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10 April 2003

Sir David Tweedie
Chair of the International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

RE: *Exposure Draft ED 2 – Shared-Based Payment*

ATTACHMENT I
ATTACHMENT II

Dear Sir David:

The Global Financial Reporting Advocacy Committee (GFRAC) of the Association for Investment Management and Research (AIMR)[1] is pleased to respond to the International Accounting Standards Board (IASB) *Exposure Draft ED 2 – Shared-Based Payment.*

The GFRAC is a standing committee of AIMR charged with representing the views of investors to and maintaining a liaison with bodies that set financial accounting and reporting standards in a global context, particularly the IASB. The committee is also charged with responding to requests for comment from national standard setters and regulators on international financial reporting issues. The composition of the Committee represents AIMR members from Asia, Europe, and North America with varying professional backgrounds and expertise in the investment industry.

General Comments

The GFRAC commends the Board on its decision to address this current gap (or lack of an accounting standard for share-based payments) in the International Accounting Standards. We strongly believe (and thus, support the Board's proposal) that share-based payments, or stock options, are

(1) Financial instruments that can be measured reliably at fair value;

[1]With headquarters in Charlottesville, VA, and regional offices in Hong Kong and London, the Association for Investment Management and Research® is a non-profit professional organization of over 62,000 financial analysts, portfolio managers, and other investment professionals in 115 countries of which 55,800 are holders of the Chartered Financial Analyst® (CFA®) designation. AIMR's membership also includes 125 affiliated societies and chapters in 44 countries. AIMR is internationally renowned for its rigorous CFA curriculum and examination program, which has more than 102,300 candidates from 148 nations enrolled for the June 2003 exam.

(2) Compensation to the grantee of such options; and

(3) An operating expense of the grantor that should be recognized and reported in the income statement.

These positions are clearly aligned with the IASB Framework, in particular, *The Objective of Financial Statements* regarding the quality of information provided about an enterprise's financial position, performance, and changes in financial position –

> Paragraph 15 – *The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation….*
>
> Paragraph 17 – *Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future….*
>
> Paragraph 18 – *Information concerning changes in the financial position of an enterprise is useful in order to assess its investing, financing and operating activities during the period. This information is useful in providing the user with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows….*

A Long History of Debate

The discussion about the appropriate accounting treatment for employee stock options is not a new one. It has been deliberated and argued for more than three decades, starting with the U.S. Accounting Principles Board in the early 1970s. Contentious opposition to expensing stock options was most notable in the early 1990s when the Financial Accounting Standards Board (FASB) was developing Statement of Financial Accounting Standard No. 123, *Accounting for Stock Options,* (SFAS 123). The FASB faced considerable resistance and opposition from various industry and professional trade groups, and even the U.S. Congress. (Such opposition almost resulted in the FASB's demise.) Consequently, the FASB softened its original position by recommending instead of requiring that all employee stock options should be measured and recognized as compensation expense in the financial statements.

Unfortunately, this compromise resulted in a significant deviation from the FASB's conceptual framework. A framework established to –

- *To serve the public interest by providing a structure and direction to financial accounting and reporting* [which would be used]

- *To facilitate the provision of evenhanded financial and related information that is useful in assisting capital and other markets to function efficiently in allocating scarce resources in the economy.*

On 12 March 2003, the FASB, responding to requests from investors, financial analysts and other users of financial information, added a project to its agenda to improve the accounting and disclosures relating to stock-based compensation. Amongst other issues, the project on stock-based compensation will address whether to require that the cost of employee stock options be treated as an expense. The Board plans to start deliberating the key issues on this subject at future public meetings with a view to issuing an Exposure Draft later this year that could become effective in 2004.

We applaud and strongly support this action by the FASB. Our position mirrors that of the AIMR Financial Accounting Policy Committee (FAPC) stated in its comment letter[2] to the FASB –

> *"We believe that both objectives – improving U.S. reporting standards and promoting international convergence - are critically important steps toward improving the efficiency and effectiveness of global financial markets. Specifically, these will help to serve the needs of investors and other users for relevant, reliable, transparent, and comparable information. These needs should supersede other considerations and we believe them to be the intent of financial reporting rule-makers."*

Disclosures are No Substitute for Proper Accounting

We strongly believe that disclosures are no substitute for the proper accounting and reporting. ***All* transactions, including stock option grants for goods and services provided by outside vendors *and* employees of an enterprise, should be recognized in the primary financial statements.** Financial reporting and accounting standards should properly measure and report the economic substance of those transactions. In this particular situation, the accounting should reflect the transfer of the opportunity cost to the enterprise for those stock options (from grant date through exercise date), representing -

- The compensation expense and a corresponding obligation when the stock options are granted; and

- Adjustments to this obligation for changes in the value of those options until the options are exercised or expired.

