Basis for Conclusions on
Exposure Draft

ED 2 SHARE-BASED PAYMENT

Comments to be received by 7 March 2003

This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in ED 2 *Share-based Payment* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **7 March 2003**.

All replies will be put on the public record unless confidentiality is requested by the commentator. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org.uk** or addressed to:

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ED 2 Share-based Payment

Basis for Conclusions

This Basis for Conclusions is not part of the Exposure Draft. It summarises the Board's considerations in reaching the conclusions in the Exposure Draft. Individual Board members gave greater weight to some factors than to others. Appendix A of the draft IFRS lists all defined terms.

REASONS FOR ISSUING THE EXPOSURE DRAFT

BC1 Entities often issue* shares or share options to pay employees or other parties. Share and share option plans are a common feature of employee pay, not only for directors and senior executives, but also for many other employees. Some entities issue shares or share options to pay suppliers, such as suppliers of professional services.

BC2 There is no International Financial Reporting Standard (IFRS) covering these transactions. Concerns have been raised about this gap in international standards. For example, the International Organization of Securities Commissions (IOSCO), in its 2000 report on international standards, stated that IASC (the IASB's predecessor body) should consider the accounting treatment of share-based payment.

BC3 Few countries have standards on the topic. This is of particular concern in Europe, where the use of share-based payment has increased in recent years and continues to spread. European standard-setting bodies have been working on this issue and some have recently published proposals. For example, the German Accounting Standards Committee published a draft accounting standard *Accounting for Share Option Plans and Similar Compensation Arrangements* in June 2001. The Danish Institute of State Authorised Public Accountants issued a Discussion Paper *The Accounting Treatment of Share-Based Payment* in April 2000. The UK Accounting Standards Board led the development of the Discussion Paper *Accounting for Share-based Payment*, published in July 2000 by IASC, the ASB and other G4+1 member bodies.*

BC4 Users of financial statements are calling for improvements in the accounting treatment of share-based payment. For example, the proposal in the IASC/G4+1 Discussion Paper, that share-based payment transactions should be recognised in the financial statements, resulting in an expense when the goods or services are consumed, received strong support from investors and other users of financial statements. The primary objective of financial statements is to provide high quality, transparent and comparable information to help users make economic decisions. The purpose of setting accounting standards is to ensure that, wherever possible, financial statements meet that objective. If the users of financial statements consider that improvements are required, this suggests that existing accounting guidance might not represent the best solution and that there are issues that need to be dealt with.

BC5 When national standard-setters have attempted to introduce new standards on accounting for share-based payment, a common concern of their constituents has been that entities in their country would be at a competitive disadvantage if the national standard-setter were to introduce changes in isolation from other standard-setting bodies. Their constituents have emphasised the need to deal with this topic at an international level. Responding to this concern, the IASB has a unique opportunity to provide leadership on accounting for share-based payment, by developing a high quality accounting standard that will provide a basis for international convergence of standards in this area of accounting.

BC6 The Board has therefore issued this Exposure Draft as part of its due process in developing a new IFRS on share-based payment.

SCOPE

BC7 Much of the controversy and complexity surrounding accounting for share-based payment relates to employee share options. However, the scope of the proposed IFRS is broader than that. It covers transactions in which shares or other equity instruments are granted to employees. It also covers transactions with parties other than employees, in which

* The word 'issue' is used in a broad sense. For example, a transfer of shares held in treasury (own shares held) to another party is regarded as an 'issue' of equity instruments. Some argue that if options or shares are granted with vesting conditions, they are not 'issued' until those vesting conditions have been satisfied. However, even if this argument is accepted, it does not change the Board's conclusions on the proposals in the draft IFRS, and therefore the word 'issue' is used broadly, to include situations in which equity instruments are conditionally transferred to the counterparty, subject to the satisfaction of specified vesting conditions.

* The G4+1 comprised members of the national accounting standard-setting bodies of Australia, Canada, New Zealand, the UK and the US, and IASC.

goods or services are received as consideration for the issue of shares, options or other equity instruments. The term 'goods' includes inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets. Lastly, the draft IFRS covers payments in cash (or other assets) that are 'share-based' because the amount of the payment is based on the price of the entity's shares or other equity instruments, eg cash share appreciation rights.

Employee share purchase plans

BC8 Typically, employee share purchase plans provide employees with an opportunity to buy a specific number of shares at a discounted price, ie at an amount that is less than the fair value of the shares. The employee's entitlement to discounted shares is usually conditional upon specific conditions being satisfied, such as remaining in the service of the entity for a specified period. Often a trust is set up to administer the plan, and employees may contribute a portion of their salary to the trust on an ongoing basis.

BC9 The issues that arise with respect to employee share purchase plans are:

(a) are these plans somehow so different from other employee share plans that a different accounting treatment is appropriate?

(b) even if the answer to the above question is 'no', are there circumstances, such as where the discount is very small, when it is appropriate to exempt employee share purchase plans from an accounting standard on share-based payment?

BC10 The Discussion Paper invited comments on the application of its proposals to employee share purchase plans. Some respondents argued that such plans should be exempt from an accounting standard on share-based payment. The reason usually given was that requiring the recognition of an expense in respect of these types of plans was perceived to be contrary to government policy to encourage employee share ownership. In contrast, other respondents saw no difference between employee share purchase plans and other employee share plans, and argued that the same accounting method should therefore apply. However, some suggested that there should be an exemption if the discount is small.

BC11 The Board concluded that, in principle, there is no reason to treat employee share purchase plans differently from other employee share plans (the issue of 'small' discounts is considered later). That governments in some countries have a policy of encouraging employee share ownership is not a valid reason for according these types of plans a different accounting treatment, because it is not the role of financial reporting to give favourable accounting treatment to particular transactions to encourage entities to enter into them. For example, governments might wish to encourage entities to provide pensions to their employees, to lessen the future burden on the state, but that does not mean that pension costs should be excluded from the financial statements. To do so would impair the quality of financial reporting. The purpose of financial reporting is to give information to users of financial statements, to assist them in making economic decisions. If expenses are omitted, profits are overstated and the financial statements are not neutral, are less transparent and comparable, and are potentially misleading to users.

BC12 There remains the question whether there should be an exemption for some plans, when the discount is small. For example, FASB Statement of Financial Accounting Standards No. 123 *Accounting for Stock-Based Compensation* contains an exemption for employee share purchase plans that meet specified criteria, of which one is that the discount is small.

BC13 On the one hand, it seems reasonable to exempt an employee share purchase plan if it has substantially no option features and the discount is small. In such situations, the rights given to the employees under the plan probably do not have a significant value, from the entity's perspective.

BC14 On the other hand, even if one accepts that an exemption is appropriate, specifying its scope is problematic, eg deciding what constitutes a 'small' discount. Some argue that a 5 per cent discount from the market price (as specified in SFAS 123) is too high, noting that a block of shares can be sold on the market at a price close to the current share price. Furthermore, it could be argued that it is unnecessary to exempt these plans from the standard. If the rights given to the employees do not have a significant value, this suggests that the amounts involved are immaterial. Because it is not necessary to include immaterial information in the financial statements, there is no need for a specific exclusion in an accounting standard.

BC15 For the reasons given in the preceding paragraph, the Board concluded that employee share purchase plans should not be exempted from the proposed IFRS.

Transfers of equity instruments to employees

BC16 In some situations, an entity might not issue shares or options to the employees (or other parties) direct. Instead, a shareholder (or shareholders) might transfer equity instruments to the employees (or other parties).

BC17 Under this arrangement, the entity has received services (or goods) that were paid for by its shareholders. The arrangement could be viewed as being, in substance, two transactions—one transaction in which the entity has reacquired equity instruments for nil consideration, and a second transaction in which the entity has received services (or goods) as consideration for equity instruments issued to the employees (or other parties).

BC18 The second transaction is a share-based payment transaction. Therefore, the Board concluded that the entity should account for transfers of equity instruments by shareholders to employees or other parties in the same way as other share-based payment transactions. The Board reached the same conclusion with respect to transfers of equity instruments of the entity's parent, or of another entity within the same group as the entity, to the entity's employees or other suppliers.

BC19 However, such a transfer is not a share-based payment transaction if the transfer of equity instruments to an employee or other party is clearly for a purpose other than payment for goods or services supplied to the entity. This would be the case, for example, if the transfer is to settle a shareholder's personal obligation to an employee that is unrelated to employment by the entity, or if the shareholder and employee are related and the transfer is a personal gift because of that relationship.

Transactions within the scope of IAS 22 [IFRS X] *Business Combinations*

BC20 An entity might acquire goods (or other non-financial assets) as part of the net assets acquired in a business combination for which the consideration paid included shares or other equity instruments issued by the entity. Because the acquisition of assets and issue of shares in

connection with a business combination are dealt with in IAS 22 [IFRS X], that is the more specific standard that should be applied to that transaction.

Contracts within the scope of IAS 32 (revised 200X) *Financial Instruments: Disclosure and Presentation* and IAS 39 (revised 200X) *Financial Instruments: Recognition and Measurement*

BC21 The draft IFRS includes consequential amendments to IAS 32 and IAS 39 to exclude from their scope transactions within the scope of the IFRS.

BC22 For example, suppose the entity enters into a contract to purchase gold, whereby it is required to pay cash to the counterparty in an amount equal to the value of 1,000 of the entity's shares at the date of delivery of the gold. The entity will acquire goods and pay cash at an amount based on its share price. This meets the definition of a share-based payment transaction and therefore is included within the scope of the draft IFRS on share-based payment. Moreover, because the contract is to purchase gold, which is a non-financial item, the contract is not within the scope of IAS 32 and IAS 39.

BC23 However, the scope of IAS 32 and IAS 39 includes contracts to buy non-financial items settled net in cash (ie where the entity does not take delivery of the underlying non-financial item but instead settles the contract net in cash). Those standards also cover contracts to buy non-financial items that are not settled net in cash but where the entity takes delivery of the underlying and sells it within a short period of time for the purpose of generating a profit from short-term fluctuations in price or dealer's margin (Exposure Draft of revised IAS 32, paragraphs 4A and 4B; Exposure Draft of revised IAS 39, paragraphs 6 and 7).

BC24 The Board concluded that these contracts should remain within the scope of IAS 32 and IAS 39 and they are therefore excluded from the scope of the draft IFRS.

RECOGNITION OF EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTIONS

BC25 The Board first considered conceptual arguments relating to the recognition of an expense arising from equity-settled share-based payment transactions, including arguments advanced by respondents to the Discussion Paper and other commentators. Other respondents who disagreed with the recognition of an expense arising from particular share-based payment transactions (those involving employee share options) did so for practical, rather than conceptual, reasons. The Board considered those practical issues later (see paragraphs BC278-BC294).

BC26 The Board focused its discussions on employee share options, because that is where most of the complexity and controversy lie, but the question whether expense recognition is appropriate is broader than that—it covers all transactions involving the issue of shares, options or other equity instruments to employees or suppliers of goods and services. For example, the Board noted that arguments made by respondents and other commentators against expense recognition are directed solely at employee share options. However, if conceptual arguments made against recognition of an expense in relation to employee share options are valid (eg that there is no cost to the entity), those arguments ought to apply equally to transactions involving other equity instruments (eg shares) and to equity instruments issued to other parties (eg suppliers of professional services).

BC27 The rationale for recognising all types of share-based payment transactions—irrespective of whether the equity instrument is a share or a share option, and irrespective of whether the equity instrument is granted to an employee or to some other party—is that the entity has engaged in a transaction that is in essence the same as any other issue of equity instruments. In other words, the entity has received resources (goods or services) as consideration for the issue of shares, options or other equity instruments. It should therefore account for the inflow of resources (goods or services) and the increase in equity. Subsequently, either at the time of receipt of the goods or services or at some later date, the entity should also account for the expense arising from the consumption of those resources.

BC28 This rationale is explained further below, in the course of the discussion of the following arguments commonly made against expense recognition:

(a) the transaction is between the shareholders and the employees, not the entity and the employees.

(b) the employees do not provide services for the options.

(c) there is no cost to the entity, because no cash or other assets are given up; the shareholders bear the cost, in the form of dilution of their ownership interests, not the entity.

(d) the recognition of an expense is inconsistent with the definition of an expense in the conceptual frameworks used by accounting standard-setters, including the IASB's *Framework for the Preparation and Presentation of Financial Statements*.

(e) the cost borne by the shareholders is recognised in the dilution of earnings per share (EPS); if the transaction is recognised in the entity's accounts, the resulting charge to the income statement would mean that EPS is 'hit twice'.

(f) requiring the recognition of a charge would have adverse economic consequences, because it would discourage entities from introducing or continuing employee share plans.

'The entity is not a party to the transaction'

BC29 Some argue that the effect of employee share plans is that the existing shareholders transfer some of their ownership interests to the employees and that the entity is not a party to this transaction.

BC30 The Board did not accept this argument. Entities, not shareholders, set up employee share plans and entities, not shareholders, issue options to their employees. Even if that were not the case, eg if shareholders transferred shares or options direct to the employees, this would not mean that the entity is not a party to the transaction. The equity instruments are issued in return for services rendered by the employees and the entity, not the shareholders, receives those services. Therefore, the Board concluded that the entity should account for the services received in return for the equity instruments issued. The Board noted that this is no different from other situations in which equity instruments are issued. For example, if an entity issues warrants for cash, the entity recognises the cash received in return for the warrants issued. Although the effect of an issue, and subsequent exercise, of warrants might be described as a transfer of ownership interests from the existing shareholders to the warrant holders, the entity nevertheless is a party to the transaction because it receives resources (cash) for the issue of warrants and further resources (cash) for the issue of shares upon exercise of the warrants. Similarly, with employee share options, the entity receives resources (employee services) for the issue of the options and further resources (cash) for the issue of shares on the exercise of options.

'The employees do not provide services'

BC31 Some who argue that the entity is not a party to the transaction counter the points made above with the argument that employees do not provide services for the options, because the employees are paid in cash (or other assets) for their services.

BC32 Again, the Board was not convinced by this argument. If it were true that employees do not provide services for their options, this would mean that entities are issuing valuable share options and getting nothing in return. Employees do not pay cash for the options they receive. Hence, if they do not provide services for the options, the employees are providing nothing in return. If this were true, by issuing such options the entity's directors would be in breach of their fiduciary duties to their shareholders.

BC33 Typically, shares or options granted to employees form one part of their pay package. For example, an employee might have a pay package consisting of a basic cash salary, company car, pension, healthcare benefits, and other benefits including shares and options. It is usually not possible to identify the services received in respect of individual components of that pay package, eg the services received in respect of healthcare benefits. But that does not mean that the employee does not provide services for those healthcare benefits. Rather, the employee provides services for the entire pay package.

BC34 In summary, shares, options or other equity instruments are granted to employees because they are employees. The equity instruments granted form a part of their total pay package, regardless of whether that represents a large part or a small part.

