cash stock appreciation rights
- Non-recourse (or partial recourse) loans to employees to purchase shares, or any other arrangement that is structured to appear as though an employee is purchasing the shares or options (and not receiving them as remuneration) when in substance the arrangement involves equity compensation

In relation to the last feature noted, it is recommended that consideration be given to identifying whether the benefit from an interest-free loan to an employee to buy shares should be addressed in the proposed IFRS or in IAS 19 "Employee Benefits". Structures whereby an executive is granted an interest-free loan from a company to purchase shares in that company, with the 'loan' being successively reduced to zero over the next five years, seem to be share-based payment transactions in substance but, based on their form, likely to escape the provisions of the proposed IFRS.

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?*

While we agree that the emphasis in standards should be on establishing principles, rather than listing a set of detailed rules, we believe that sufficient detail must be included so that the principles are adequately and sufficiently described and ensure the requirements of a standard are unambiguous and self-evident.

We believe that the proposals relating to valuing options would benefit from the inclusion of more detailed guidance. Since the FASB issued SFAS 123 in October 1995, option pricing models have been further developed and their use become almost common place. The structure prescribed in SFAS 123 (prescribe the six variables but not one specific model) has shown itself capable of benefiting from developments. However, the IASB's proposals represent a substantial shift away from previous practice in the USA and more detailed authoritative guidance is needed in the proposed IFRS.

In relation to the use of option pricing models, we consider more guidance is needed on how to determine values for each of the six variables (factors) to be used as input to the models. For example, one of the most critical variables, expected life, is not discussed in the proposed IFRS. The definition is brief and the term occurs in only three paragraphs in the proposed IFRS (excluding Appendices); paragraph 21 explicitly requires its use in specific circumstances and paragraphs 46 and 48 require various disclosures. The Appendices provide illustrations of its use but not its derivation. From the illustrations (including the example in the Implementation Guidance, IG43), expected life appears to be used in circumstances other than that nominated in paragraph 21. Its use in valuing any share option grant appears sanctioned in the Basis for Conclusions, where it is stated (BC176) that "*the potential for error is mitigated by the use of expected life rather than contracted life.*" It is unclear whether it is required to re-estimate expected life in repricing situations. We are doubtful that the subjectivity inherent in determining an expected life, compared to the certainty of a contractual expiry date, is likely to increase the reliability of results.

Option pricing models are used to derive the fair value at reporting date for outstanding cash Stock Appreciation Rights (SARs) but there is no indication whether it is required to use contractual life (time remaining to expiry) or expected life at grant date or expected life at each reporting date. In the case of cash SARs, any errors in the initial estimation are mitigated by the fact that the value of a cash SAR is remeasured at each reporting date, thus allowing correction of prior errors.

We recommend that the guidance on derivation of the six variables provided in the Implementation Guidance should be included in the proposed IFRS, either by incorporation into the text or by inclusion of an Appendix that is an integral part of the proposed IFRS. Further, we believe that more direction is needed to identify when contractual life, not expected, must be used and to clarify whether the grant date estimate of expected life should change (and if so, how) over the life of a cash SAR (pre and post vesting).

The existing guidance on adjustments for vesting conditions in the proposed IFRS is negligible and that proposed in the Implementation Guidance does not efficiently constrain choices. There is no guidance on whether service and performance estimates are to be applied successively or conjointly. There is no limit on the expected rates of forfeit that may be used, for either service or performance. It would appear possible to use expected forfeit rates of greater than 50% and construct schemes so as to take advantage of the absence of guidance. The current level of detail is not sufficient to ensure consistent and correct application of the principle.

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 agree that the incremental value conveyed to employees when an entity reprices an employee share option grant (or otherwise modifies the terms and conditions so as to benefit the option holders) prior to vesting should be recognised.

We find it surprising that that there would be a significant number of cases where an employer has the power to unilaterally change the terms of (or cancel) a contract with an employee. We note that, in the Australian context, the restrictions imposed by the Listing Rules of the Australian Stock Exchange on changing the terms of options (whether these are quoted or unquoted securities) are such that it is rare for any changes to occur.

The two methods illustrated in Example 3 appear appropriate to different circumstances and insufficient information is given so as to decide which is appropriate in the example.