[2] FAPC comment letter addressed the FASB's ED on *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, Accounting for Stock-based Compensation and Its Related Interpretations, and IASB Proposed IFRS, ED 2 Share-based Payments.* A copy of the letter provided as Attachment I to the GFRAC's letter.

The accounting and reporting over the life of the stock options should represent the opportunity cost to the enterprise, or the difference between cash received (or exercised price of the shares) and the current market value of the shares at the date the options are exercised. It is the capital that the enterprise opted to forego by issuing the shares to its employees at lower price than the prevailing market price of those shares.

Although U.S. generally accepted accounting principles (GAAP) require the disclosure of information and data about employee stock options in the notes to the financial statements, academic studies have shown that users of this information placed less emphasis on it than if reported in the primary financial statements. (Based on recent financial reporting debacles, it appears that preparers and auditors also place less emphasis on the quality of information provided in note disclosures.)

The limited use of stock option information (provided in note disclosures) was reflected in a survey conducted by AIMR in 2001[3]. The survey asked AIMR members - who are analysts and portfolio managers - nine questions, including the following –

> ***Do you use this information and data [about a company's share-based or stock option plans] in your evaluation of a firm's performance and determination of its value?***
>
> **66%** - *Use this information whether recognized in the income statement or disclosed in the notes to the financial statements or other sources.*
>
> **15%** - *Use this information only when it is recognized as compensation expense in the income statement.*
>
> **19%** - *Do not use this information*.

We believe that the response would be significantly different for less sophisticated users of financial information, i.e., the percentage would be much greater for the third category - *Do not use this information*.

Information and data provided in the notes to the financial statements are integral and important *supplements* to the information provided in the primary financial statements. Such disclosures enable users - investors and analysts - to fully understand and properly assess an enterprise's financial performance and condition. Therefore, adequate disclosures about stock option plans are quite necessary and important in formulating and making well-informed investment decisions.

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[3] The results of the 2001 AIMR survey is included as several attachments to the GFRAC's comment letter sent to the IASB on 8 April 2002 in regards to the G4+1 Position Paper on Share-based Payments. This letter is available on AIMR's web site at http://www.aimr.org/advocacy/02commltr/02sharebased.html. The results to the survey questions are provided in Attachment II to this letter.

Arguments Against Expensing Employee Stock Options

Many have argued throughout this three-decade debate that –

(1) Employee stock options are not compensation or a real cost.

(2) Stock options cannot be reliably measured.

(3) Recognition of an expense would cripple start-up industries which grant stock options in lieu of cash compensation.

(1) Not compensation or a real cost

The first argument, or fallacy, is that the issuance of employee stock options is not compensation because there is no effect on cash. We believe that this argument is without merit and is used less frequently today because it cannot be supported.

We believe that a transfer, or outflow, of an enterprise's resources does not have to occur in the form of an initial cash payment or a subsequent settlement in cash to be recognized and reported as an expense. Today, more and more business transactions, involving transfer of assets and assumption of liabilities, occur without the payment of cash. Barter exchanges of like-kind items and dissimilar items (e.g., stock for stock in business combinations and commercial real estate building for private residence, respectively) are common place, as well as the issuance of financial instruments, or stock options, in lieu of cash compensation.

Post-retirement benefit plans are another example of compensation that does not always result in an immediate cash outflows. Such plans represent future obligations to pay cash benefits or cover specific medical and life insurance needs of retirees. The once common "pay-as-you-go" accounting treatment was changed because it did not properly reflect the enterprise's current costs for such benefit plans.

An additional slant to this argument is that stock options have no value, or the intrinsic value is zero, at the date of grant. If such options have no value, why are key executives of enterprises willing to forego cash salaries and bonuses to obtain those options? In an extreme case, the CEO of a credit card firm received only stock options as remuneration for his time and service. Certainly, this executive believed he was being compensated with those stock options.

(2) Cannot be measured reliably

The argument that stock options cannot be reliably measured is based on a practical, rather than on a conceptual, basis. Since many opponents have conceded that such options are compensation, they argue that the fair value of options cannot be reliably measured. (Especially stock options granted by privately held enterprises.)