'There is no cost to the entity, therefore there is no expense'

BC35 Some argue that because share-based payments do not require the entity to sacrifice any cash or other assets, there is no cost to the entity, and therefore no expense should be recognised.

BC36 The Board regards this argument as unsound, because it overlooks that:

(a) every time an entity receives resources as consideration for the issue of equity instruments, there is no outflow of cash or other assets, and on every other occasion the resources received as consideration for the issue of equity instruments are recognised in the financial statements; and

(b) the expense arises from the consumption of those resources, not from an outflow of assets.

BC37 In other words, irrespective of whether one accepts that there is a cost to the entity, an accounting entry is required to recognise the resources received as consideration for the issue of equity instruments, just as it is on other occasions when equity instruments are issued. For example, where shares are issued for cash, an entry is required to recognise the cash received. If a non-monetary asset, such as plant and machinery, is received for those shares instead of cash, an entry is required to recognise the asset received. If the entity acquires another business or entity by issuing shares in a business combination, the entity recognises the net assets acquired.

BC38 The recognition of an expense arising out of such a transaction represents the consumption of resources received, ie the 'using up' of the resources received for the shares or options. In the case of the plant and machinery mentioned above, the asset would be depreciated over its expected life, resulting in the recognition of an expense each year. Eventually, the entire amount recognised for the resources received when the shares were issued would be recognised as an expense (including any residual value, which would form part of the gain or loss on disposal of the asset). Similarly, if another business or entity is acquired by an issue of shares, an expense is recognised when the assets acquired are consumed. For example, inventories acquired will be recognised as an expense when sold, even though no cash or other assets were disbursed to acquire those inventories.

BC39 The only difference in the case of employee services (or other services) received as consideration for the issue of shares or options is that usually the resources received are consumed immediately upon receipt. This means that an expense for the consumption of resources is recognised immediately, rather than over a period of time. The Board concluded that the timing of consumption does not change the principle; the financial statements should recognise the receipt and consumption of resources, even when consumption occurs at the same time as, or soon after, receipt. This point is discussed further in paragraphs BC40-BC48.

‘Expense recognition is inconsistent with the definition of an expense’

BC40 Some have questioned whether recognition of an expense arising from particular share-based payment transactions is consistent with accounting standard-setters’ conceptual frameworks, in particular, the *Framework*, which states:

> Expenses are decreases in economic benefits during the accounting period in the form of outflows or *depletions of assets* or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. (paragraph 70, emphasis added)

BC41 Some argue that if services are received in a share-based payment transaction, there is no transaction or event that meets the definition of an expense. They contend that there is no outflow of assets and that no liability is incurred. Furthermore, because services usually do not meet the criteria for recognition as an asset, it is argued that the consumption of those services does not represent a depletion of assets.

BC42 The *Framework* defines an asset and explains that the term ‘asset’ is not limited to resources that can be recognised as assets in the balance sheet (*Framework*, paragraphs 49 and 50). Although services to be received in the future might not meet the definition of an asset,* services are assets when received. These assets are usually consumed immediately. This is explained in FASB Statement of Financial Accounting Concepts No. 6 *Elements of Financial Statements*:

> Services provided by other entities, including personal services, cannot be stored and are received and used simultaneously. They can be assets of an entity only momentarily—as the entity receives and uses them—although their use may create or add value to other assets of the entity… (paragraph 31)

* eg because the entity might not have control over future services

BC43 This applies to all types of services, eg employee services, legal services and telephone services. It also applies irrespective of the form of payment. For example, if an entity purchases services for cash, the accounting entry is:

Dr Services received

Cr Cash paid

BC44 Sometimes, those services are consumed in the creation of a recognisable asset, such as inventories, in which case the debit for services received is capitalised as part of a recognised asset. But often the services do not create or form part of a recognisable asset, in which case the debit for services received is charged immediately to the income statement as an expense. The debit entry above (and the resulting expense) does not represent the cash outflow—that is what the credit entry was for. Nor does it represent some sort of balancing item, to make the accounts balance. The debit entry above represents the resources received, and the resulting expense represents the consumption of those resources.

BC45 The same analysis applies if the services are acquired with payment made in shares or options. The resulting expense represents the consumption of services, ie a depletion of assets.

BC46 To illustrate this point, suppose that an entity has two buildings, both with gas heating, and the entity issues shares to the gas supplier instead of paying cash. Suppose that, for one building, the gas is supplied through a pipeline, and so is consumed immediately upon receipt. Suppose that, for the other building, the gas is supplied in bottles, and is therefore consumed over a period of time. In both cases, the entity has received assets as consideration for the issue of equity instruments, and should therefore recognise the assets received, and a corresponding contribution to equity. If the assets are consumed immediately (the gas received through the pipeline), an expense is recognised immediately; if the assets are consumed later (the gas received in bottles), an expense is recognised later when the assets are consumed.

BC47 Therefore, the Board concluded that the recognition of an expense arising from share-based payment transactions is consistent with the definition of an expense in the *Framework*.

BC48 The FASB considered the same issue and reached the same conclusion in SFAS 123:

Some respondents pointed out that the definition of expenses in FASB Concepts Statement No. 6, *Elements of Financial Statements*, says that expenses result from outflows or using up of assets or incurring of liabilities (or both). They asserted that because the issuance of stock options does not result in the incurrence of a liability, no expense should be recognised. The Board agrees that employee stock options are not a liability—like stock purchase warrants, employee stock options are equity instruments of the issuer. However, equity instruments, including employee stock options, are valuable financial instruments and thus are issued for valuable consideration, which…for employee stock options is employee services. Using in the entity's operations the benefits embodied in the asset received results in an expense… (Concepts Statement 6, paragraph 81, footnote 43, notes that, in concept most expenses decrease assets. However, if receipt of an asset, such as services, and its use occur virtually simultaneously, the asset often is not recorded.) [paragraph 88]

'Earnings per share is "hit twice"'

BC49 Some argue that any cost arising from share-based payment transactions is already recognised in the dilution of earnings per share (EPS). If an expense were recognised in the income statement, EPS would be 'hit twice'.

BC50 However, the Board noted that this result is appropriate. For example, if the entity paid the employees in cash for their services and the cash was then returned to the entity, as consideration for the issue of options, the effect on EPS would be the same as issuing those options direct to the employees.

BC51 The dual effect on EPS simply reflects the two economic events that have occurred: the entity has issued shares or options, thereby increasing the number of shares included in the EPS calculation—although, in the case of options, only to the extent that the options are regarded as dilutive—and it has also consumed the resources it received for those options, thereby decreasing earnings. This is illustrated by the plant and machinery example mentioned in paragraphs BC37 and BC38. Issuing shares affects the number of shares in the EPS calculation, and the consumption (depreciation) of the asset affects earnings.

BC52 In summary, the Board concluded that the dual effect on diluted EPS is not double-counting the effects of a share or option grant—the same effect is not counted twice. Rather, two different effects are each counted once.

'Adverse economic consequences'

BC53 Some argue that to require recognition (or greater recognition) of employee share-based payment would have adverse economic consequences, in that it might discourage entities from introducing or continuing employee share plans.

BC54 Others argue that if the introduction of accounting changes did lead to a reduction in the use of employee share plans, it might be because the requirement for entities to account properly for employee share plans had revealed the economic consequences of such plans. They argue that this would correct the present economic distortion, whereby entities obtain and consume resources by issuing valuable shares or options without accounting for those transactions.

BC55 In any event, the Board noted that the role of accounting is to report transactions and events in a neutral manner, not to give 'favourable' treatment to particular transactions to encourage entities to engage in those transactions. To do so would impair the quality of financial reporting. If expenses are omitted from the income statement, profits are overstated. The financial statements are less transparent. Comparability is impaired, given that expenses arising from employee share-based payment transactions vary from entity to entity, from sector to sector, and from year to year. More fundamentally, accountability is impaired, because the entities are not accounting for transactions they have entered into and the consequences of those transactions.

MEASUREMENT OF EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTIONS

BC56 To recognise equity-settled share-based payment transactions, it is necessary to decide how the transactions should be measured. The Board began by considering how to measure share-based payment transactions in principle. Later, it considered practical issues arising from the application of its preferred measurement approach. In terms of accounting principles, there are two basic questions:

(a) which measurement basis should be applied?

(b) when should that measurement basis be applied?

BC57 To answer these questions, the Board considered the accounting principles applying to equity transactions. The *Framework* states:

> Equity is the residual interest in the assets of the enterprise after deducting all of its liabilities…The amount at which equity is shown in the balance sheet is dependent upon the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise… (paragraphs 49 and 67)

BC58 The accounting equation that corresponds to this definition of equity is:

assets minus liabilities equals equity

BC59 Equity is a residual interest, dependent on the measurement of assets and liabilities. Therefore, accounting focuses on recording changes in the left side of the equation (assets minus liabilities, or net assets), rather than the right side. Changes in equity arise from changes in net assets. For example, if an entity issues shares for cash, it recognises the cash received and a corresponding increase in equity. Subsequent changes in the market price of the shares do not affect the entity's net assets and therefore those changes in value are not recognised.

BC60 Hence, the Board concluded that, when accounting for an equity-settled share-based payment transaction, the primary accounting objective is to account for the goods or services received as consideration for the issue of equity instruments. Hence, equity-settled share-based payment transactions should be accounted for in the same way as other issues of equity instruments, by recognising the consideration received (the change in net assets), and a corresponding increase in equity.

BC61 Given this objective, the Board concluded that, in principle, the goods or services received should be measured at their fair value at the date when the entity obtains those goods or as the services are received. In other words, because a change in net assets occurs when the entity obtains the goods or as the services are received, the fair value of those goods or services at that date provides an appropriate measure of the change in net assets.

BC62 However, for many share-based payment transactions, particularly those involving employee services, it is usually difficult to measure directly the fair value of the services received. As noted earlier, typically shares or options are granted to employees as one component of their pay package. It is usually not possible to identify the services rendered in respect of individual components of that package. It might also not be possible to measure independently the fair value of the total package, without measuring directly the fair value of the equity instruments

granted. Furthermore, options or shares are sometimes granted as part of a bonus arrangement, rather than as a part of basic pay, eg as an incentive to the employees to remain in the entity's employ, or to reward them for their efforts in improving the entity's performance. By granting options, in addition to other remuneration, the entity is paying additional remuneration to obtain additional benefits. Estimating the fair value of those additional benefits is likely to be difficult.

BC63 Given these practical difficulties in measuring the fair value of the services received directly, the Board concluded that it is necessary to measure the other side of the transaction, ie the fair value of the equity instruments granted, as a surrogate measure of the fair value of the services (or goods) received. In this context, the Board considered the same basic questions, as mentioned above:

(a) which measurement basis should be applied?

(b) when should that measurement basis be applied?

Measurement basis

BC64 The Board discussed the following measurement bases, to decide which should be applied in principle:

(a) historical cost

(b) intrinsic value

(c) minimum value

(d) fair value.

Historical cost

BC65 In jurisdictions where legislation permits, entities commonly repurchase their own shares, either directly or through a vehicle such as a trust, which are used to fulfil promised grants of shares to employees or the exercise of employee options. A possible basis for measuring a grant of options or shares would be the historical cost (purchase price) of its own shares that an entity holds (own shares held), even if they were acquired before the award was made.

BC66 For options, this would entail comparing the historical cost of own shares held with the exercise price of options granted to employees. Any shortfall would be recognised as an expense. Also, presumably, if the exercise price exceeded the historical cost of own shares held, the excess would be recognised as a gain.

BC67 At first sight, if one simply focuses on the cash flows involved, the historical cost basis appears reasonable: there is a cash outflow to acquire the shares, followed by a cash inflow when those shares are transferred to the employees (the exercise price), with any shortfall representing a cost to the entity. If the cash flows related to anything other than the entity's own shares, this approach would be appropriate. For example, suppose ABC Ltd bought shares in another entity, XYZ Ltd, for a total cost of CU500,000,* and later sold the shares to employees for a total of CU400,000. The entity would recognise an expense for the CU100,000 shortfall.

BC68 But when this analysis is applied to the entity's own shares, the logic breaks down. The entity's own shares are not an asset of the entity.† Rather, the shares are an interest in the entity's assets. Hence, the distribution of cash to buy back shares is a return of capital to shareholders, and should therefore be recognised as a decrease in equity. Similarly, when the shares are subsequently reissued or transferred, the inflow of cash is an increase in shareholders' capital, and should therefore be recognised as an increase in equity. It follows that no revenue or expense should be recognised in the income statement. Just as the issue of shares does not represent revenue to the entity, the repurchase of those shares does not represent an expense.

BC69 Therefore, the Board concluded that historical cost is not an appropriate basis upon which to measure equity-settled share-based payment transactions.

* All monetary amounts in this Basis for Conclusions are denominated in 'currency units' (CU).

† The Discussion Paper discusses this point:

> Accounting practice in some jurisdictions may present own shares acquired as an asset, but they lack the essential feature of an asset—the ability to provide future economic benefits. The future economic benefits usually provided by an interest in shares are the right to receive dividends and the right to gain from an increase in value of the shares. When a company has an interest in its own shares, it will receive dividends on those shares only if it elects to pay them, and such dividends do not represent a gain to the company, as there is no change in net assets: the flow of funds is simply circular. Whilst it is true that a company that holds its own shares in treasury may sell them and receive a higher amount if their value has increased, a company is generally able to issue shares to third parties at (or near) the current market price. Although there may be legal, regulatory or administrative reasons why it is easier to sell shares that are held as treasury shares than it would be to issue new shares, such considerations do not seem to amount to a fundamental contrast between the two cases. (Footnote to paragraph 4.7)

Intrinsic value

BC70 An equity instrument could be measured at its intrinsic value. The intrinsic value of an option at any point in time is the difference between the market price of the underlying shares and the exercise price of the option.

BC71 Often, employee share options have zero intrinsic value at the date of grant—commonly the exercise price is at the market value of the shares at grant date. In many cases, therefore, valuing options at their intrinsic value at grant date is equivalent to attributing no value to the options.

BC72 However, the intrinsic value of an option does not fully reflect its value. Options sell in the market for more than their intrinsic value. This is because the holder of an option need not exercise it immediately and benefits from any increase in the value of the underlying shares. In other words, although the ultimate benefit realised by the option holder is the option's intrinsic value at the date of exercise, the option holder is able to realise that future intrinsic value because of having held the option. Thus, the option holder benefits from the right to participate in future gains from increases in the share price. In addition, the option holder benefits from the right to defer payment of the exercise price until the end of the option term. These benefits are commonly referred to as the option's 'time value'.

BC73 For many options, time value represents a substantial part of their value. As noted earlier, many employee options have zero intrinsic value at grant date, and hence the option's value consists entirely of time value. In such cases, ignoring time value by applying the intrinsic value method at grant date understates the value of the option by 100 per cent.

BC74 The Board concluded that the intrinsic value measurement basis is not appropriate for measuring share-based payment transactions, because omitting the option's time value ignores a potentially substantial part of an option's total value. Measuring share-based payment transactions at such an understated value would fail to represent those transactions faithfully in the financial statements.