We suggest that each repricing or modification of an unvested option grant should be treated as a buy back of the original grant from those employees remaining in the scheme and issue of a new grant. This would minimise the potential for inclusion in the expenses recognised subsequently of any element based on estimates made at the time of the original grant (and likely to have become invalid in the circumstances prompting the repricing). The mechanics of the buy back could be structured to ensure that any pro rata amounts previously recognised are not reduced (unless cash payments to employees occur) but remain in equity and, depending on the details of the reconstruction, may be transferred to appropriate accounts in equity. The notional amount of the original grant remaining to be expensed (the original fair value per option times the pro rata number of options remaining to be earned) should be fully expensed in the period of repricing unless it was justifiable, depending on the circumstances, to treat some part of that amount as consideration yet to be received for the new grant. It is suggested that the 'buy back, re-issue' approach would provide a more reliable and relevant representation of the expense (and the value conveyed to employees) in the repricing period and in subsequent periods. It has the capacity to provide a generic model for all changes (repricing, modification of terms, cancellation) to all share-based grants (vested or unvested, equity-settled or cash-settled).

We consider it would be appropriate to extend our proposed 'buy-back, re-issue' approach beyond unvested share option grants to apply to all unvested grants. The principle should apply consistently to all unvested grants and include all other modifications, such as reductions in the service time or performance level required for vesting of share rights or removal of the restrictions in restricted (or deferred) share grants.

The proposals in ED 2 apply only to repricing prior to vesting of an option grant. We consider it is necessary to recognise also the value conveyed to employees when an entity reprices (or otherwise modifies) vested options prior to exercise. Since the services necessary for vesting would have already been received in such circumstances, then, consistent with the immediate recognition of an expense for equity grants that vest at grant, the entire value of repricing should be recognised in the period in which the repricing occurs. This extension could be accommodated without difficulty within the 'buy-back, re-issue' approach suggested above.

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.*

It is acknowledged that cancellation has sometimes been used inappropriately in the past and it is considered that the proposed method would certainly act as a deterrent to cancellations.

It is suggested that cancellation of a grant of options prior to vesting should result in the entire amount outstanding being expensed in that period, as if it were a 'share buyback'. Effectively, the transaction is completed in the year of cancellation and it is inappropriate that any effect should carry over into subsequent years. In subsequent years, an employee stands to gain nothing from a cancelled grant and the entity is under no obligation to provide any form of compensation under that grant for services received. It seems pointless to continue to record an expense.

The proposals do not appear to cover the situation when a vested grant is cancelled and replaced by another (vested) grant.

The proposed treatment for cash payments for the cancellation of unvested instruments (paragraph 29(b)) appears almost identical to that proposed for the 'repurchase of vested equity instruments' (paragraph 30). It is suggested that, even if the principle on which this is based is to be retained, more guidance is required and that there should be a distinction between the treatment of those options in respect of which an amount has previously been recognised and those in respect of which no amount has yet been recognised in an equity account. It would seem incorrect to deduct from equity the fair value (measured at settlement) of shares or options granted but in respect of which no amount has yet been recorded.

It is suggested that the cancellation of vested and unvested equity instruments and the repurchase of vested equity instruments should be treated in the same manner as applicable to a hybrid share-based payment arrangement where the entity has the choice of settlement, has initially accounted for the grant as equity-settled and has ultimately settled in cash.

Question 19

For cash-settled share-based payment transactions, the draft IFRS proposes that the entity should measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity should remeasure the fair value of the liability at each reporting date, with any changes in value recognised in the income statement.

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

We support the measurement of the expense for cash-settled share-based payment transactions based on the fair value of the liability at reporting date and actual payments (in excess of amounts previously recognised) during the period.

As noted earlier in relation to Question 16, we recommend that explicit directions be added to clarify the use of expected life, instead of contractual life, when an option pricing model is used to derive the fair value of the cash SARs.

We note that the position with regard to 'adjustments' to the fair value of an unvested cash SAR, based on the expected likelihood of vesting, is unclear. The reference to "*adjusted as appropriate to allow for the possibility of forfeiture of the share appreciation rights*" in paragraph 34 does not make clear whether this permits all the adjustments discussed in relation to equity settled grants or whether the adjustment is to the value or number of rights. The position for cash SARS is very different from equity-settled transactions (where the adjustment is made once at grant date), since cash SARs are revalued at each reporting date (and the adjustment is likely to be different every time).