Option pricing models, such as Black-Scholes, use the characteristics of the underlying stock to value the option. The capability of these models is evident in the tremendous growth of option markets over the past 30 years. In today's global capital markets, securities that are more complex than employee stock options valued at trillions of dollars in aggregate are priced using such models and traded daily on those markets.

Clearly, market participants - both those who trade options contracts and those who compensate employees - must believe that the values determined by these pricing models are reliable. Those who argue that the pricing models are not reliable have failed to explain what basis they use for determining the value of the stock options granted.

Moreover, public companies in the U.S. have been providing fair value data for employee stock options within the notes to financial statements since 1995, or seven years now. Over those years, investors and analysts have used (thus, *relied* upon) this information in their assessments of enterprises' performance and financial condition. This assessment was used ultimately to make investments decisions about whether to purchase, sale, or hold investment positions in those enterprises.

(3) Recognition will cripple start-up industries

Another argument is that expensing stock options will create undue hardship on start-up companies and stifle entrepreneurial endeavors, such as high-tech firms. Most of these firms have limited access to cash so they must use shares of stock, another form of currency, to attract and retain key personnel. It is noted that a similar argument was used in the debate for determining the appropriate accounting treatment for business combinations in regards to the pooling of interests method. Notwithstanding, we believe the arguments to be specious.

We recognize the importance of maintaining vibrant economies that promote entrepreneurial ventures, such as high-tech or bio-tech firms. Such enterprises also benefit societies through important developments that improve people's lifestyles and quality of life. Expensing of stock options would only harm start-up enterprises if:

(1) *Stock options are an actual expense to these enterprises that has been previously unreported and*

(2) *Investors and analysts are misled into initially overstating these enterprises' values (i.e., undervaluing the effect that those stock options have on the value of these enterprises), and as a result*

(3) The market reacts accordingly by devaluing these enterprises' shares of stock because actual costs are dramatically higher than the previously reported costs.

If fewer start-up enterprises occur due to the improved transparency of stock option costs and the result is reallocation of capital to other investments with higher returns given the risks and rewards, than we believe that the economy (and society) would be better served.

We strongly believe that similar transactions - cash compensation versus share-based compensation - should be accounted for in a similar way. Both should be consistently measured at the fair value of resources transferred and recognized as incurred in the income statement accompanied by adequate disclosures explaining –

- The terms and conditions of the compensation,
- Valuation methods and key assumptions used to determine values, and
- Other relevant information and data needed to understand the economic significance of the transactions.

Accounting Treatment for Share-based Payments

The Committee's current position on how share-based payments are measured and recognized in the financial statements differs from the IASB's proposed ED. This position represents a modification to the previously stated position in our comment letter issued on 31 October 2000, responding to the G4+1 Special Report – Accounting for Share-based Payment. We answered the following question:

8. If you consider that grant date is the appropriate measurement date:

a. Should the transaction amount be subsequently adjusted if the number of options that actually vest is greater or less than originally expected (paragraph 5.20) and, if so, how would you reconcile this view with the conceptual framework, whereby equity instruments are not re-measured after issue (paragraphs 3.6-3.8)?

Yes, we believe that the transaction should be subsequently adjusted as the fair value of the contingent claim changes. Companies have an estimate of the value of an option when issued and are able to make ongoing adjustments to the value of the option as additional information becomes available. <u>In our view, the option becomes an equity instrument when issued on grant date because the owner of the contract may have the option to participate in the risks and rewards of being an owner of the company. Only if the firm was to settle using cash, cash equivalents, or another asset should the contract be recognized as a liability</u>.

Upon further deliberation about whether stock options are liability or equity items, we have concluded that the appropriate accounting for share-based payments, settled in cash or settled in equity shares, should be as follows:

(1) *At grant date* - the stock options or share-based payments should be measured at fair value using credible option pricing models and relevant market inputs.

(2) *Over the vesting period of the granted stock options –*
   - The fair value at grant date should be recognized as compensation expense.
   - A corresponding entry should be made to reflect the liability for this compensation.

(3) *Over the vesting period and through exercise date* - a valuation adjustment should be calculated and recognized for changes in market inputs as a financing charge or credit. (We believe that the enterprise uses its shares of stock rather than cash as a way to finance compensation expense.)