Minimum value

BC75 An option could be measured at its minimum value. Minimum value is based on the premise that someone who wants to buy a call option on a share would be willing to pay at least (and the option writer would demand at least) the value of the right to defer payment of the exercise price until the end of the option's term. Therefore, minimum value can be calculated using a present value technique. For a dividend-paying share, the calculation is:

(a) the current price of the share, minus

(b) the present value of expected dividends on that share during the option term (if the option holder does not receive dividends), minus

(c) the present value of the exercise price.

BC76 Minimum value can also be calculated using an option pricing model with an expected volatility of effectively zero (not exactly zero, because option pricing models use volatility as a divisor, and zero cannot be a divisor).

BC77 The minimum value measurement basis captures part of the time value of options, being the value of the right to defer payment of the exercise price until the end of the option's term. It does not capture the effects of volatility. Option holders benefit from volatility because they have the right to participate in gains from increases in the share price during the option term without having to bear the full risk of loss from decreases in the share price. By ignoring volatility, the minimum value method produces a value that is lower, and often much lower, than values produced by methods designed to estimate the fair value of an option.

BC78 The Board concluded that minimum value is not an appropriate measurement basis, because ignoring the effects of volatility ignores a potentially large part of an option's value. As with intrinsic value, measuring share-based payment transactions at the option's minimum value would fail to represent those transactions faithfully in the financial statements.

Fair value

BC79 Fair value is already used in other areas of accounting, including other transactions in which non-cash resources are acquired through the issue of equity instruments. For example, a business acquisition is measured

at the fair value of the consideration given, including the fair value of any equity instruments issued by the entity.

BC80 Fair value, which is the amount at which an equity instrument granted could be exchanged between knowledgeable, willing parties in an arm's length transaction, captures both intrinsic value and time value and therefore provides a measure of the option's total value (unlike intrinsic value or minimum value). It is the value that reflects the bargain between the entity and its employees, whereby the entity has agreed to grant options to employees for their services to the entity. Hence, measuring share-based payment transactions at fair value ensures that those transactions are represented faithfully in the financial statements, and consistently with other transactions in which the entity receives resources as consideration for the issue of equity instruments.

BC81 Therefore, the Board concluded that shares, options or other equity instruments granted should be measured at their fair value.

Measurement date

BC82 The Board considered at which date the fair value of equity instruments should be determined for the purpose of measuring share-based payment transactions. The possible measurement dates discussed were grant date, service date, vesting date and exercise date. Much of this discussion was in the context of options rather than shares or other equity instruments, because only options have an exercise date.

BC83 In the context of an employee share option, grant date is when the entity and the employee enter into an agreement, whereby the employee is granted rights to the share option, provided that specified conditions are met, such as the employee's remaining in the entity's employ for a specified period. Service date is the date when the employee renders the services necessary to become unconditionally entitled to the option.* Vesting date is the date when the employee has satisfied all the conditions necessary to become entitled to the option. For example, if the employee is required to remain in the entity's employ for three years, vesting date is at the end of that three-year period. Exercise date is when the option is exercised.

* Service date measurement theoretically requires the entity to measure the fair value of the option at each date when services are received. For pragmatic reasons, an approximation would probably be used, such as the fair value of the option at the end of each accounting period, or the value of the option measured at regular intervals during each accounting period.

BC84 To help determine the appropriate measurement date, the Board applied the accounting concepts in the *Framework* to each side of the transaction. The Board concluded that grant date is the appropriate measurement date, as explained in paragraphs BC85-BC104. The Board also considered some other issues, as explained in paragraphs BC105-BC120.

The debit side of the transaction

BC85 Focusing on the debit side of the transaction means focusing on measuring the fair value of the resources received. This measurement objective is consistent with the primary objective of accounting for the goods or services received as consideration for the issue of equity instruments (see paragraphs BC59 and BC60). The Board therefore concluded that, in principle, the goods or services received should be measured at their fair value at the date when the entity obtains those goods or as the services are received.

BC86 However, if the fair value of the services received is not readily determinable, then a surrogate measure must be used, such as the fair value of the options or shares granted. This is the case for employee services.

BC87 If the fair value of the equity instruments granted is used as a surrogate measure of the fair value of the services received, both vesting date and exercise date measurement are inappropriate because the fair value of the services received during a particular accounting period is not affected by subsequent changes in the fair value of the equity instrument. For example, suppose that services are received during years 1-3 as the consideration for options that are exercised at the end of year 5. For services received in year 1, subsequent changes in the value of the option in years 2-5 are unrelated to, and have no effect on, the fair value of those services when received.

BC88 Service date measurement measures the fair value of the equity instrument at the same time as the services are received. This means that changes in the fair value of the equity instrument during the vesting period affect the amount attributed to the services received. Some argue that this is appropriate, because, in their view, there is a correlation between changes in the fair value of the equity instrument and the fair value of the services received. For example, they argue that if the fair value of an option falls, so does its incentive effects, which causes employees to reduce the level of services provided for that option, and/or

demand extra pay. Some argue that when the fair value of an option falls because of a general decline in share prices, pay levels also fall, and therefore service date measurement reflects this decline in pay levels.

BC89 The Board concluded, however, that there is unlikely to be a high correlation between changes in the fair value of an equity instrument and the fair value of the services received. For example, if the fair value of an option doubles, it is unlikely that the employees work twice as hard, or accept a reduction in the rest of their pay package. Similarly, even if a general rise in share prices is accompanied by a rise in pay levels, it is unlikely that there is a high correlation between the two. Furthermore, it is likely that any link between share prices and pay levels is not universally applicable to all industry sectors.

BC90 The Board concluded that, at grant date, it is reasonable to presume that the fair value of both sides of the contract are substantially the same, ie the fair value of the services expected to be received is substantially the same as the fair value of the equity instruments granted. This conclusion, together with the Board's conclusion that there is unlikely to be a high correlation between the fair value of the services received and the fair value of the equity instruments granted at later measurement dates, led the Board to conclude that grant date is the most appropriate measurement date for the purposes of providing a surrogate measure of the fair value of the services received.

The credit side of the transaction

BC91 Although focusing on the debit side of the transaction is consistent with the primary accounting objective, some approach the measurement date question from the perspective of the credit side of the transaction, ie the issue of an equity instrument. The Board therefore considered the matter from this perspective too.

Exercise date

BC92 Under exercise date measurement, the entity recognises the resources received (employee services) for the issue of share options, and also recognises changes in the fair value of the option until it is exercised or lapses. Thus, if the option is exercised, the transaction amount is ultimately 'trued up' to equal the gain made by the option holder on exercise of the option. However, if the option lapses at the end of the exercise period, any amounts previously recognised in the income statement are effectively reversed, hence the transaction amount is ultimately 'trued up' to equal zero. The Discussion Paper rejected exercise date measurement because it requires share options to be treated as liabilities, which is inconsistent with the definition of liabilities in the conceptual frameworks of the G4+1 member bodies. Exercise date measurement requires share options to be treated as liabilities because it requires the remeasurement of share options after initial recognition, which is inappropriate if the share options are equity instruments. The Discussion Paper concluded that a share option does not meet the definition of a liability, because it does not contain an obligation to transfer cash or other assets.

BC93 The definition of a liability in the *Framework* is as follows:

> A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. (paragraph 49)

BC94 Other conceptual frameworks issued by national standard-setters have similar, albeit not identical, definitions of liabilities. The Discussion Paper stated that although there are differences in the wording used to define liabilities in each framework/statement issued by the various G4+1 member bodies, the concepts are in essence the same.

BC95 However, as noted in the Discussion Paper,* some argue that those conceptual frameworks, such as the *Framework*, that define liabilities in terms of an obligation to transfer 'economic benefits', rather than in terms of an obligation to transfer 'assets', contain broader definitions of liabilities that encompass an obligation to issue an equity instrument.

BC96 It is unlikely that there was any intention to have a broader definition. The frameworks that refer to 'economic benefits' are based on the FASB's framework, which refers to 'assets'. As noted in paragraph BC94, the G4+1 regarded the various definitions as essentially the same.

BC97 The Board concluded that, under the *Framework*, an obligation to issue an equity instrument does not meet the definition of a liability, and therefore the Board agreed with the Discussion Paper's conclusion that a share option is not a liability.

* Footnote to paragraph 3.3

Vesting date, service date and grant date

BC98 The Discussion Paper supported vesting date measurement, and rejected grant date and service date measurement, because it concluded that the option is not issued until vesting date. It noted that the employees must perform their side of the arrangement by providing the necessary services and meeting any other performance criteria before the entity is obliged to perform its side of the arrangement. The provision of services by the employees is not merely a condition of the arrangement, it is the consideration they use to 'pay' for the option. Therefore, the Discussion Paper concluded, in economic terms the option is not issued until vesting date. Because the entity performs its side of the arrangement on vesting date, that is the appropriate measurement date.

BC99 The Discussion Paper also proposed recognising an accrual in equity during the vesting period to ensure that the services are recognised when they are received. It proposed that this accrual should be 'trued up' on vesting date to equal the fair value of the option at that date. This means that amounts credited to equity during the vesting period will be subsequently remeasured to reflect changes in the value of that equity interest before vesting date. That is inconsistent with the *Framework* because equity interests are not subsequently remeasured, ie any changes in their value are not recognised. The Discussion Paper justified this remeasurement by arguing that because the option is not issued until vesting date, the option is not being remeasured. The credit to equity during the vesting period is merely an interim measure that is used to recognise the partially completed transaction.

BC100 However, the Board noted that even if one accepts that the option is not issued until vesting date, this does not mean that there is no equity interest until then. If an equity interest exists before vesting date, that interest should not be remeasured. Moreover, the conversion of one type of equity interest into another should not, in itself, cause a change in total equity, because no change in net assets has occurred.

BC101 Some supporters of vesting date suggest that the accrual during the performance period meets the definition of a liability. However, the basis for this conclusion is unclear. The entity is not required to transfer cash or other assets to the employees. Its only commitment is to issue equity instruments.

BC102 The Board concluded that vesting date measurement is inconsistent with the *Framework*, because it requires the remeasurement of equity.

BC103 Service date measurement does not require remeasurement of equity interests after initial recognition. However, as explained earlier, the Board concluded that incorporating changes in the fair value of the option into the transaction amount is unlikely to produce an amount that fairly reflects the fair value of the services received, which is the primary objective.

BC104 The Board therefore concluded that, no matter which side of the transaction one focuses upon (the receipt of resources or the issue of an equity instrument), grant date is the appropriate measurement date under the *Framework*, because it does not require remeasurement of equity interests and it provides a reasonable surrogate measure of the fair value of the services received.

Other issues

IAS 32 *Financial Instruments: Disclosure and Presentation*

BC105 Although the Board concluded that an obligation to issue an equity instrument does not meet the definition of a liability under the *Framework*, it noted that IAS 32 contains an exception to this conclusion. IAS 32 (revised 2000) states:

> An enterprise may have a contractual obligation that it can settle either by payment of financial assets or by payment in the form of its own equity securities. In such a case, if the number of equity securities required to settle the obligation varies with changes in their fair value so that the total fair value of the equity securities paid always equals the amount of the contractual obligation, the holder of the obligation is not exposed to gain or loss from fluctuations in the price of its equity securities. Such an obligation should be accounted for as a financial liability of the enterprise. (paragraph 5)

BC106 In many cases, this exception is not relevant to share-based payment transactions. For example, employee share plans do not usually involve the issue of a variable number of options or shares to an agreed value.

BC107 However, there are situations in which the exception in IAS 32—and, in particular, the proposed amendments to IAS 32—would be relevant. The Exposure Draft of proposed amendments to IAS 32 states:

> A derivative contract (such as an option, warrant, or forward) shall be classified as an equity instrument of the entity if, and only if, the contract will be settled by the exchange of a fixed number of an entity's own equity instruments (other than derivatives) for a fixed monetary amount of cash or other financial assets…A derivative contract is not classified as an equity instrument of the entity solely because it may result in the receipt or delivery of an entity's own equity instruments or because the value of the derivative contract is determined on the basis of the value of an entity's own equity instruments… a derivative contract that requires settlement on a net basis in an entity's own equity instruments is a derivative asset or a derivative liability. Such contracts are not classified as equity instruments because they will not result in the receipt or delivery of a fixed number of an entity's own equity instruments in exchange for a fixed amount of cash or other financial assets at the maturity date. (Exposure Draft of revised IAS 32, paragraphs 29C and 29D)

BC108 In some cases, the number of options to which employees are entitled varies. For example, the number of options to which the employees will be entitled on vesting date might vary depending on whether, and to the extent that, a particular performance target is exceeded. Another example is share appreciation rights settled in shares. In this situation, a variable number of shares will be issued, equal in value to the appreciation of the entity's share price over a period of time.

BC109 Therefore, if the requirements of IAS 32 and the proposed amendments thereto were applied to equity-settled share-based payment transactions, in some situations an obligation to issue equity instruments would be classified as a liability. In such cases, final measurement of the transaction would be at a measurement date later than grant date.

BC110 In developing the Exposure Draft of the proposed amendments to IAS 32, the Board concluded that for derivatives that do not involve the receipt or delivery of a fixed number of equity instruments in exchange for a fixed amount of cash or other assets, the entity is exposed to changes in an underlying variable in a manner more similar to net-settled derivatives than equity instruments. The Board therefore concluded that such derivatives should be classified as liabilities.

BC111 The Board concluded that different considerations apply in developing a new IFRS on share-based payment. For example, drawing a distinction between fixed and variable option plans and requiring a later measurement date for variable option plans has undesirable consequences, as discussed in paragraphs BC253-BC258.

BC112 The Board concluded that the requirements in IAS 32, and the proposed amendments thereto, whereby some obligations to issue equity instruments are classified as liabilities, should not be applied in the IFRS on share-based payment. The Board recognises that this will create a difference between the IFRS and IAS 32. Before deciding whether and how that difference should be eliminated, the Board concluded that it is necessary to address this issue in a broader context, as part of a fundamental review of the definitions of liabilities and equity in the *Framework*, particularly as this is not the only debt/equity issue that has arisen in the share-based payment project, as explained below.

Suggestions to change the definitions of liabilities and equity

BC113 In concluding that grant date is the appropriate measurement date under the *Framework*, the Board noted that some support other measurement dates because they believe that the definitions of liabilities and equity in the *Framework* should be revised.

BC114 For example, some supporters of vesting date argue that receipt of employee services between grant date and vesting date creates an obligation on the entity to pay for those services, and that the method of settlement should not matter. In other words, it should not matter whether that obligation is settled in cash or in equity instruments—both ought to be treated as liabilities. Therefore, the definition of a liability should be modified so that all types of obligations, however settled, are included in liabilities. But it is not clear that this approach would necessarily result in vesting date measurement: a share option contains an obligation to issue shares, and hence if all types of obligations are included in liabilities, then a share option would be a liability, which would result in exercise date measurement.