The valuation of the liability is critical in measuring the expense and this liability should not be exempt from the criteria for the recognition of a liability in the conceptual framework. We suggest that the possibility of forfeit should be reflected in the *number* (not the value) of rights recognised at reporting date as payable or construed in the circumstances as being more likely than not to be payable. The vesting estimates should be reassessed at each reporting date. Even though the amount of the liability would be the same if the same vesting estimates were applied to either number or value, it is considered that application to the number of rights provides a clearer focus on what is being estimated at that reporting date, separate from other considerations applicable to an option pricing model. It also provides a more conceptually correct approach.

It is suggested that the illustration given in Appendix C should be amended to clarify the differences between the use of an option pricing model in the equity-settled examples and use in relation to cash SARs. It is also noted that, in the given illustration, the liability calculated at the end of each year prior to vesting is based on the number of employees employed at the end of that year (times the pro rata number of rights). In years 1 and 2, this number exceeds the number that the entity expected at grant date would become entitled to the rights at the end of the three-year vesting period. It is stated that " *in years 1 and 2, the fair value estimate takes into account the possibility of forfeiture*" but it would appear that the grant date estimate of 80% vesting has been applied to reduce the fair value per right at the end of both years. Accordingly, the illustration appears incorrect, in that the liability is calculated by including pro rata rights in respect of more employees than are expected to remain the entire three years and applying a value per right that is less than the fair value.

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 requirements in respect of share-based payment transactions where settlement may be in either cash or equity (hybrids) contain several inconsistencies, both within the requirements and compared to other requirements. The suggestions below as to what might be removed to achieve greater consistency are also aimed at removing detailed prescription where this seems redundant or contrary to the general principles.

The first inconsistency noted among the hybrid requirements is the difference between the treatments required for two types of hybrids that are similar in that both give rise to a liability. Briefly described, the situation is:

- Hybrid where employee has choice: value as compound financial instrument
- Hybrid where employer has choice but past practice is to settle in cash: value as cash SAR

It is recommended that both should be treated equally as cash SARs. Despite the conceptual purity of requiring a compound instrument approach for the first hybrid, the refinement of measurement (measuring of both debt and equity components) is likely to be required in only a small number of instances, since, as acknowledged in the Implementation Guidance (IG42), it is typical for the debt and equity alternatives to be equal in value.

The increase in complexity appears unjustified by an increase in information disclosed (nothing specific) or accuracy of the expense recognised. More paragraphs in the proposed IFRS are devoted to this hybrid (and a very small subset of it) than are used to address the more common cash SAR. Further, the requirement in paragraph 41 to retain in equity any equity component that was recognised pre vesting (remeasurement post vesting applies only to the debt component) after cash settlement has occurred appears to contradict the requirements elsewhere on repurchase of vested equity instruments (paragraph 30) and cancellation (other than forfeiture for failing the vesting conditions) (paragraph 29(b)). When an entity is settling the liability with cash, as described in paragraph 41, then the right has vested and the election by the employee to take cash represents the employee's decision to exchange any rights to equity for cash. Even if the term 'forfeit' is used, it does not refer to forfeit for failure to meet the vesting conditions.

The second major inconsistency noted in the area of hybrids relates to hybrids where the employer has the choice and no past practice of settling in cash. Paragraph 44 requires that these shall be accounted for in the same way as equity-settled transactions but, inconsistently, proposes in paragraph 44(c) to apply a 'penalty' at the date of 'settlement' that is not applicable to 'ordinary' equity-settled transactions. Not only is this inconsistent, it appears unnecessary and ambiguous. It is uncertain whether 'date of settlement' means the date of the decision on the form of settlement or the date of the exercise of the share option (and issue of equity instruments) or the date of the issue of a share option (or right or other equity instrument).

It is suggested that such hybrids should be treated exactly the same as equity-settled transactions unless and until the employer entity decides on cash settlement. Where the decision to pay cash is made at settlement date (or the date of payment), it would be consistent to treat this the same as a cancellation or buy back of equity rights. More detailed guidance should be provided to cover situations where an irrevocable choice is made by the employer entity at any time between grant and settlement, to ensure the hybrid is treated subsequently as a cash SAR and the transition is correctly accounted for in both pre and post vesting situations.

We suggest it would be conceptually defensible and far simpler to avoid constructing separate systems for hybrids and to focus instead on classifying as either equity-settled or cash-settled, according to substance, and describing how to account for transitions from one classification to the other.

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)?

Our comments are divided into responses to the three nominated areas followed by comments not specific to a single area.

(a) In relation to the disclosure requirements in paragraphs 45 and 46.