(4) *At exercise date* – the liability should be eliminated or settled when the shares of stock are issued, offset by any cash received from the grantees - consultants, vendors, or employees.

We realize that the current IASB Framework's definition of a liability does not support this accounting treatment for equity-settled share-based payments. However, we believe that -

(1) A definition of an item which results in different treatment of two transactions with identical economic effects indicates an inconsistency with the definition.

(2) Similar accounting for both cash-settled and equity-settled share-based payments would eliminate many of the nuances requiring special or different accounting treatment.

Comments to Specific Questions in the ED 2

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In summary, the GFRAC strongly supports the proposal to measure and recognize share-based payments at fair value on the date that the options are granted. However, we do not believe that different accounting treatment is necessary to properly record those options settled in cash versus those settled in shares of the company's stock. Moreover, share-based payments, or stock option, granted in exchange for services or goods are a liability to the company until exercise date and, therefore, any change in the fair value of those stock options should flow through the income statement.

Although we disagree with the Board's current proposal to account for equity settled share-based payments differently from cash settled share-based payments, we strongly support and concur with the overall thrust of the proposal to measure and recognize such payments as expenses in the income statement.

The Committee's responses to specific questions are provided below.

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

We concur with the proposed scope of the draft IFRS that no exemptions should be allowed. All share-based payments should be recognized in the financial statements. This is consistent with the overarching principle for a single method of accounting for transactions that are in substance economically similar.

Question 2
Paragraphs 4-6 of the draft IFRS propose requirements for the recognition of share-based payment transactions; including the recognition of an expense when the goods or services received or acquired are consumed.

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

We agree that an expense should be recognized when share-based payments or stock options are granted for goods and services received. However, we do not believe that separate or different accounting treatment is appropriate for similar transactions depending on the means for settlement – cash-settled versus equity-settled. As mentioned in our **General Comments** to this letter, only one method of accounting should be permitted for transactions that are economically the same.

We realize that our position, regarding equity-settled share-based payments would require a modification to the current IASB Framework's definition of liability and equity items. Therefore, for the interim (or until the Framework is revised and the IFRS amended), we <u>support</u> the Board's proposal because our primary objective is to recognize the share-based payments in the primary financial statements.

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?

We agree with the measurement principle proposed for equity-settled payment transactions given the current IASB Framework and our position for the accounting treatment of share-based payments provide in the **General Comments** to this letter.

Question 4
If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured directly, the draft IFRS proposes that fair value should be measured at the date when the entity obtains the goods or receives the services (paragraph 8).

Do you agree that this is the appropriate date at which to measure the fair value of the goods or services received? If not, at which date should the fair value of the goods or services received be measured? Why?

We agree that the goods and services should be measured at fair value. However, we find the current wording of paragraph 8 confusing regarding the dates for determining the fair value of the goods or services received whether directly or indirectly.

> *"If the fair value of the goods or services received is <u>measured directly</u>, fair value shall be measured at **the date the entity obtains** those goods or the counterparty renders service. If the fair value of the goods or services received is <u>measured indirectly</u>, by reference to the fair value of the equity instruments granted, fair value shall be measured at **grant date.** The fair value of the equity instruments granted measured at grant date is a surrogate measure of the fair value of the goods or services received."*

We believe that the goods and services should be measure at their fair value at the grant date of the stock options. For example, a firm enters into a forward contract to purchase $1,000 in oranges for 100 stock options. Subsequently, the value of the oranges increases to $1,050 at the date of delivery. We believe that the oranges should be valued at $1,050 and the gain of $50 would be associated with the forward contract to purchase the oranges. The options should be valued at $1,000 rather than $1,050 if the value of the underlying shares remains the same. However, we are not sure the current wording would result in the same answer.

The following entries illustrate how we believe the above example should be accounted for by the enterprise.

(1) Record gain on the forward contract to purchase oranges.

Forward contract asset	$ 50	
Gain on Forward contract		$ 50

(2) Record the delivery of oranges at current fair value of $1,050 and stock options at the current fair value of $10 X 100 or$1,000.

Inventory – oranges	$1,050	
Forward Contract – asset		$ 50
Stock options for settling forward contract		1,000

If the fair value of the underlying share of stock changes causing the value of the stock option to increase by $.15 or $10.15, than the following entry would be recorded at delivery.

(2a) Record the delivery of oranges reflecting the change in the fair value of the options.