BC115 Some support exercise date measurement on the grounds that it produces the same accounting result as 'economically similar' cash payments. For example, it is argued that share appreciation rights (SARs) settled in cash are substantially similar to SARs settled in shares, because in both cases the employee receives consideration to the same value. Also, if the SARs are settled in shares and the shares are immediately sold, the employee ends up in exactly the same position as under a cash-settled SAR, ie with cash equal to the appreciation in the entity's share price over the specified period. Similarly, some argue that share options and cash-settled SARs are economically similar. This is particularly true when the employee realises the gain on the exercise of options by selling the shares immediately after exercise, as commonly occurs. Either way, the employee ends up with an amount of cash that is based on the appreciation of the share price over a period of time. If cash-settled transactions and equity-settled transactions are economically similar, the accounting treatment should be the same.

BC116 However, it is not clear that changing the distinction between liabilities and equity to be consistent with exercise date measurement is the only way to achieve the same accounting treatment. For example, the distinction could be changed so that cash-settled employee share plans are measured at grant date, with the subsequent cash payment debited directly to equity, as a distribution to equity participants.

BC117 Others who support exercise date measurement do not regard option holders as part of the ownership group, and therefore believe that options should not be included in equity. Option holders, some argue, are only potential owners of the entity. But it is not clear whether this view is held generally, ie applied to all types of options. For example, some who support exercise date measurement for employee options do not necessarily advocate the same approach for options or warrants issued for cash in the market. However, any revision to the definitions of liabilities and equity in the *Framework* would affect the classification of all options and warrants issued by the entity.

BC118 Given that there is more than one suggestion to change the definitions of liabilities and equity, and these suggestions have not been fully explored, it is not clear exactly what changes to the definitions are being proposed.

BC119 Moreover, the Board concluded that these suggestions should not be considered in isolation, because changing the distinction between liabilities and equity affects all sorts of financial interests, not just those relating to employee share plans. All of the implications of any suggested changes should be explored in a broader project to review the definitions of liabilities and equity in the *Framework*. If such a review resulted in changes to the definitions, the Board would then consider whether the IFRS on share-based payment should be revised.

BC120 Therefore, after considering the issues discussed above, the Board confirmed its conclusion that grant date was the appropriate date at which to measure the fair value of the equity instruments granted for the purposes of providing a surrogate measure of the fair value of the services received.

BC121 The Board also considered whether an entity should disclose information on the income statement effects of the different measurement principles applying to equity-settled and cash-settled share-based payment transactions, as explained in paragraphs BC236 and BC237.

Share-based payment transactions with parties other than employees

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.

BC123 In many share-based payment transactions with parties other than employees, it is likely that it will be possible to measure reliably the fair value of the goods or services received. However, in some situations, it might not be straightforward. For example, suppose the entity enters into a contract with an advertising agency, whereby the agency is paid in cash at usual market rates, plus a bonus of a specified number of shares if, during the advertising campaign, the entity achieves specified sales targets or a specified increase in market share. In return for the shares, the entity expects to receive additional or enhanced services, over and above the services it receives for the cash payment. Placing a value on those additional or enhanced services is likely to be difficult. Therefore, in some situations it will be necessary to use the value of the shares or options granted as a surrogate measure of the value of the services.

BC124 Some measurement issues that arise in respect of share-based payment transactions with employees also arise in transactions with other parties. For example, there might be performance (vesting) conditions that must be met before the other party is entitled to the shares or options. Therefore, any conclusions reached on how to treat vesting conditions in the context of share-based payment transactions with employees also apply to transactions with other parties.

BC125 Similarly, performance by the other party might take place over a period of time, rather than on one specific date, which again raises the question of the appropriate measurement date.

BC126 SFAS 123 does not specify a measurement date for share-based payment transactions with parties other than employees, on the grounds that this is usually a minor issue in such transactions. However, the date at which to estimate the fair value of equity instruments issued to parties other than employees is specified in the US interpretation EITF 96-18 *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*:

> [The measurement date is] the earlier of the following:
>
> 1. The date at which a commitment for performance by the counterparty to earn the equity instruments is reached (a "performance commitment"), or
>
> 2 The date at which the counterparty's performance is complete. (extract from Issue 1, footnotes excluded)

BC127 The second of these two dates corresponds to vesting date, because vesting date is when the other party has satisfied all the conditions necessary to become unconditionally entitled to the options or shares. The first of the two dates does not necessarily correspond to grant date. For example, under an employee share plan, the employees are (usually) not committed to providing the necessary services, as they are usually able to leave at any time. Indeed, EITF 96-18 makes it clear that the fact that the equity instrument will be forfeited if the counterparty fails to perform is not sufficient evidence of a performance commitment (Issue 1, footnote 3). Therefore, in the context of share-based payment transactions with parties other than employees, if the other party is not committed to perform, there would be no performance commitment date, in which case the measurement date would be vesting date.

BC128 Accordingly, under SFAS 123 and EITF 96-18, the measurement date for share-based payment transactions with employees is grant date, but for transactions with other parties the measurement date could be vesting date, or some other date between grant date and vesting date. The Board concluded that this is not a desirable outcome, and that the same measurement basis and date applied in the context of share-based payment transactions with employees should also be applied in transactions with other parties.

FAIR VALUE OF EMPLOYEE SHARE OPTIONS

BC129 The Board spent much time discussing how to measure the fair value of employee share options. These discussions focused on measuring fair value at grant date, not only because the Board regarded grant date as the appropriate measurement date, but also because more measurement issues arise at grant date than at later measurement dates. In reaching its conclusions, the Board received assistance from the project's Advisory Group and from a panel of experts.

BC130 Market prices provide the best evidence of the fair value of options. However, options with terms and conditions similar to employee options are seldom traded in the markets. The Board therefore concluded that, if market prices are not available, it will be necessary to apply an option pricing model to estimate the fair value of options.

BC131 The Board decided that it is not necessary or appropriate to prescribe the precise formula or model to be used for option valuation. There is no particular option pricing model that is regarded as theoretically superior to the others, and there is the risk that any model specified might be superseded by improved methodologies in the future. In any event, there should be little difference between the results of the various models. Although the Black-Scholes model is the most well-known model, there does not seem to be any reason to specify that this model should be used rather than another. Entities should select whichever model is most appropriate in the circumstances, provided that the model selected takes into account the features of the options concerned, as discussed further below.

BC132 Option pricing models take into account the following option features:

- the exercise price of the option
- the current market price of the share
- the expected volatility of the share price
- the dividends expected to be paid on the shares
- the rate of interest available in the market
- the term of the option.

BC133 The first two items define the intrinsic value of an option; the remaining four are relevant to the option's time value. Expected volatility, dividends and interest rate are all based on expectations over the option term. Therefore, the option term is an important part of calculating time value, because it affects the other inputs.

BC134 One aspect of time value is the value of the right to participate in future gains, if any. The valuation does not attempt to predict what the future gain will be, only the amount that a buyer would pay at the valuation date to obtain the right to participate in any future gains. In other words, option pricing models estimate the value of the option at the measurement date, not the value of the underlying share at some future date.

BC135 The Board noted that some argue that any estimate of the fair value of an option is inherently uncertain, because it is not known what the ultimate outcome will be, eg whether the option will expire worthless or whether the employee (or other party) will make a large gain on exercise. However, the valuation objective is to measure the fair value of the rights granted, not to predict the outcome of having granted those rights. Hence, irrespective of whether the option expires worthless or the employee makes a large gain on exercise, that outcome does not mean that the grant date estimate of the fair value of the option was unreliable or wrong.

BC136 A similar analysis applies to the argument that options do not have any value until they are 'in the money', ie the share price is greater than the exercise price. This argument refers to the option's intrinsic value only. Options also have a time value, which is why options trade in the markets at prices greater than their intrinsic value. The option holder has a valuable right to participate in any future increases in the share price. So even 'at the money' options have a value when granted. The subsequent outcome of that option grant, even if it expires worthless, does not change the fact that the option had a value at grant date.

Application of option pricing models to unlisted and newly listed entities

BC137 As explained above, two of the inputs to an option pricing model are the entity's share price and the expected volatility of its share price. For an unlisted entity, there is no published share price information. The entity would therefore need to estimate the fair value of its shares (eg based on the share price of similar entities that are listed, or on a net assets or earnings basis). It would also need to estimate the expected volatility of that value.

BC138 The Board considered whether unlisted entities should be permitted to use the minimum value method instead of a fair value measurement method. The minimum value method is explained earlier, in paragraphs BC75-BC78. Because it excludes the effects of expected volatility, the minimum value method produces a value that is lower, often much lower, than that produced by methods designed to estimate the fair value of an option. Therefore, the Board discussed how an unlisted entity could estimate expected volatility.

BC139 An unlisted entity that regularly issues options or shares to employees (or other parties) might have an internal market for its shares. The volatility of the internal market share prices provides a basis for estimating expected volatility. Alternatively, an entity could use the historical or implied volatility of similar entities that are listed, and for which share price or option price information is available, as the basis for an estimate of expected volatility. This would be appropriate if the entity has estimated the value of its shares based on the share prices of these similar listed entities. If the entity has instead used another methodology to value its shares, the entity could derive an estimate of expected volatility consistent with that methodology. For example, the entity might value its shares on the basis of net asset values or earnings, in which case it could use the expected volatility of those net asset values or earnings as a basis for estimating expected share price volatility.

BC140 The Board acknowledged that these approaches for estimating the expected volatility of an unlisted entity's shares are subjective. However, the Board thought it likely that, in practice, the application of these approaches would result in underestimates of expected volatility, rather than overestimates, because entities were likely to exercise caution in making such estimates, to ensure that the resulting option values are not overstated. Therefore, estimating expected volatility is likely to produce a more reliable measure of the fair value of options granted by unlisted entities than an alternative valuation method, such as the minimum value method.

BC141 Newly listed entities would not need to estimate their share price. However, like unlisted entities, newly listed entities could have difficulties in estimating expected volatility when valuing share options,

because they might not have sufficient historical share price information upon which to base an estimate of expected volatility.

BC142 SFAS 123 requires such entities to consider the historical volatility of similar entities during a comparable period in their lives:

> For example, an entity that has been publicly traded for only one year that grants options with an average expected life of five years might consider the pattern and level of historical volatility of more mature entities in the same industry for the first six years the stock of those entities were publicly traded. (paragraph 285b)

BC143 The Board concluded that unlisted and newly listed entities should not be exempt from a requirement to apply fair value measurement and that the IFRS should include implementation guidance on estimating expected volatility for the purposes of applying an option pricing model to options granted by unlisted and newly listed entities.

Application of option pricing models to employee options

BC144 Option pricing models are widely used in, and accepted by, the financial markets. However, there are differences between employee options and traded options. The Board considered the valuation implications of these differences, with assistance from its Advisory Group and other experts, to determine what adjustments, if any, should be made to option pricing models (either to the inputs to the models themselves or to the values produced by such models) to estimate the fair value of employee share options. Employee options usually differ from traded options in the following ways, which are discussed further below:

(a) there is a vesting period, during which time the options are not exercisable;

(b) the options are non-transferable;

(c) there are conditions attached to vesting which, if not satisfied, cause the options to be forfeited; and

(d) the option term is significantly longer.

Inability to exercise during the vesting period

BC145 Typically, employee options have a vesting period, during which time the options cannot be exercised. For example, an option might be granted with a ten-year life and a vesting period of three years, so the option is not exercisable for the first three years and can then be exercised at any time during the remaining seven years. Employee options cannot be exercised during the vesting period because the employees must first 'pay' for the options, by providing the necessary services. Furthermore, there might be other specified periods during which an employee share option cannot be exercised (eg during a closed period).

BC146 In the finance literature, employee options are sometimes called Bermudan options, being partly European and partly American. An American option can be exercised at any time during the option's life, whereas a European option can be exercised only at the end of the option's life. An American option is more valuable than a European option, although the difference in value is not usually significant.

BC147 Therefore, other things being equal, an employee option would have a higher value than a European option and a lower value than an American option, but the difference between the three values is unlikely to be significant.

BC148 Anecdotal evidence suggests that many entities use the Black-Scholes model to estimate the value of employee share options (eg for the purposes of disclosures required by SFAS 123). That model values European options. Therefore, there is no need to adjust the Black-Scholes model for the inability to exercise an option in the vesting period (or any other period), because the model already assumes that the option cannot be exercised during that period.

BC149 There are other option pricing models that value American options, such as the binomial model, and the inability to exercise an option during the vesting period can be taken into account in applying such a model.

BC150 Although the inability to exercise the option during the vesting period does not, in itself, have a significant effect on the value of the option, there is still the question whether this restriction has an effect when combined with non-transferability. This is discussed in the following section.

BC151 The Board therefore concluded that:

(a) if the entity uses an option pricing model that values European options, such as the Black-Scholes model, no adjustment is required for the inability to exercise the options during the vesting period, because the model already assumes that they cannot be exercised during that period.

(b) if the entity uses an option pricing model that values American options, such as a binomial model, the application of the model should take account of the inability to exercise the options during the vesting period.

Non-transferability

BC152 From the option holder's perspective, the inability to transfer an option limits the opportunities available when the option has some time yet to run and the holder wishes either to terminate the exposure to future price changes or to liquidate the position. For example, the holder might believe that over the remaining term of the option the share price is more likely to decline than to increase. Also, employee option plans typically require employees to exercise vested options within a fixed period of time after the employee leaves the entity, or to forfeit the options.

BC153 In the case of a conventional option, the holder would sell the option rather than exercise it and then sell the shares. Selling the option enables the holder to receive the option's fair value, including both its intrinsic value and remaining time value, whereas exercising the option enables the holder to receive intrinsic value only.

BC154 However, the option holder is not able to sell a non-transferable option. Usually, the only possibility open to the option holder is to exercise it, which entails forgoing the remaining time value. (This is not always true. The use of other derivatives to, in effect, sell or gain protection from future changes in the value of the option is discussed later.)

BC155 At first sight, the inability to transfer the option could seem irrelevant from the entity's perspective, because the entity must issue shares at the exercise price upon exercise of the option, no matter who holds it. In other words, from the entity's perspective, its commitments under the contract are unaffected by whether the shares are issued to the original option holder or to someone else. Therefore, in valuing the entity's side of the contract, from the entity's perspective, non-transferability seems irrelevant.

BC156 However, the lack of transferability often results in early exercise of the option, because that is the only way for the employees to liquidate their position. Therefore, by imposing the restriction on transferability, the entity has caused the effective life of the option to be shorter than its contracted life. For example, one aspect of time value is the value of the right to defer payment of the exercise price until the end of the option term. If the option is exercised early because of non-transferability, the entity receives the exercise price much earlier than it otherwise would. Thus, the effective time value granted by the entity to the option holder is less than that indicated by the option's contracted life.

BC157 Recent accounting standards and proposed standards issued by other standard-setters address this issue by requiring the expected life of a non-transferable option to be used in valuing it, rather than the contractual option term. Expected life can be estimated either for the entire share option plan or for subgroups of employees participating in the plan. The estimate takes into account factors such as the length of the vesting period, the average length of time similar options have remained outstanding in the past and the expected volatility of the underlying shares.