The numbers for options required by paragraph 46(b) are useful but it would be more useful if the requirements included identification of how many are vested (and the amount recorded in respect of these), how many are unvested but allocated (and the amount recognised in respect of these) and how many remain to be allocated (and the grant date value). Requiring the weighted average exercise price for each group does not provide any indication of amounts recognised in respect of each group.

Disclosure of expected life should be required in addition to contractual life (paragraph 46(a)(iv)).

(b) In relation to the disclosure requirements in paragraphs 47 to 50.

Paragraph 48(a) requires disclosures about options granted during the period but does not require disclosure of the number granted. It would be consistent with the requirement to disclose number of shares in paragraph 48(b). Similarly, it would be consistent to include in paragraph 48(c) a requirement to disclose the number of cash SARs or hybrid instruments granted.

Given that the deemed fair value per service unit for a grant is required to be determined at grant date, it would be a useful addition (not causing additional preparation cost) to require this to be disclosed. Related to this, disclosure of the number of service units used to calculate the deemed value per service unit would be informative (and would, similarly, not add to preparation cost).

Paragraph 50 requires disclosure if the rebuttable presumption in paragraph 9 has been rebutted; there should also be disclosure if the presumption in paragraph 11 is rebutted.

(c) In relation to the disclosure requirements in paragraph 52.

Paragraph 52(a) does not clearly specify that the dollar amount related to equity-settled share-based payment transactions included in the total expense must be disclosed; it can be read as merely requiring that the total includes this component.

There is no requirement to identify any component of the expense attributable to hybrids (equity-settled transactions where settlement may be in cash or equity). No disclosure is required that would enable users to gain information from the accounting treatment specified in paragraph 39 requiring an entity to "*account separately for the goods or services received or acquired in respect of each component of the compound financial instrument.*"

Given that two very different methods can be used to measure the equity component (depending on whether the counterparty is an employee or not), it would seem useful to require separate disclosure of two amounts when the equity component of the expense includes an amount for non-employees. Although the method of calculating an expense in respect of cash SARs is the same for employee or non-employee, a similar split might be deemed useful in order that users may be able to identify the total *employee* expense. While share-based payment transactions covered by the proposed IFRS will most commonly be with employees (and thus separate disclosure of non-employee amounts required only rarely), it would be unfortunate if users regarded all amounts disclosed as employee expense, particularly when the proposed concurrent deletion of all equity compensation disclosures from IAS 19 would remove the possibility of cross-checking.

Failure to distinguish between expenses incurred and costs carried forward leads to uncertainty as to whether disclosure of 'total expense recognised for the period' required by paragraph 52(a) includes costs carried forward, such as employee expenses embodied in the transformation cost of inventories. It is not clear whether the nominated disclosure is intended to show the cost of acquisition of services (and goods) received in the period or the amount expensed in the period in respect of services (and goods) received.

Share-based payment can be used to acquire goods that are depreciable assets. It is presumed that depreciation expense for such an asset would not be included in the total expense disclosed, even though it could be loosely described as 'arising from share-based payment transactions'

Additional comments

It is noted that there is no paragraph explicitly addressing disclosure of balance sheet items or amounts (or details) of non-employee transactions. It is suggested that consideration should be given to requiring disclosure of some information on assets acquired during the period and paid for (or to be settled) with equity instruments.

It is unclear whether the generic disclosure requirements in other IAS standards will operate so as to elicit disclosure of the amount of the liability in relation to cash SARs at reporting date or, in the equity section, the distinction between amounts based on whether the equity instruments they represent are vested or unvested. It is suggested it would also be useful for users to know what percentage of the total liability in respect of SARs relates to unvested SARs.

While we would not support retention in IAS 19 "Employee Benefits" of all those sections proposed to be deleted, it is suggested that consideration should be given to requiring some specific disclosures about total numbers of shares held in employee share plan structures by trustees (or other nominees). Trustee structures are common in Australia and, since the trustee must act in the interests of the beneficiaries and not the client entity, their operations are not included in the consolidated accounts. Further, we suggest that it would be desirable to provide some information on the amount of outstanding loans to employees to purchase shares in the entity and the number of shares in question. We realise that in some jurisdictions it is already required that any asset of loans owing by employees for share purchase must be offset against the subscribed capital in equity.

Despite the preceding suggestions for some additional disclosures, we advise that the majority of the submissions we received from our constituents (before 5 March 2003) considered the proposed disclosures to be excessive.

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.

In respect of grants of equity instruments, the proposed transitional arrangements that limit retrospectivity are supported. It is suggested that the position in relation to hybrid grants should be clarified, particularly for those grants required to be measured as compound financial instruments.