Inventory – oranges	$1,050	
Financing charge - loss on stock options	15	
Forward Contract – asset		$ 50
Stock options for settling forward contract		1,015

Note: A gain would be recorded instead if the fair value of the share of stock changes causing the value of the stock option to decrease.

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?

We agree with the initial measurement date should be the grant date for those equity instruments granted for goods and services. (Please refer to our comments to Question 4.) Based on our position that all share-based payments should be accounted for similarly, we believe that the value of the options should be re-measured until exercise date.

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?

Generally, we agree that fair value of goods and services provided by outside vendors are more readily available and should be used for measuring the expense. However, we do not believe that a distinction should be made (valuing services) between transactions with employees and non-employees. Such a distinction could result in different accounting (measurement and recognition) for similar types of transactions. (Please refer to our illustrative example in response to ***Question 4***.)

Additionally, disclosures should be required explaining how the fair value was determined on either (1) the underlying goods and services or (2) the equity instrument. Also, other key assumptions should be disclosed, such as the valuation method or model and the market-based inputs used to determine the fair value.

***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?

Please refer to our response to ***Question 6***.

Our experiences indicate that the value of compensation is often determined separately, usually before the number of options is determined. Companies use this compensation amount to compute the number of options that will be granted, given the option's current fair value and the total compensation covered by those stock option grants. However, there may be situations when the option is granted at a lower value than its current fair value. In those situations, we believe that a loss would be recognized at grant date similar to our illustrative example (entry 2a) in response to ***Question 4***.

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

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

We agree with the presumption that the services provided by the counterparty in exchange for stock options are received during the vesting period.

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 to you propose?

We agree with the Board's proposal requiring the determination of the unit of service when the equity instrument is used as the surrogate fair value measure for the services received. This information is useful in evaluating and understanding fluctuations in compensation expense related to stock options. Also, we concur with the proposed method for calculating the unit of service.

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

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

As mentioned in the **General Comments** of our letter, we do not believe that there should be a distinction made between cash-settled and equity-settled share-based payments. Both forms of settlements result in a similar economic outcome – an expense during the vesting period and an obligation to the enterprise at grant date through exercise date. Therefore, we believe the corresponding increase would be a liability rather than an increase in equity. Additionally, this liability should be re-measured at fair value, including adjustments for non-vesting and expired options, for each reporting period.

Again, we realize that this accounting treatment (recording an equity-settled share-based payment as a liability) would be inconsistent with the current IASB Framework. Nonetheless, we firmly believe this is the appropriate treatment for these types of transactions. <u>However, we urge the Board to continue with the Standard as proposed, presuming that this issue (liability vs. equity) will be addressed and resolved in the near future.</u>

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 granted (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 of impracticable to take into account any of the factors listed above in applying an option pricing model?

We agree with the proposal requiring the use of an option pricing model (one that has been tested and proven, e.g., Black-Scholes) and the following factors:

- *the exercise price of the option,*
- *the expected 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*

The above factors, along with a sensitivity analysis, need to be disclosed in the notes to the financial statements. (Please refer to our comments to ***Question 21***.) We are encouraged by the initiative that a few companies have taken to provide sensitivity disclosures, e.g., the effect resulting from a change in the expected volatility assumption.

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?

Generally, we agree that the expected life of the option should be used for determining the fair value. For further elaboration, please refer to our comments to ***Question 16***.

Question 13

If a grant of shares or options is conditional upon satisfying specified vesting conditions, the draft IFRS proposes that these conditions should be taken into account when an entity measures the fair value of the shares or options granted. In the case of options, vesting conditions should be taken into account either by incorporating them into the application of an option pricing model or by making an appropriate adjustment to the value produced by such a model (paragraph 24).

Do you agree that vesting conditions should be taken into account when estimating the fair value of options or shares granted? If not, why not? Do you have any suggestions for how vesting conditions should be taken into account when estimating the fair value of shares or options granted?

We concur with the draft IFRS proposal that vesting conditions should be taken into account. Such consideration is consistent with valuation methods used for post-retirement benefits that have vesting conditions. Vesting conditions also have an effect on the benefits and risks (economic or fair value of the options) and therefore, should be incorporated into any valuation model used. We prefer consideration within the valuation method rather than in post-computation adjustments because such adjustments are not often explained adequately. Nonetheless, if the amount of an adjustment can be subsequently measured, we question why it cannot be estimated and incorporated into the valuation model.