BC158 Some employees can mitigate the effects of non-transferability, because they are able to 'sell' the options or protect themselves from future changes in the value of the options by selling or buying other derivatives. For example, the employee might be able to 'sell' an employee option by entering into an arrangement with an investment bank whereby the employee sells a similar call option to the bank, ie an option with the same exercise price and term. A zero-cost collar is one means of obtaining protection from changes in the value of an employee option, by selling a call option and buying a put option.

BC159 However, it appears that such arrangements are not always available. For example, the amounts involved have to be sufficiently large to make it worth while for the investment bank, which would probably exclude many employees (unless some sort of collective arrangement was made). Also, it appears that investment banks are unlikely to enter into such an arrangement unless the entity is a top listed company, with shares traded in a deep and active market, to enable the investment bank to hedge its own position.

BC160 It would not be feasible to stipulate in an accounting standard that an adjustment to take account of non-transferability is necessary only if the employees cannot mitigate the effects of non-transferability through the use of other derivatives. However, using expected life copes with both situations. If employees were able to mitigate the effects of non-transferability by using derivatives, this would often result in the employee options being exercised later than they otherwise would be. Therefore, the expected life of the option would be longer, and hence the estimated fair value of the option would be higher, which makes sense, given that non-transferability is not a constraint in this case. If the employees cannot mitigate the effects of non-transferability through the use of derivatives, they are likely to exercise the options much earlier than is optimal. In this case, expected life would be significantly shorter than contracted life, and hence using expected life rather than contracted life in the option pricing model would significantly reduce the estimated value of the option.

BC161 This still leaves the question whether there is any need for further adjustment for the combined effect of being unable to exercise or transfer the option during the vesting period. In other words, the inability to exercise an option does not, in itself, appear to have a significant effect on its value. But if the option cannot be transferred and cannot be exercised, and assuming that other derivatives are not available, the holder is unable to extract any value from the option or protect its value during the vesting period.

BC162 But it should be noted why these restrictions are in place: the employee has not yet 'paid' for the option. The holder of a traded option pays for that option up front, hence is immediately out of pocket and exposed to the risk of loss of the funds invested. An employee, at grant date, has contributed nothing for the option, so has nothing to lose. Moreover, because most employee options are granted 'at the money', there would usually be no point in exercising it immediately.

BC163 Of course, this situation will change during the vesting period. But, in any event, the value of the option at grant date already incorporates future possibilities, including the possibility that the option will be 'out of the money' by the time it becomes exercisable—and the possibility that it will be deeply 'in the money'.

BC164 Moreover, for accounting purposes, the question is the value of the option from the entity's perspective, not the employee's perspective. The entity is committed to issuing the shares at the exercise price, provided that the vesting conditions are satisfied and the exercise price is paid during the specified period. The effect of the vesting conditions is considered below. The effect of the option being non-exercisable during the vesting period has already been considered above, as has the effect of non-transferability. There does not seem to be any additional effect, from the entity's perspective, of the combination of non-exercisability and non-transferability during the vesting period. The combination does not cause the entity's commitments to be reduced in any way.

BC165 After considering all of the above points, the Board concluded that expected life rather than contracted life should be used in the option pricing model, to take account of the effect of non-transferability.

Vesting conditions

BC166 Employee options usually have vesting conditions. The most common condition is that the employee must remain in the entity's employ for a specified period, say three years. If the employee leaves during that period, the options are forfeited. There might also be other performance conditions, eg that the entity achieves a specified growth in share price or earnings.

BC167 Vesting conditions ensure that the employees provide the required services to 'pay' for their options. For example, the usual reason for imposing service conditions is to retain staff; the usual reason for imposing other performance conditions is to provide an incentive for the employees to work towards specified performance targets.

BC168 Some argue that the existence of vesting conditions does not necessarily imply that the value of employee options is significantly less than the value of traded options. The employees have to satisfy the vesting conditions to fulfil their side of the arrangement. In other words, the employees' performance of their side of the arrangement is what they do to 'pay' for their options. Employees do not pay for the options with cash, as do the holders of traded options; they 'pay' with their services. Having to 'pay' for the options does not make the options less valuable. On the contrary, it proves that the options are valuable.

BC169 Others argue that the possibility of forfeiture without compensation for part-performance suggests that the options are less valuable. The employees might partly perform their side of the arrangement, eg by working for part of the period, then have to leave for some

reason, and forfeit the options without compensation for that part performance. If there are other performance conditions, such as achieving a specified growth in the share price or earnings, the employees might work for the entire vesting period, but fail to meet the vesting conditions and therefore forfeit the options.

BC170 Similarly, some argue that the entity would take into account the possibility of forfeiture when entering into the agreement at grant date. In other words, in deciding how many options to grant in total, the entity would allow for expected forfeitures. Hence, if the objective is to estimate at grant date the fair value of the entity's commitments under the option agreement, that valuation should take into account that the entity's commitment to fulfil its side of the option agreement is conditional upon the vesting conditions being satisfied.

BC171 The Board concluded that the valuation of rights to options or shares granted to employees (or other parties) should take into account all types of vesting conditions, including both service conditions and performance conditions. In other words, the grant date valuation should be reduced to allow for the possibility of forfeiture due to failure to satisfy the vesting conditions.

BC172 Such a reduction might be achieved by adapting an option pricing model to incorporate vesting conditions. Alternatively, a more simplistic approach might be applied. One such approach is to estimate the possibility of forfeiture at grant date, and reduce the value produced by an option pricing model accordingly. For example, if the valuation calculated using an option pricing model was CU15, and the entity estimated that 20 per cent of the options would be forfeited because of failure to satisfy the vesting conditions, allowing for the possibility of forfeiture would reduce the grant date value of each option granted from CU15 to CU12.

BC173 The Board decided against proposing detailed guidance on how the grant date value should be adjusted to allow for the possibility of forfeiture. This is consistent with the Board's objective of setting principles-based standards. The measurement objective is to estimate fair value. That objective might not be achieved if detailed, prescriptive rules were specified, which would probably become outdated by future developments in valuation methodologies.

Option term

BC174 Employee share options often have a long contractual life, eg ten years. Traded options typically have short lives, often only a few months. Estimating the inputs required by an option pricing model, such as expected volatility, over long periods can be difficult, giving rise to the possibility of significant estimation error. This is not usually a problem with traded options, given their much shorter lives.

BC175 However, some options traded over the counter have long lives, such as ten or fifteen years. Option pricing models are used to value them. Therefore, contrary to the argument sometimes advanced, option pricing models can be (and are being) applied to long-lived options.

BC176 Moreover, the potential for estimation error is mitigated by the use of expected life rather than contracted life. Because employees often exercise their options relatively early in the option's life, expected life is usually much shorter than contracted life.

Other features of employee share option plans

BC177 Whilst the features discussed above are common to most employee share options, some might include other features. For example, some options have a reload feature. This entitles the employee to automatic grants of additional options whenever he/she exercises previously granted options and pays the exercise price in the entity's shares rather than in cash. Typically, the employee is granted a new option, called a reload option, for each share surrendered when exercising the previous option. The exercise price of the reload option is usually set at the market price of the shares on the date the reload option is granted.

BC178 When SFAS 123 was developed, the FASB concluded that, ideally, the value of the reload feature should be included in the valuation of the original option at grant date. However, at that time the FASB believed that it was not possible to do so. Accordingly, SFAS 123 does not require the reload feature to be included in the grant date valuation of the original option. Instead, reload options granted upon exercise of the original options are accounted for as a new option grant.

BC 179 However, recent academic research indicates that it is possible to value the reload feature at grant date, eg Saly, Jagannathan and Huddart (1999).* However, if significant uncertainties exist, such as the number and timing of expected grants of reload options, it might not be practicable to include the reload feature in the grant date valuation.

BC180 The Board therefore concluded that the reload feature should be taken into account, where practicable, when measuring the fair value of the options granted. However, if the reload feature was not taken into account, then at the date when the reload option is granted, it should be accounted for as a new option grant.

BC181 There may be other features of employee (and other) share options that the Board has not yet considered. But even if the Board were to consider every conceivable feature of employee (and other) share options that exist at present, new features might be developed in the future.

BC182 The Board therefore concluded that the proposed IFRS should focus on setting out clear principles to be applied to share-based payment transactions, not on prescribing extensive application guidance, which would be likely to become outdated.

BC183 Nevertheless, the Board considered whether there are options with such unusual or complex features that it is too difficult to make a reliable estimate of their fair value and, if so, what the accounting treatment should be.

BC184 SFAS 123 states that "it should be possible to reasonably estimate the fair value of most stock options and other equity instruments at the date they are granted" (paragraph 21). However, the standard also states that, "in unusual circumstances, the terms of the stock option or other equity instrument may make it virtually impossible to reasonably estimate the instrument's fair value at the date it is granted". The standard requires that, in such situations, measurement should be delayed until it is possible to estimate reasonably the instrument's fair value. It notes that this is likely to be the date at which the number of shares to which the employee is entitled and the exercise price are determinable. This could be vesting date. The standard requires that

* P J Saly, R Jagannathan and S J Huddart. 1999. Valuing the Reload Features of Executive Stock Options. *Accounting Horizons* 13 (3): 219-240.

estimates of compensation expense for earlier periods (ie until it is possible to estimate fair value) should be based on current intrinsic value.

BC185 Although it is common accounting practice, when significant measurement uncertainties exist, to delay measurement until those uncertainties are sufficiently resolved, this would bring the effects of changes in value of the equity instrument into the transaction amount, which is contrary to grant date measurement.

BC186 Possible approaches to this issue include:

(a) allowing an exception to the full fair value measurement basis in very rare cases.

(b) applying the SFAS 123 approach, ie delay measurement until it becomes possible to make a reasonable estimate of the instrument's fair value.

(c) permitting no exceptions to the grant date fair value measurement method. If an entity did not apply the requirements of the IFRS to particular options, it would have to explain its departure from the standard.

BC187 The Board rejected the first suggested approach. First, it would permit entities reluctant to apply a fair value measurement basis to claim that the options granted are simply 'too difficult' to measure. Second, given that the Board concluded that there should be no exceptions to the fair value measurement basis for unlisted or newly listed entities, it saw no reason to permit any exceptions for listed entities.

BC188 The Board did not adopt the SFAS 123 approach, because it would result in departures from the grant date measurement basis, and possibly lead to inconsistencies between entities.

BC189 The Board thought it extremely unlikely that entities could not reasonably determine the fair value of options at grant date. The options form part of the employee's pay package, and it seems reasonable to presume that an entity's management would consider the value of the options to satisfy itself that the employee's pay package is fair and reasonable.

BC190 Taking into account all of the above points, the Board concluded that there should be no exceptions to the requirement to apply a fair value measurement basis, and therefore it is not necessary to include in the

proposed IFRS specific accounting requirements for options that are difficult to value.

RECOGNITION AND MEASUREMENT OF SERVICES RECEIVED IN AN EQUITY-SETTLED SHARE-BASED PAYMENT TRANSACTION

BC191 In an equity-settled share-based payment transaction, the accounting objective is to recognise the goods or services received as consideration for the entity's equity instruments, measured at the fair value of those goods or services when received. For transactions in which the entity receives employee services, it is often difficult to measure directly the fair value of the services received. In this case, the Board concluded that the fair value of the equity instruments granted should be used as a surrogate measure of the fair value of the services received. This raises the question how to use that surrogate measure to derive an amount to attribute to the services received. Another related question is how the entity should determine when the services are received.

BC192 Starting with the latter question, some argue that shares or options are often granted to employees for past services rather than future services, or mostly for past services, irrespective of whether the employees are required to continue working for the entity for a specified future period before their rights to those shares or options vest. Conversely, some argue that shares or options granted provide a future incentive to the employees and those incentive effects continue after vesting date, which implies that the entity receives services from employees during a period that extends beyond vesting date. For options in particular, some argue that employees render services beyond vesting date, because employees are able to benefit from an option's time value between vesting date and exercise date only if they continue to work for the entity (since usually a departing employee must exercise the options within a short period, otherwise they are forfeited).

BC193 However, the Board concluded that if the employees are required to complete a specified service period to become entitled to the shares or options, this requirement provides the best evidence of when the employees render services in return for the shares or options. Consequently, the Board concluded that the entity should presume that the services are received during the vesting period. If the shares or options vest immediately, it should be presumed that the entity has already received the services, in the absence of evidence to the contrary. An example of when immediately vested shares or options are not for past services is when the employee concerned has only recently begun working for the entity, and the shares or options are granted as a ‘signing bonus’. But in this situation, it might nevertheless be necessary to recognise an expense immediately, if the future employee services do not meet the definition of an asset.

BC194 Returning to the first question in paragraph BC191, the Board developed an approach whereby the fair value of the shares or options granted, measured at grant date and allowing for all vesting conditions, is divided by the number of units of service expected to be received to determine the deemed fair value of each unit of service subsequently received. In developing this approach, the Board considered and rejected an alternative approach, whereby the fair value of the shares/options granted is divided by the maximum number of units of service that could be received during the vesting period. Under the alternative approach, the transaction amount never exceeds the grant date fair value of the options/shares granted.

BC195 For example, suppose that the fair value of options granted, before taking into account the possibility of forfeiture, is CU750,000. Suppose that the entity estimates the possibility of forfeiture due to failure of the employees to complete the required three-year period of service is 20 per cent (based on a weighted average probability), and hence it estimates the fair value of the options granted at CU600,000 (CU750,000 × 80%). The entity expects to receive 1,350 units of service over the three-year vesting period, and the maximum number of units of service (ie if all employees completed the required three years of service) is 1,500.

BC196 Under the Board’s approach, the deemed fair value per unit of service subsequently received is CU444.44 (CU600,000/1,350). If everything turns out as expected, the amount recognised for services received is CU600,000 (CU444.44 × 1,350). Under the alternative approach, the deemed fair value per unit of service subsequently received is CU400 (CU600,000/1,500). If everything turns out as expected, the amount recognised for services received is CU540,000 (CU400 × 1,350).

BC197 The Board’s approach is based on the presumption that there is a fairly bargained contract at grant date. Thus the entity has granted options valued at CU600,000 and expects to receive services valued at CU600,000 in return. It does not expect all options granted to vest

because it does not expect all employees to complete three years’ service. Expectations of forfeiture due to employee departures are taken into account when estimating the fair value of the options granted. The Board concluded that it would be inconsistent to take into account expected employee departures when determining the fair value of the options granted but ignore expected employee departures when determining the fair value of the services to be received in return.

BC198 An argument for the alternative approach is that the possibility of forfeiture exists at grant date, and this fact is unaffected by what happens in the future. Even if no employees leave, and all options vest, those options were still worth less at grant date because of the possibility of forfeiture. Therefore, it is appropriate that the fair value of the options granted (CU600,000) is the upper limit of the transaction amount, which is reached only if no employees leave.