In respect of cash share appreciation rights (and hybrids measured in the same manner), the proposed transitional arrangements appear unnecessarily complex. If it is considered unduly onerous to apply the proposed fair value method to *vested* rights (vested as at effective date), then it would seem equally onerous (and inconsistent) to require the fair value method to be used for any (constructive) liabilities recognised in a prior period for rights not vested at that point in time. The inconsistency would be particularly apparent in the case of rights vested at the effective date but not vested at the end of the prior reporting period.

If an entity has applied the fair value method to estimating cash SAR-related liabilities in prior reporting periods, it would seem retrograde to require that the entity "*should measure such liabilities at their settlement amount*".

Paragraph 55 appears to address only the measurement of liabilities that exist at the effective date of the proposed IFRS, but it is uncertain whether this means only liabilities already recognised immediately before the effective date or extends to include those that would be recognised when the proposed IFRS is effective. The requirements in the proposed IFRS in respect of SAR-related liabilities go beyond measuring; they address recognition and make it clear that vesting is not required for recognition. It is likely this will cause recognition of a liability for some unvested rights not previously recognised. Liabilities arising from vested rights will almost certainly have been recognised and measured earlier and these will benefit from the relaxation of, the general retrospectivity requirements (exempting them from remeasurement at fair value). However, the exemption will not apply to those liabilities that the IFRS has caused to be recognised and it will therefore be necessary for them to be measured at fair value for comparative prior periods.

We suggest that the (implicit) intention in paragraph 55 to 'grandfather' existing liabilities would be better served by modifying the general retrospectivity requirements so as to:

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

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?

The proposed requirements presume that there will be a timing difference between recognition of an expense and claiming a tax deduction. Currently in Australia, equity-settled transactions are not deductible and may result in an entity paying additional tax (an 'untainting' tax to cure the tainting of its share capital account caused by crediting that account with an expense).

While it is hoped that this situation will be rectified in Australia, the proposed requirements seem to contemplate only the effect of a decrease in taxation liabilities associated with the recognition of an expense from equity-settled share-based payment transactions, not an increase in taxation liabilities.

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) .... to ... (f)

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

Our opinions on many of the above differences have been explained earlier but in the interests of clarity and comprehensiveness, the following lists briefly the position in relation to each sub paragraph.

(a) Exemptions from applying IFRS or fair value measurements

- We support the exclusion in SFAS 123, for employee share purchase plans provided specified criteria are met, such as the discount given to employees is relatively small, as explained in relation to Question 1.
- We do not support the other 'exemptions' in SFAS 123. We support the IASB proposals to require recognition of expenses based on the fair value measurement method (with no alternative to use 'intrinsic value') by all reporting entities (with no provision for unlisted entities to omit the volatility variable when using an option pricing model).

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

- We do not fully support either approach to measurement.
- We support the proposals in the draft IFRS that prohibit subsequent reversals of amounts recognised for instruments that are forfeited pre vesting (or lapse unexercised).

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

- We support the principle in SFAS 123 that treats those equity instruments as having immediately vested and requires recognition at the date of settlement (cash payment) of the amount of compensation expense measured at grant date but not yet recognised. We do not support proposals in the draft IFRS to ignore cash payment and require the entity to 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. ... Under the draft IFRS, the fair value of the equity instruments granted is measured at grant date in all cases.

- We do not support the absence from SFAS 123 of prescription on how to measure equity compensation transaction with non-employee. We do support the inclusion in the draft IFRS of measurement and recognition requirements consistent with those for transactions with employees. We do not believe that "*measured at grant date in all cases*" describes the current proposals correctly.

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

- We do not support the requirement in SFAS 123 that liabilities for cash SARs be measured using an intrinsic value measurement method. We support the proposal in the draft IFRS that such rights be measured using a fair value measurement method (and option pricing model as appropriate) but we do not support the application of the 'fair value' to unvested rights not yet considered to be 'constructive liabilities'.

(f) Treatment of realised tax benefits

- We do not support the requirement in SFAS 123 that realised tax benefits be credited direct to equity as additional paid-in capital, to the extent that those tax benefits exceed the tax benefits on the total amount of compensation expense recognised in respect of that grant of equity instruments. We do support the proposal in the draft IFRS to require all tax effects of share-based payment transactions to be recognised in profit or loss, as part of tax expense.

Question 25

Do you have any other comments on the Exposure Draft?