Additionally, any assumptions relating to inputs of the valuation model should be disclosed, including a comparison between the assumed and actual options vested over the vesting period of the options.

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?

Generally, we do not support an alternative approach that would result in different measurement and timing of recognition for similar transactions. If it is *truly* impracticable to include the effect of reload options at initial measurement or grant date, than we believe that the proposal is reasonable. However, we believe it unlikely that enterprises would grant compensation for which they cannot reliably measure the value, including the effect of reload features.

In addition, disclosures should be required, indicating –

- How the reload feature is handled in the measurement - either in the initial measurement at grant date or as a new option when the reload option is granted – and why the particular treatment was selected; and

- The amount relating to the reload feature.

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 agree with the common features noted in paragraphs 21-25, including:

- *Expected life of the option for non-transferable options;*

- *Contractual life of the option for transferable options;*

- *Vesting conditions and/or restrictions;*

- *Expected dividends on the underlying shares of stock if the counterparty is not entitled to receive dividends; and*

- *Reload features.*

We have identified the following features and/or related issues to stock option grants which should be addressed in the final IFRS:

- Share repurchase agreements that the enterprise enters to repurchase a certain number of shares upon or soon after the stock options are exercised;
- Acceleration clauses in the compensation agreement pertaining to vesting periods;
- Loans issued to cover the exercise price of the stock options; and
- Guarantees to cover taxes resulting from the issuance of stock options.

Certainly, there will be other features or issues that arise over time. To cover additional new features in the future, the final IFRS should indicate that *all features of the options which may affect the fair value of the share-based payment should be considered in the measurement model and adequate disclosure should be required to explain these features and the effect they have the value of the share-based payment*.

Question 16
The draft IFRS does not contain prescriptive guidance on the estimation of the fair value of options, consistently with the Board's objective of setting principles-based standards and to allow for future developments in valuation methodologies.

Do you agree with this approach? Are there specific aspects of valuing options for which such guidance should be given?

We agree with the proposed approach which does not outline a prescriptive method for estimating the fair value of options. Flexibility is needed in the models to adjust to any future changes in option features and improvements in the method used to measure the stock option's value. However, such flexibility requires more discipline in the information and data provided to users. The disclosure must outline clearly and consistently the valuation methods and market-based inputs used to determine the fair value measurements.

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 requested. This means that the entity is required to recognize additional amounts for services received during the remainder of the vesting period, i.e. additional to the amounts recognized in respect of the original option grant.

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 granted should be considered, but do not agree with the alternative approach illustrated, whereby the two grants are averaged and spread over the remainder of the vesting period. The proposal shows an incremental benefit that is recognized subsequent to the grant date, indicating that the services were received at or over a different period of time compared to the initial grant date. This approach better reflects the timing of the benefit than the alternative "averaging" which results in an allocation that cannot be supported.

Question 18

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

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

We believe that such requirements are necessary under the proposed accounting treatment for equity-settled share-based payments However, if such options were accounted for as a liability with the changes in fair value flowing through the income statement as a financing charge or credit, the current proposal would overstate the compensation expense.

Question 19

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

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

Yes. We agree that the liability should be revalued at each reporting date, with any adjustments to the fair value flowing through the income statement. This approach is consistent with our proposed accounting treatment for share-based payments in our **General Comments**.

Question 20
For share-based payment transactions in which either the entity of 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.

Under the current IASB Framework, we agree with the proposed requirements. However, this is another issue resulting from the distinction between cash-settled and equity-settled that would be eliminated if all share-based payments were accounted for in a similar manner - an expense during the vesting period and an obligation to the enterprise at grant date through exercise date, or until the options are exercised or expired.

Question 21
The draft IFRS proposes that an entity should disclose information to enable users of financial statements to understand:

- *(a) the nature and extent of share-based payment arrangements that existed during the period,*
- *(b) how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined, and*
- *(c) the effect of expenses arising from share-based payment transactions on the entity's profit or loss.*

Are these disclosure requirements appropriate? If not, which disclosure requirements do you suggest should be added, deleted or amended (and how)?