BC199 However, the Board noted that the reason why there is a possibility of forfeiture is that employees might not complete the required period of service. If employees leave, the options are forfeited and the entity does not receive further services from those employees. In other words, 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.* Therefore, the Board concluded that expected departures should be taken into account when determining the fair value of both sides of the bargain made at grant date.

BC200 Under the Board’s approach, the amount recognised for services received during the vesting period might exceed CU600,000, if the entity receives more services than expected. This is because the objective is to account for the services subsequently received, not the fair value of the options granted. In other words, the Board’s approach does not entail estimating the fair value of the options granted and then spreading that amount over the vesting period. Rather, the objective is to account for the services subsequently received, because it is the receipt of those services that causes a change in net assets and hence a change in equity. Because of the practical difficulty of valuing those services directly, the fair value of the options granted is used as a

* The effects on each side of the transaction are not identical. In the example, expected departures mean that the entity expects 80% of the options to vest and 90% of the maximum possible quantity of services to be received. This is because the entity expects departing employees to complete, on average, half of the required service period before leaving. Nevertheless, it is the same event that affects both sides of the transaction.

surrogate measure to determine the fair value of each unit of service subsequently received, and therefore the transaction amount is dependent upon the number of units of service actually received. If more are received than expected, the transaction amount will be greater than CU600,000. If fewer services are received, the transaction amount will be less than CU600,000.

BC201 Hence, a grant date measurement method is used as a practical expedient to achieve the accounting objective, which is to account for the services actually received in the vesting period. The Board noted that many who support grant date measurement do so for reasons that focus on the entity's commitments under the contract, not the services received. They take the view that the entity has conveyed to its employees valuable equity instruments at grant date and that the accounting objective should be to account for the equity instruments conveyed. Similarly, supporters of vesting date measurement argue that the entity does not convey valuable equity instruments to the employees until vesting date, and that the accounting objective should be to account for the equity instruments conveyed at vesting date. Supporters of exercise date measurement argue that, ultimately, the valuable equity instruments conveyed by the entity to the employees are the shares issued on exercise date and the objective should be to account for the value 'given up' by the entity by issuing equity instruments at less than their fair value.

BC202 Hence all of these arguments for various measurement dates are focused entirely on what the entity (and/or its shareholders) has 'given up' under the share-based payment arrangement, and accounting for that 'sacrifice'. Therefore, if 'grant date measurement' were applied as a matter of principle, the primary objective would be to account for the value of the rights granted. Depending on whether the services have already been received and whether a prepayment for services to be received in the future meets the definition of an asset, the other side of the transaction would either be recognised as an expense at grant date, or capitalised as a prepayment and amortised over some period of time, such as over the vesting period or over the expected life of the option. Under this view of 'grant date measurement', there would be no subsequent adjustment for actual outcomes. No matter how many options vest or how many options are exercised, that does not change the value of the rights given to the employees at grant date.

BC203 Therefore, the reason why some support 'grant date measurement' differs from the reason why the Board concluded that the fair value of

the equity instruments granted should be measured at grant date. This means that some will have different views about the consequences of applying 'grant date measurement'. Because the Board's approach is based on using the fair value of the equity instruments granted, measured at grant date, as a surrogate measure of the fair value of the services received, the total transaction amount is dependent upon the number of units of service received.

Options that are forfeited or lapse

BC204 Some options might not be exercised. For example, an option holder is unlikely to exercise an option if the share price is below the exercise price throughout the exercise period. Once the last date for exercise is passed, the option will lapse.

BC205 The lapse of an option at the end of the exercise period does not change the fact that the original transaction occurred, ie goods or services were received as consideration for the issue of an equity instrument (the share option). The lapsing of the option does not represent a gain to the entity, because there is no change to the entity's net assets. In other words, although some might see such an event as being a benefit to the remaining shareholders, it has no effect on the entity's financial position. In effect, one type of equity interest (the option holders' interest) becomes part of another type of equity interest (the shareholders' interest). The Board therefore concluded that the only accounting entry that might be required is a movement within equity, to reflect that the options are no longer outstanding (ie as a transfer from one type of equity interest to another).

BC206 This is consistent with the treatment of other equity instruments, such as warrants issued for cash. Where warrants subsequently lapse unexercised, this is not treated as a gain; instead the amount previously recognised when the warrants were issued remains within equity.*

BC207 The same analysis applies to equity instruments that are forfeited, ie do not vest because of failure to meet the vesting conditions. The entity received (and consumed) goods or services as consideration for the issue of equity instruments. The subsequent forfeiture of the equity instruments granted does not change that fact. Nor does it represent a change in assets. Hence, the Board concluded that the contribution to

* However, an alternative approach is followed in some jurisdictions (eg Japan and the UK), where the entity recognises a gain when warrants lapse. But under the *Framework*, recognising a gain on the lapse of warrants would be appropriate only if warrants were liabilities, which they are not.

equity recognised when the goods or services were received should remain within equity. This applies irrespective of whether an individual grant of equity instruments is forfeited (eg where equity instruments are forfeited by individual employees upon cessation of employment) or whether all equity instruments granted under a group arrangement are forfeited (eg where all equity instruments granted to a group of employees are forfeited because of failure to achieve a specified performance target).

MODIFICATIONS TO THE TERMS AND CONDITIONS OF SHARE-BASED PAYMENT ARRANGEMENTS

BC208 An entity might modify the terms of or conditions under which the equity instruments were granted. For example, the entity might reduce the exercise price of options granted to employees (ie reprice the options), which increases the fair value of those options.

BC209 The Discussion Paper considered repricing (or any other changes in the option's terms or conditions) under vesting date measurement, and therefore focused on repricing after vesting date. (For simplicity, the term 'repricing' is used in the following discussion, but it should be taken to include all other modifications in the option's terms and conditions.)

BC210 For repricings after vesting date, the Discussion Paper noted that the fair value attributed to the original option was based upon its original terms. Therefore, it is appropriate to amend that valuation if the terms are changed. The Discussion Paper also argued that if the entity reprices its options it has, in effect, replaced the original option with a more valuable option. The entity presumably believes that it will receive an equivalent amount of benefit from doing so, because otherwise the directors would not be acting in the best interests of the entity or its shareholders. This suggests that the entity expects to receive additional or enhanced employee services equivalent in value to the incremental value of the repriced options. The Discussion Paper therefore proposed that the incremental value given (ie the difference between the value of the original option and the value of the repriced option, as at the date of repricing) should be recognised as additional remuneration expense.

BC211 Because the Discussion Paper discussed repricing in the context of

vesting date measurement, this still leaves open the question whether the same reasoning applies under an earlier measurement date, such as grant date, in respect of repricings that occur between grant date and vesting date. SFAS 123, which applies a grant date measurement basis for employee share-based payment, contains reasoning similar to the Discussion Paper.

BC212 This reasoning seems appropriate if grant date measurement is being applied on the grounds that the entity made a 'payment' to the employees on grant date by granting them valuable rights to equity instruments of the entity. If the entity is prepared to replace that payment with a more valuable payment, it must believe it will receive an equivalent amount of benefit from doing so.

BC213 The same conclusion is drawn if grant date measurement is applied on the grounds that some kind of equity interest is created at grant date, and thereafter changes in the value of that equity interest accrue to the option holders as equity participants, not as employees. Repricing is inconsistent with the view that option holders bear changes in value as equity participants. Hence it follows that the incremental value has been granted to the option holders in their capacity as employees (rather than equity participants), as part of their pay for services to the entity. Therefore additional remuneration expense arises in respect of the incremental value given.

BC214 It could be argued that, if (a) grant date measurement is used as a surrogate measure of the fair value of the services received, and (b) the repricing occurs between grant date and vesting date, and (c) the repricing merely restores the option's original value at grant date, then the entity may not receive additional services. Rather, the repricing might simply be a means of ensuring that the entity receives the services it originally expected to receive when the options were granted. Under this view, it is not appropriate to recognise additional remuneration expense to the extent that the repricing restores the option's original value at grant date.

BC215 Some argue that the effect of a repricing is to create a 'new deal' between the entity and its employees, and therefore the entity should estimate the fair value of the repriced options at the date of repricing to calculate a new measure of the fair value of the services received subsequent to repricing. Under this view, the entity would cease using the deemed fair value per unit of employee service measured at grant date, and calculate a new deemed fair value per unit of employee service to apply to services received in the future, between the date of repricing and the end of the vesting period.

BC216 In the context of measuring the fair value of the equity instruments as a surrogate measure of the fair value of the services received, the Board concluded that the incremental value granted on repricing should be taken into account when measuring the services received, because:

(a) there is an underlying presumption that the fair value of the equity instruments, at grant date, provides a surrogate measure of the fair value of the services received. That fair value is based on the option's original terms and conditions. Therefore, if those terms or conditions are modified, the modification should be taken into account when measuring the services received.

(b) an option that will be repriced if the share price falls is more valuable than an option that will not be repriced. Therefore, by presuming at grant date that the option will not be repriced, the entity underestimated the fair value of that option. The Board concluded that, because it is impractical to include the possibility of repricing in the estimate of fair value at grant date, the incremental value granted on repricing should be taken into account as and when the repricing occurs. This is analogous to the Board's conclusion on reload features: if it is impracticable to include the reload feature in the estimate of the option's fair value at grant date, the reload option is accounted for as a new option grant. Similarly, the incremental value granted on repricing is accounted for as a new option grant.

BC217 The Board also discussed situations in which repricing might be effected by cancelling options and issuing replacement options. For example, suppose an entity grants 'at the money' options with an estimated fair value of CU20 each. Suppose the share price drops, so that the options become significantly 'out of the money', and are now worth CU2 each. Suppose the entity is considering repricing, so that the options are again 'at the money', which would result in the options being worth, say, CU10 each. (Note that the options are still worth less than at grant date, because the share price is now lower. Other things being equal, an 'at the money' option on a low priced share is worth less than an 'at the money' option on a high priced share.)

BC218 Under the Board's proposed treatment of repricing, the incremental value given on repricing (CU10 - CU2 = CU8 increment in fair value per option) would be accounted for when measuring the services rendered,

resulting in the recognition of additional expense, ie additional to any amounts recognised in the future in respect of the original option grant (valued at CU20). If the entity instead cancelled the existing options and then issued what were, in effect, replacement options, but treated the replacement options as a new option grant, this could reduce the expense recognised. Although the 'new' grant would be valued at CU10 rather than incremental value of CU8, the entity would not recognise any further expense in respect of the original option grant, valued at CU20. Although some regard such a result as appropriate (and consistent with their views on repricing, as explained in paragraph BC215), it is inconsistent with the Board's treatment of repricing.

BC219 By this means, the entity could, in effect, reduce its remuneration expense if the share price goes down, without having to increase the expense if the share price goes up (because no repricing would be necessary in this case). In other words, the entity could structure a repricing so as to achieve a form of service date measurement if the share price falls and grant date measurement if the share price goes up.

BC220 The Board concluded that if an entity cancels a share or option grant during the vesting period (other than cancellations due to employees' failing to satisfy the vesting conditions), it should nevertheless continue to account for services received, as if that share or option grant had not been cancelled. In the Board's view, it is very unlikely that a share or option grant would be cancelled without some compensation to the counterparty, either in the form of cash or replacement options. Moreover, the Board saw no difference between a repricing of options and a cancellation of options followed by the granting of replacement options at a lower exercise price, and therefore concluded that the accounting treatment should be the same. If cash is paid on the cancellation of the share or option grant, the Board concluded that the payment should be accounted for as the repurchase of an equity interest, ie as a deduction from equity.

BC221 The Board noted that its proposed treatment means that an entity will continue to recognise services received during the remainder of the original vesting period, even though the entity might have paid cash compensation to the counterparty upon cancellation of the share or option grant. The Board discussed an alternative approach applied in SFAS 123: if an entity settles unvested shares or options in cash, those shares or options are treated as having immediately vested. The entity is required to recognise immediately an expense for the amount of compensation expense that would otherwise have been recognised during the remainder of the original vesting period. Although the Board would prefer to adopt this approach, it is difficult to apply in the context of the proposed accounting method in the draft IFRS, given that there is not a specific amount of unrecognised compensation expense—the amount recognised in the future depends on the number of units of service received in the future. Moreover, an entity might partly settle an unvested share or option grant in cash and also grant replacement shares or options. The Board concluded that a grant of replacement shares or options should be treated in the same way as a repricing, which means that services are recognised over the remainder of the vesting period in respect of the original share or option grant. It would therefore be difficult to have a different accounting treatment for situations in which a share or option grant is settled in cash and situations in which replacement shares or options are granted. In any event, the Board noted that the main difference between its approach and that applied in SFAS 123 is the timing of expense recognition, rather than whether an expense is recognised. The Board's approach requires recognition of the services received (and hence an expense) over the remainder of the original vesting period whereas the approach in SFAS 123 requires immediate expense recognition upon settlement of the unvested share or option grant.

SHARE APPRECIATION RIGHTS SETTLED IN CASH

BC222 Some transactions are 'share-based', even though they do not involve the issue of shares, options or any other form of equity instrument. Share appreciation rights (SARs) settled in cash are transactions in which the amount of cash paid to the employee (or another party) is based upon the increase in the share price over a specified period, usually subject to vesting conditions, such as the employee's remaining with the entity during the specified period. (Note that the following discussion focuses on SARs granted to employees, but also applies to SARs granted to other parties.)

BC223 In terms of accounting concepts, share-based payment transactions involving an outflow of cash (or other assets) are different from transactions in which goods or services are received as consideration for the issue of equity instruments.

BC224 In an equity-settled transaction, only one side of the transaction causes a change in assets, ie an asset (services) is received but no assets are

disbursed. The other side of the transaction increases equity; it does not cause a change in assets. Accordingly, not only is it not necessary to 'true up' the transaction upon settlement, it is not appropriate, because equity interests are not remeasured.

BC225 In contrast, in a cash-settled transaction, both sides of the transaction cause a change in assets, ie an asset (services) is received and an asset (cash) is ultimately disbursed. Therefore, no matter what value is attributed to the first asset (services received), eventually it will be necessary to recognise the change in assets when the second asset (cash) is disbursed. Thus, no matter how the transaction is accounted for between the receipt of services and the settlement in cash, it will be 'trued up' to equal the amount of cash paid out, to account for both changes in assets.

BC226 Because cash-settled SARs involve an outflow of cash (rather than the issue of equity instruments) cash SARs should be accounted for in accordance with the 'usual' accounting for similar liabilities. That sounds straightforward, but there are some questions to consider:

(a) should a liability be recognised before vesting date, ie before the employees have fulfilled the conditions to become unconditionally entitled to the cash payment?

(b) if so, how should that liability be measured?

(c) how should the expense be presented in the income statement?

Is there a liability before vesting date?

BC227 It could be argued that the entity does not have a liability until vesting date, because the entity does not have a present obligation to pay cash to the employees until the employees fulfil the conditions to become unconditionally entitled to the cash; between grant date and vesting date there is only a contingent liability.