Appendix E –

If any amendment proposed in Appendix E has not been incorporated into the text of another standard issued on or before the date the proposed IFRS is issued (and remains in Appendix E), we would recommend that Appendix E be included as an integral part of the proposed IFRS to ensure that the proposed amendments to other Standards have equivalent status to the Standards being amended. Otherwise, it seems technically impossible for a pronouncement at a lower level in the hierarchy to operate with sufficient authority to amend or change something that is superior to itself.

The amendment to the definition of 'cost' in IAS 16 "Property, Plant and Equipment", IAS 38 "Intangible Assets" and IAS 40 "Investment Property" proposed in Appendix E (paragraph E7) appears unnecessary and potentially confusing. It appears to provide scope for ignoring the fair value (at the time of acquisition) of equity instruments provided as consideration (or in part payment) for the acquisition of an asset. The lack of guidance on how to 'measure directly' the fair value of either goods or services supplied by non-employees was raised in response to Question 4, noting in particular that where there is no established market, there is no guidance. Further, where the presumption in paragraph 9 is rebutted, and the entity is required to value the transaction based on the fair value of the equity instruments granted, the requirements address only 'units of service', not goods.

Glossary /Definitions

The definitions proposed for some new terms appear overly restrictive. The amendments proposed for several current definitions are unnecessary and their reach is indeterminate. It is uncertain whether it is intended to continue the present practice permitting the co-existence of different definitions in various standards. Our concerns are identified in the following table.

Term	Comments
cash-settled share-based payment transaction equity-settled share-based payment transaction *(Comments apply to both)*	The meaning of 'transaction' is unclear, since it is uncertain when the transaction takes place. In the draft IFRS, it appears to refer variously to: 1. the date on which the executory contract comes into existence (and not required to be recorded) (for example, paragraph 11) 2. the period during which employee services are received (for example, paragraph 4) 3. the reporting date at the end of the period (paragraph 34); 4. the date when the employee receives, in return for the services provided, the rights and entitlements due (for example, paragraphs 13 & 33)

Term	Comments
Fair Value	We strongly recommend the removal of the proposed addition of 'equity instrument granted' to this definition, because the proposed addition: • is unsuitable for inclusion in a generic definition (with such wide use as this) since its relevance is limited to this IFRS and it appears to import a restriction on the timing of valuation • by qualifying 'equity instrument' with 'granted', appears to fix the timing of value to the date of grant and thus preclude referring to its fair value at any other time • is internally inconsistent because, for assets and liabilities that could be exchanged, it is presumed the fair value relates to the date of exchange, whereas the exchange of the rights, benefits and entitlements in an equity instrument granted only occurs at grant date if vesting simultaneously • appears to rank this subset of the third major element of a balance sheet on a par with the two other elements (assets and liabilities) and thereby implies the independent, rather than residual, valuation of equity • refers to only a subset of equity instruments and by definition includes conditional rights that are not subject to the same recognition criteria as assets and liabilities and that, arguably, do not comply with the definition of equity instrument • is ineffectual, because an equity instrument granted that is not vested cannot be exchanged, not even hypothetically, as the holder of such an instrument cannot transfer rights that do not exist at the date of grant (particularly when the rights to equity interest depend on the future services of the holder) • is unnecessary in respect of this IFRS, since the concept of fair value can be applied to equity instruments issued by the entity, since they can be assets of the other party (employees). FASB did not consider it necessary to redefine 'fair value' in order to apply that concept to equity instruments of the reporting entity (see SFAS 123, Appendix E, definition of fair value)
grant date	It is unnecessarily restrictive to require agreement between the entity and 'another party'; it would be sufficient to refer to the date when the terms of the grant are decided. If that decision involves both parties, then it will include the situation currently described in the definition. In the case where a Board of Directors decides to (unilaterally) grant some shares to the CEO, it would appear unnecessary to require the date to be delayed until the CEO "agreed" to accept the grant.
share option	These are defined in such a way that the existence of an exercise price is integral. This means that some equity instruments, such as performance rights, are not included in this classification and do not appear to be specifically included in the proposals.

Implementation Guidance

As explained in relation to Question 16, we believe that the Implementation Guidance should be stated to be an integral part of the proposed IFRS or that the guidance (and numeric illustration) contained therein should be located in an Appendix that is an integral part of the IFRS. It is inconsistent and inconvenient to have one numeric example located at the end of the Implementation Guidance and not in the Appendices where the other illustrations appear.