We strongly support the Board's disclosure principles listed above and supported by the disclosure requirements outlined in Paragraphs 45–53. Detailed disclosures that embody those principles completely are critical to fully understanding the potential effects of the share payments on the company's financial performance. In particular, Paragraph 46 requires essential information for analyzing the financial effect from share-based payments –

> 46. *To give effect to the principle in paragraph 45* [disclose information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period], *the entity shall disclose at least the following:*

(a) A description of each type of share-based payment arrangement that existed at any time during the period, including details of:

(i) Whether the rights granted by the entity to employees or other parties pursuant to the arrangement consisted of rights to shares, share options, other equity instruments, cash or other assets;

(ii) When those rights were granted;

(iii) Those to whom the rights were granted (e.g., a description of the number and class of employees participating in a group employee share plan);

(iv) The contractual life of options granted;

(v) Whether the exercise price is fixed or variable (and, if variable, how the exercise price is determined); and

(vi) A description of the vesting requirements, including service conditions and performance conditions.

(b) The number and weighted average exercise prices of options for each of the following groups of options:

(i) Outstanding at the beginning of the period;

(ii) Granted during the period;

(iii) Forfeited during the period;

(iv) Exercised during the period;

(v) Expired during the period;

(vi) Outstanding at the end of the period; and

(vii) Exercisable at the end of the period.

(c) For options exercised during the period, the weighted average share price at the date of exercise.

(d) For options outstanding at the end of the period, the range of exercise prices and weighted average remaining expected life and contractual life.

> *If the range of exercise prices is wide, the outstanding options shall be divided into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received upon exercise of those options.*

In addition to the disclosures proposed in paragraphs 45-53, we believe the following are necessary information:

- The *tax benefit* (either in the cash flow statement or the notes to the financial statements) and the *deferred tax* related to the share-based payments shown separately in the note detailing the tax information of the financial statements.
- The current market value of all outstanding options;
- A discussion about the vesting conditions should include the probability of those conditions being met;
- A sensitivity analysis of the effects of key valuation assumptions;
- A disclosure of the basis for adjusting historically observed input, for example, volatility.

Question 22

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

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

Except for share appreciation rights (SARs), we disagree with the proposed exception for the measuring equity instruments,. At transition or upon adoption of the final IFRS, we believe all equity instruments granted as share-based payments should be measured similarly to SARs. The reported value should reflect the settlement amount that would have been paid when the liability is settled had the counterparty demanded settlement at the date the liability is measured. This transition approach would account for and report similar financial items in the same way.

Question 23
The draft IFRS proposes a consequential amendment to IAS 12 (revised 2000) Income Taxes *to add an example to that standard illustrating how to account for the tax effects of share-based payment transactions. As shown in that example, it is proposed that all tax effects of share-based payment transactions should be recognized in the income statement.*

Are the proposed requirements appropriate?

We agree with the proposed requirements. In addition, the cash effects from share-based payments should be displayed separately on the statement of cash flows, including the amount received for exercised options as well as the tax benefit. Often, an argument is made that stock options have no cash impact. We believe this argument to be misguided, and that it persists, because information about the actual cash impact is not transparent to the user of financial statements.

Question 24
In developing the Exposure Draft, the Board considered how various issues are dealt with under the US standard SFAS 123 Accounting for Stock-Based Compensation, *as explained further in the Basis for Conclusions. Although the draft IFRS is similar to SFAS 123 in many respects, there are some differences. The main differences include the following.*

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

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

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

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

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

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

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

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

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

effects of share-based payment transactions should be recognized in profit or loss, as part of tax expense.

For each of the above differences, which treatment is the most appropriate? Why? If you regard neither treatment as appropriate, please provide details of your preferred treatment. (Respondents may wish to note that further details of the differences between the draft IFRS and SFAS 123 are given in the FASB's Invitation to Comment.)

Please refer to the comment letter filed by the AIMR Financial Accounting Policy Committee provided as **Attachment I** to this comment letter.

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

We recommend that the final IFRS include illustrative examples showing how to apply the principles outlined. These examples should illustrate how –

- To incorporate common features of share-based payments or stock options, using accepted valuation methods (Black-Scholes and binomial models).
- To provide adequate supporting explanatory discussions.

Closing Remarks

The GFRAC appreciates the opportunity to comment on the IASB's proposed standard for the accounting and reporting of share-based payments. In addition to our strong support for this proposal, we believe that the final Standard should be effective prior to the proposed timeframe for a stable platform. If you have any questions or require further elaboration of our views, please do not hesitate to contact Georgene Palacky at 1.434.951.5334 or georgene.palacky@aimr.org.

Sincerely,

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Chair, Global Financial Reporting Advocacy Committee

Robert Morgan, CFA
Subcommittee Chair, Share-based Payments

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Associate, Advocacy

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