BC228 The Board noted that this argument applies to all sorts of employee benefits settled in cash, not just SARs. For example, it could be argued that an entity has no liability for pension payments to employees until the employees have met the specified vesting conditions. This argument was considered by IASC in IAS 19 (revised 2000) *Employee Benefits*. The Basis for Conclusions states:

> Paragraph 54 of the new IAS 19 summarises the recognition and measurement of liabilities arising from defined benefit plans…Paragraph 54 of

> the new IAS 19 is based on the definition of, and recognition criteria for, a liability in IASC's Framework…The Board believes that an enterprise has an obligation under a defined benefit plan when an employee has rendered service in return for the benefits promised under the plan…The Board believes that an obligation exists even if a benefit is not vested, in other words if the employee's right to receive the benefit is conditional upon future employment. For example, consider an enterprise that provides a benefit of 100 to employees who remain in service for two years. At the end of the first year, the employee and the enterprise are not in the same position as at the beginning of the first year, because the employee will only need to work for one year, instead of two, before becoming entitled to the benefit. Although there is a possibility that the benefit may not vest, that difference is an obligation and, in the Board's view, should result in the recognition of a liability at the end of the first year. The measurement of that obligation at its present value reflects the enterprise's best estimate of the probability that the benefit may not vest.
> (IAS 19, Basis for Conclusions, paragraphs 11-14)

BC229 Therefore, the Board concluded that to be consistent with IAS 19, which covers other cash-settled employee benefits, a liability should be recognised in respect of cash-settled SARs during the vesting period, as services are rendered by the employees. Thus, no matter how the liability is measured, the Board concluded that it should be accrued over the vesting period, to the extent that the employees have performed their side of the arrangement. For example, if the terms of the arrangement require the employees to perform services over a three-year period, the liability would be accrued over that three-year period, consistently with the treatment of other cash-settled employee benefits.

How should the liability be measured?

BC230 A simple approach would be to base the accrual on the entity's share price at the end of each reporting period. If the entity's share price rose over the vesting period, expenses would be larger in later reporting periods compared with earlier reporting periods. This is because each reporting period will include the effects of (a) an increase in the liability in respect of the employee services received during that reporting period and (b) an increase in the liability due to the increase in the entity's share price during the reporting period, which increases the amount payable in respect of past employee services received.

BC231 This approach is consistent with SFAS 123 (paragraph 25) and FASB Interpretation No. 28 *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*.

BC232 However, this is not a fair value approach. Like share options, the fair value of SARs includes both their intrinsic value (the increase in the share price to date) and their time value (the value of the right to participate in future increases in the share price, if any, that may occur between the valuation date and the settlement date). An option pricing model can be used to estimate the fair value of SARs.

BC233 Ultimately, however, no matter how the liability is measured during the vesting period, the liability—and therefore the expense—will be 'trued up', when the SARs are settled, to the amount of the cash paid out. The amount of cash paid will be based on the SARs' intrinsic value at the settlement date. Some support measuring the SAR liability at intrinsic value for this reason, and because intrinsic value is easier to measure.

BC234 The Board concluded that measuring SARs at intrinsic value would be inconsistent with the measurement basis proposed in the rest of the draft IFRS. Furthermore, although a fair value measurement basis is more complex to apply, it was likely that many entities would be measuring the fair value of similar instruments regularly, eg new SAR or option grants, which would provide much of the information required to remeasure the fair value of the SAR at each reporting date. Moreover, because the intrinsic value measurement basis does not include time value, it is not an adequate measure of either the SAR liability or the cost of services consumed.

BC235 The question of how to measure the liability is linked with the question how to present the associated expense in the income statement, as explained below.

How should the associated expense be presented in the income statement?

BC236 SARs are economically similar to share options. Hence some argue that the accounting treatment of SARs should be the same as the treatment of share options, as discussed earlier (paragraph BC115). However, as noted in paragraphs BC224 and BC225, in an equity-settled transaction there is one change in net assets (the goods or services received) whilst in a cash-settled transaction there are two changes in net assets (the goods or services received and the cash or other assets paid out). To differentiate between the effects of each change in net assets in a cash-settled transaction, the expense could be separated into two components:

- an amount based on the fair value of the SARs at grant date, recognised over the vesting period, in a manner similar to accounting for equity-settled share-based payment transactions, and
- changes in estimate between grant date and settlement date, ie all changes required to 'true up' the transaction amount to the amount paid out on settlement date.

BC237 The Board concluded that information about these two components would be helpful to users of financial statements and that there should therefore be separate disclosure, either on the face of the income statement or in the notes, of that portion of the expense recognised during each accounting period that is attributable to changes in the estimated fair value of the liability between grant date and settlement date.

SHARE-BASED PAYMENT TRANSACTIONS WITH CASH ALTERNATIVES

BC238 Under some employee share-based payment arrangements the employees can choose to receive cash instead of shares or options, or instead of exercising options. There are many possible variations of share-based payment arrangements under which a cash alternative may be paid. For example, the employees may have more than one opportunity to elect to receive the cash alternative, eg the employees may be able to elect to receive cash instead of shares or options on vesting date, and/or elect to receive cash instead of exercising the options. The entity rather than the employee may have the choice over the form of settlement, ie whether to pay the cash alternative instead of issuing shares or options on vesting date or instead of issuing shares upon the exercise of the options. The amount of the cash alternative may be fixed or variable and, if variable, may be determinable in a manner that is related, or unrelated, to the price of the entity's shares.

BC239 The draft IFRS contains different accounting methods for cash-settled and equity-settled share-based payment transactions. Hence, if the entity or the employee has the choice of settlement, it is necessary to

determine which accounting method should be applied. The Board considered situations when (a) the employee has the choice of settlement and (b) the entity has the choice of settlement.

The employee has the choice of settlement

BC240 Share-based payment transactions without cash alternatives do not give rise to liabilities under the *Framework*, because the entity is not required to transfer cash or other assets to the other party. However, this is not so if the contract between the entity and the employee gives the employee the contractual right to demand the cash alternative. In this situation, the entity has an obligation to transfer cash to the employee and hence a liability exists. Furthermore, because the employee has the right to demand settlement in equity instead of cash, the employee also has a conditional right to equity instruments. Hence, on grant date the employee was granted rights to a compound financial instrument, ie a financial instrument that includes both debt and equity components.

BC241 It is common for the alternatives to be structured so that the fair value of the cash alternative is always the same as the fair value of the equity alternative, eg where the employee has a choice between share options and SARs. However, if this is not so, then the fair value of the compound financial instrument will usually exceed both the individual fair value of the cash alternative (because of the possibility that the share/option may be more valuable than the cash alternative) and that of the share/option (because of the possibility that the cash alternative may be more valuable than the option).

BC242 Under IAS 32, a compound instrument is separated into its debt and equity components. At present, the standard does not specify a methodology, although it suggests two possible approaches, both of which are based on allocating the proceeds received for the issue of a compound instrument to its debt and equity components.* This is possible if those proceeds are cash or non-cash consideration whose fair value can be readily determined. If that is not the case, it will be necessary to estimate the fair value of the compound instrument itself.

* The proposed amendment to IAS 32 would eliminate one of these approaches and modify the other, requiring the entity to determine the liability component and then assign the remainder of the proceeds received to the equity component. Hence the approach is based on allocating the proceeds received.

BC243 The Board concluded that the compound instrument should be measured by first valuing the liability component (the cash alternative) and then valuing the equity component (the option)—with that valuation taking into account that the employee must forfeit the cash alternative to receive the option—and adding the two component values together. This is consistent with the approach adopted in the proposed amendment to IAS 32, whereby the liability component is measured first and the residual is allocated to equity. If the fair value of each settlement alternative is always the same, then the fair value of the equity component of the compound instrument will be zero and hence the fair value of the compound instrument will be the same as the fair value of the liability component.

BC244 The Board concluded that the entity should separately account for the services rendered in respect of each component of the compound financial instrument, to ensure consistency with the Board's proposals on equity-settled and cash-settled share-based payment transactions. Hence, for the debt component, the entity should recognise the services received, and a liability to pay for those services, as the employees render services, in the same manner as other cash-settled share-based payment transactions (eg SARs). For the equity component (if any), the entity should recognise the services received, and an increase in equity, as the employees render services, in the same way as other equity-settled share-based payment transactions.

BC245 The Board concluded that the liability should be remeasured to its fair value as at the date of settlement, before accounting for the settlement of the liability. This ensures that, if the entity settles the liability by issuing equity instruments, the resulting increase in equity is measured at the fair value of the consideration received for the equity instruments issued, being the fair value of the liability settled.

BC246 The Board also concluded that, if the entity pays cash rather than issuing equity instruments on settlement, any contributions to equity previously recognised in respect of the equity component should remain in equity. By electing to receive cash rather than equity instruments, the employee has surrendered his/her rights to receive equity instruments. That event does not cause a change in net assets and hence there is no change in total equity. This is consistent with the Board's conclusions on other forfeitures of equity instruments (see paragraphs BC204-BC207).

The entity has the choice of settlement

BC247 For share-based payment transactions in which the entity may choose whether to settle in cash or by issuing equity instruments, the entity would need first to determine whether it has an obligation to settle in cash. Although the contract might specify that the entity can choose whether to settle in cash or by issuing equity instruments, the Board concluded that the entity will have an obligation to settle in cash if the choice of settlement in equity is not a substantive choice, or if the entity has a past practice or a stated policy of settling in cash.

BC248 Even if the entity is not obliged to settle in cash until it chooses to do so, at the time it makes that election a liability will arise for the amount of the cash payment. This raises the question how to account for the debit side of the entry. It could be argued that any difference between (a) the amount of the cash payment and (b) the total expense recognised for services received and consumed up to the date of settlement (which would be based on the grant date value of the equity settlement alternative) should be recognised as an adjustment to the employee remuneration expense. However, given that the cash payment is to settle an equity interest, the Board concluded that it is consistent with the *Framework* to treat the cash payment as the repurchase of an equity interest, ie as a deduction from equity. In this case, no adjustment to the income statement is required on settlement.

BC249 However, the Board concluded that an additional expense should be recognised if the entity chooses the settlement alternative with the higher fair value because, given that the entity has voluntarily paid more than it needed to, presumably it expects to receive (or has already received) additional services from the employees in return for the additional value given.

OVERALL CONCLUSIONS ON ACCOUNTING FOR EMPLOYEE SHARE OPTIONS

BC250 The Board first considered all major issues relating to the recognition and measurement of share-based payment transactions, and reached tentative conclusions on those issues. It then drew some overall conclusions, particularly on the treatment of employee share options, which is one of the most controversial aspects of the project. In arriving at those conclusions, the Board considered the following issues:

- convergence with US GAAP

- recognition versus disclosure of expenses arising from employee share-based payment transactions
- reliability of measurement of the fair value of employee share options.

Convergence with US GAAP

BC251 Many respondents to the Discussion Paper urged the Board to develop an IFRS that was based on existing requirements under US generally accepted accounting principles (US GAAP).

BC252 More specifically, respondents urged the Board to develop a standard based on SFAS 123. However, given that convergence of accounting standards was commonly given as a reason for this suggestion, the Board considered US GAAP overall, not just one aspect of it. The main pronouncements of US GAAP on share-based payment are Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees*, and SFAS 123.

APB 25

BC253 APB 25 was issued in 1972. It deals with employee share plans only, and draws a distinction between non-performance-related (fixed) plans and performance-related and other variable plans.

BC254 For fixed plans, an expense is measured at intrinsic value (the difference between the share price and the exercise price), if any, at grant date. Typically, this results in no expense being recognised for fixed plans, because most options granted under fixed plans are granted 'at the money'.

BC255 For performance-related and other variable plans, an expense is measured at intrinsic value at the measurement date. The measurement date is when both the number of shares or options that the employee is entitled to receive and the exercise price are fixed. Because this measurement date is likely to be much later than grant date, any expense is subject to uncertainty and, if the share price is increasing, the expense for performance-related plans would be larger than for fixed plans.

BC256 In SFAS 123, the FASB noted that APB 25 is criticised for producing anomalous results and for lacking any underlying conceptual rationale. For example, the requirements of APB 25 typically result in the recognition of an expense for performance-related options but usually no expense is recognised for fixed options. This result is anomalous because fixed options are usually more valuable at grant date than performance-related options.

BC257 The FASB also noted that employee fixed options are valuable financial instruments, yet financial statements prepared in accordance with the requirements of APB 25 do not recognise that value:*

> The resulting financial statements are less credible than they could be, and the financial statements of entities that use fixed employee share options extensively are not comparable to those of entities that do not make significant use of fixed options. (SFAS 123, paragraph 56)

BC258 The Discussion Paper, in its discussion of US GAAP, noted that the different accounting treatments for fixed and performance-related plans had also had the perverse effect of discouraging entities from setting up performance-related employee share plans. There are relatively few performance-related plans in the US.

SFAS 123

BC259 SFAS 123 was issued in 1995. It requires recognition of share-based payment transactions with parties other than employees, based on the fair value of the shares or options issued or the fair value of the goods or services received, whichever is more reliably measurable. Entities are also encouraged, but not required, to apply the fair value accounting method in SFAS 123 to share-based payment transactions with employees. Generally speaking, SFAS 123 draws no distinction between fixed and performance-related plans.

BC260 If an entity applies the accounting method in APB 25 rather than that in SFAS 123, SFAS 123 requires disclosures of pro forma net income and earnings per share in the annual financial statements, as if the standard had been applied. In practice, few entities have chosen to adopt SFAS 123 for transactions with employees (although recently some companies have announced their intention to do so).

* Employee share options might be less valuable than traded options, because they usually carry restrictions that are not usually present in traded options, but they still have a value.

BC261 The FASB regards SFAS 123 as superior to APB 25, and would have preferred recognition based on the fair value of employee options to be mandatory, not optional. SFAS 123 makes it clear that the FASB decided to permit the disclosure-based alternative for political reasons, not because it thought that it was the best accounting solution:

> The Board continues to believe that financial statements would be more relevant and representationally faithful if the estimated fair value of employee stock options was included in determining an entity's net income, just as all other forms of compensation are included. To do so would be consistent with accounting for the cost of all other goods and services received as consideration for equity instruments…the Board…continues to believe that disclosure is not an adequate substitute for recognition of assets, liabilities, equity, revenues and expenses in financial statements…The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue—not because it believes that solution is the best way to improve financial accounting and reporting. (SFAS 123, paragraphs 61 and 62)

BC262 Under US GAAP, the accounting treatment of share-based payment transactions differs, depending on whether the other party to the transaction is an employee or non-employee, and whether the entity chooses to apply SFAS 123 or APB 25 to transactions with employees. For example, if an entity pays its external lawyer in share options, that transaction must be measured using the fair value measurement basis under SFAS 123 and its related interpretations. This would usually result in recognition of an expense. If that lawyer is then hired to perform the same services in-house and the entity elects to apply the intrinsic value method in APB 25, typically no expense would be recognised.

BC263 Having a choice of accounting methods is generally regarded as undesirable. Indeed, the Board recently devoted much time and effort to developing improvements to existing international standards, one of the objectives of which is to eliminate choices of accounting methods.

BC264 Research in the US demonstrates that choosing one accounting method over the other has a significant impact on the reported earnings of US entities. For example, research by Bear Stearns and Credit Suisse First Boston on the S&P 500 shows that, had the fair value measurement method in SFAS 123 been applied for the purposes of recognising an expense for employee stock-based compensation, the earnings of the S&P 500 companies would have been significantly lower, and that the effect is growing. The effect on

reported earnings is substantial in some sectors, where companies make heavy use of options.

BC265 The Canadian Accounting Standards Board (AcSB) recently completed the first phase of its project on share-based payment. In accordance with the AcSB's policy of harmonising Canadian standards with those in the US, the AcSB initially proposed a standard that was based on US GAAP, including APB 25. After considering respondents' comments, the AcSB decided to delete the guidance drawn from APB Opinion 25. The AcSB reached this decision for various reasons, including that, in its view, the intrinsic value method is flawed. Also, incorporating the requirements of APB 25 into an accounting standard would result in preparers of accounts incurring substantial costs for which users of accounts would derive no benefit—entities would spend a great deal of time and effort on understanding the rules and then redesigning option plans, usually by deleting existing performance conditions, to avoid recognising an expense in respect of such plans, thereby producing no improvement in the accounting for share option plans.

BC266 The Canadian standard is consistent with SFAS 123. This includes permitting a choice between fair value-based accounting for employee stock-based compensation expense in the income statement and disclosure of pro forma amounts in the notes to both interim and annual financial statements. However, the Chair of the AcSB commented that the Canadian standard fell short in this respect (by permitting a choice between recognition and disclosure), that disclosure does not compensate for inadequate accounting and that the AcSB decided to allow the disclosure alternative "…reluctantly and, hopefully, for a brief period of time…Harmonization with US GAAP is important, but not at the price of producing inadequate standards." (*FYI*, October 2001)

BC267 Because APB 25 contains serious flaws, the Board concluded that basing an IFRS on it is unlikely to represent much, if any, improvement in financial reporting. Moreover, the perverse effects of APB 25, particularly in discouraging performance-related option plans, may cause economic distortions. Accounting standards are intended to be neutral, not to give favourable or unfavourable accounting treatments to particular transactions to encourage or discourage entities from entering into those transactions. APB 25 fails to achieve that objective. Performance-related employee share plans are common in Europe (performance conditions are often required by law) and in other parts of the world outside the US, and investors are calling for greater use of performance conditions. Therefore, the Board concluded that introducing an accounting standard based on APB 25 would be inconsistent with its objective of developing high quality accounting standards.

BC268 That leaves SFAS 123. Comments from the FASB, in the SFAS 123 Basis for Conclusions, and from the Canadian AcSB when it developed a standard based on SFAS 123, indicate that both standard-setters regard it as inadequate, because it permits a choice between recognition and disclosure. This issue is discussed further below.

BC269 The Board also noted that some respondents to the Discussion Paper argued that the IASB should not require recognition of expenses arising from share options granted to employees because to do so would not be consistent with the objective of convergence/harmonisation of accounting standards, because "no country today requires companies to expense stock options granted to employees" (comment letters CL 160-CL 275). Apart from the fact that this statement is inaccurate—some countries, including the US, do require expense recognition, albeit measured at intrinsic value, which often, but not always, results in zero expense—these respondents seem to believe that the IASB's standard-setting role is limited to harmonising existing accounting standards, not improving them. In other words, they see the IASB as merely a follower, not a leader, in standard-setting.

BC270 The IASB's Constitution makes it clear that the Board has a leadership role, and that the convergence of accounting standards should be to high quality solutions, not just any solution and not necessarily to an existing solution.

Recognition versus disclosure

BC271 A basic accounting concept is that disclosure of financial information is not an adequate substitute for recognition in the financial statements. For example, the *Framework* states:

> Items that meet the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material. (paragraph 82)

BC272 A key aspect of the recognition criteria is that the item can be measured with reliability. This issue is discussed further below. Therefore, this discussion focuses on the 'recognition versus disclosure' issue in principle, not on measurement reliability. Once it has been determined that an item meets the criteria for recognition in the financial statements, failing to recognise it is inconsistent with the basic concept that disclosure is not an adequate substitute for recognition.

BC273 Some disagree with this concept, arguing that it makes no difference whether information is recognised in the accounts or disclosed in the notes. Either way, users of accounts have the information they require to make economic decisions. Hence, they believe that note disclosure of expenses arising from certain employee share-based payment transactions (those involving awards of options to employees), rather than recognition in the income statement, is acceptable.

BC274 The Board did not accept this argument. The Board noted that if note disclosure is acceptable, because it makes no difference whether the expense is recognised or disclosed, then recognition in the financial statements must also be acceptable for the same reason. If recognition is acceptable, and recognition rather than mere disclosure accords with the accounting principles applied to all other expense items, it is not acceptable to leave one particular expense item out of the income statement.

BC275 The Board also noted that there is significant evidence that there is a difference between recognition and disclosure. First, academic research indicates that whether information is recognised or merely disclosed affects market prices (eg Barth, Clinch and Shibano, 2002).* If information is disclosed only in the notes, users of accounts have to expend time and effort to become sufficiently expert in accounting to know (a) that there are items that are not recognised in the financial statements, (b) that there is information about those items in the notes, and (c) how to assess the note disclosures. Because gaining that expertise comes at a cost, and not all users of accounts will become accounting experts, information that is merely disclosed may not be fully reflected in share prices.

BC276 Second, both preparers and users of accounts appear to agree that there is an important difference between recognition and disclosure. Users of accounts have strongly expressed the view that all forms of share-based payment, including employee share options, should be

* M E Barth, G Clinch and T Shibano. 2002. Market Effects of Recognition and Disclosure. Working paper. Stanford University, Graduate School of Business.

recognised in the financial statements, resulting in the recognition of an expense when the goods or services received are consumed, and that note disclosure only is inadequate. Their views have been expressed by various means, including:

(a) users' responses to the Discussion Paper

(b) the 2001 survey by the Association for Investment Management and Research of analysts and fund managers—83 per cent of survey respondents said the accounting method for all share-based payment transactions should require recognition of an expense in the income statement

(c) public comments by users of accounts, such as those reported in the press or made at recent US Senate hearings.

BC277 Preparers of accounts also see a major difference between recognition and disclosure. Many preparers who responded to the Discussion Paper strongly opposed recognition of expenses arising from awards of share options for employees, while advocating disclosure of such information instead, for a variety of reasons. For example, some preparers were concerned that unless expense recognition is required in all countries, entities that are required to recognise an expense would be at a competitive disadvantage compared with entities that are permitted a choice between recognition and disclosure. Comments such as these indicate that preparers of accounts regard expense recognition as having consequences that are different from those of disclosure.

Reliability of measurement

BC278 One reason commonly given by those who oppose the recognition of an expense arising from transactions involving grants of share options to employees is that it is not possible to measure those transactions reliably.

BC279 The Board discussed these concerns about reliability, after first putting the issue into context. For example, the Board noted that when estimating the fair value of options, the objective is to measure that fair value at the measurement date, not the value of the underlying share at some future date. Some regard the fair value estimate as inherently uncertain because it is not known, at the measurement date, what the final outcome will be, ie how much the gain on exercise (if any) will be. However, the valuation does not attempt to estimate the future gain,

only the amount that the other party would pay to obtain the right to participate in any future gains. Therefore, even if the option expires worthless or the employee makes a large gain on exercise, this does not mean that the grant date estimate of the fair value of that option was unreliable or wrong.

BC280 The Board also noted that accounting often involves making estimates, and therefore reporting an estimated fair value is not objectionable merely because that amount represents an estimate rather than a precise measure. Examples of other estimates made in accounting, which may have a material effect on the income statement and the balance sheet, include estimates of the collectability of doubtful debts, estimates of the useful life of fixed assets and the pattern of their consumption, and estimates of employee pension liabilities.

BC281 However, some argue that including in the accounts an estimate of the fair value of employee share options is a different matter from including other estimates, because there is no subsequent correction of the estimate. Other estimates, such as employee pension costs, will ultimately be 'trued up' to the amount of the cash paid out. In contrast, because equity is not remeasured, if the estimated fair value of employee options is included in the accounts, there is no 'truing up' of the fair value estimate—unless exercise date measurement is used—so any estimation error is permanently embedded in the accounts.

BC282 The FASB considered and rejected this argument in developing SFAS 123. For example, for employee pension costs, the total cost is never completely 'trued up' unless the scheme is terminated, the amount attributed to any particular year is never 'trued up', and it can take decades before the amounts relating to particular employees are 'trued up'. In the meantime, users of accounts have made economic decisions based on the estimated costs.

BC283 Moreover, the Board noted that if no expense (or an expense based on intrinsic value only, which is typically zero) is recognised in respect of employee share options, that also means that there is an error that is permanently embedded in the accounts. Reporting zero (or an amount based on intrinsic value, if any) is never 'trued up'.

BC284 The Board also considered the meaning of reliability. Arguments about whether estimates of the fair value of employee stock options are sufficiently 'reliable' focus on one aspect of reliability only—whether the estimate is free from material error. The *Framework*, in common with the conceptual frameworks of other accounting standard-setters, makes it clear that another important aspect of reliability is whether the information can be depended upon by users of accounts to represent faithfully what it purports to represent. Therefore, in assessing whether a particular accounting method produces reliable financial information, it is necessary to consider whether that information is representationally faithful. This is one way in which reliability is linked to another important qualitative characteristic of financial information, relevance.

BC285 For example, in the context of share-based payment, some commentators advocate measuring employee share options at intrinsic value rather than fair value, because intrinsic value is regarded as a much more reliable measure. Whether intrinsic value is a more reliable measure is doubtful—it is certainly less subject to estimation error, but is unlikely to be a representationally faithful measure of remuneration. Nor is intrinsic value a relevant measure. Many employee options are issued 'at the money', so have no intrinsic value at grant date. An option with no intrinsic value consists entirely of time value. If the option is measured at intrinsic value at grant date, zero value is attributed to the option. Therefore, by ignoring time value, the amount attributed to the option is 100 per cent understated.

BC286 Another qualitative characteristic is comparability. Some argue that, given the uncertainties relating to estimating the fair value of employee share options, it is better for all entities to report zero, as this will make financial statements more comparable. They argue that if, for example, for two entities the 'true' amount of expense relating to employee share options is CU500,000, and estimation uncertainties cause one entity to report CU450,000 and the other to report CU550,000, the two entities' financial statements would be more comparable if both reported zero, rather than these divergent figures.

BC287 However, it is unlikely that any two entities will have the same amount of employee share-based remuneration expense. Research (eg by Bear Stearns and Credit Suisse First Boston) indicates that the expense varies widely from industry to industry, from entity to entity, and from year to year. Reporting zero rather than an estimated amount is likely to make the financial statements much less comparable, not more comparable. For example, if the estimated employee share-based remuneration expense of Company A, Company B and Company C is CU10,000, CU100,000 and CU1,000,000 respectively, reporting zero

for all three companies will not make their financial statements comparable.

BC288 In the context of the foregoing discussion of reliability, the Board addressed the question whether transactions involving share options granted to employees can be measured with sufficient reliability for the purpose of recognition in the financial statements. The Board noted that many respondents to the Discussion Paper asserted that this is not possible. They argue that option pricing models cannot be applied to employee share options, because of the differences between employee options and traded options.

BC289 The Board considered these differences, with the assistance of the project's Advisory Group and other experts, and has drawn conclusions on adjustments that should be made to the inputs to option pricing models, or to the values produced by these models, to allow for these differences.

BC290 In estimating the fair value of employee stock options, it is necessary to estimate several inputs, including expected volatility, expected life and the probability of vesting. But does that make the estimate so unreliable that it should not be included in the financial statements, particularly in comparison with other estimates already included in the accounts, such as liabilities for post employment benefits? And are measurement uncertainties likely to result in understatement or overstatement in practice?

BC291 The Board noted that there is evidence to support a conclusion that it is possible to make a reliable estimate of the fair value of employee share options. First, there is academic research to support this conclusion (eg Carpenter 1998, Maller, Tan and Van De Vyver 2002).* Second, users of accounts regard the estimated fair values as sufficiently reliable for recognition in the financial statements. Evidence of this can be found in a variety of sources, such as the comment letters received from users of accounts who responded to the Discussion Paper. Users' views are important, because the objective of financial statements is to provide high quality, transparent and comparable information to help users make economic decisions. In other words, financial statements are intended to meet the needs of users, rather

* J N Carpenter. 1998. The exercise and valuation of executive stock options. *Journal of Financial Economics* 48: 127-158.
R A Maller, R Tan and M Van De Vyver. 2002. How Might Companies Value ESOs? *Australian Accounting Review* 12 (1): 11-24.

than preparers or other interest groups. The purpose of setting accounting standards is to ensure that, wherever possible, the information provided in the financial statements meets users' needs. Therefore, if the people who use the financial statements in making economic decisions regard the fair value estimates as sufficiently reliable for recognition in the financial statements, this provides strong evidence of measurement reliability.

BC292 The Board also noted that, although the FASB decided to permit a choice between recognition and disclosure of expenses arising from employee share-based payment transactions, it did so for non-technical reasons, not because it agreed with the view that reliable measurement was not possible:

> The Board continues to believe that use of option-pricing models, as modified in this statement, will produce estimates of the fair value of stock options that are sufficiently reliable to justify recognition in financial statements. Imprecision in those estimates does not justify failure to recognize compensation cost stemming from employee stock options. That belief underlies the Board's encouragement to entities to adopt the fair value based method of recognizing stock-based employee compensation cost in their financial statements. (SFAS 123, Basis for Conclusions, paragraph 117)

BC293 In summary, if expenses arising from grants of options to employees are omitted from the financial statements, or recognised using the intrinsic value method (which typically results in zero expense) or the minimum value method, that means that there is a permanent error embedded in the accounts. So the question is, which accounting method is more likely to produce the smallest amount of error and the most relevant, comparable information—a fair value estimate, which might result in some understatement or overstatement of the associated expense, or another measurement basis, such as intrinsic value, that will definitely result in substantial understatement of the associated expense?

BC294 Taking all of the above into consideration, the Board concluded that the estimated fair value of employee share options at grant date can be measured with sufficient reliability for the purposes of recognising employee share-based payment transactions in the financial statements. The Board therefore concluded that the IFRS on share-based payment should require a fair value measurement method to be applied to all types of share-based payment transactions, including all types of employee share-based payment. Hence, the Board concluded that the IFRS should not allow a choice between a fair value measurement method and an intrinsic value measurement method, and should not permit a choice between recognition and disclosure of expenses arising from employee share-based payment transactions.

CONSEQUENTIAL AMENDMENTS TO OTHER STANDARDS

Tax effects of share-based payment transactions

BC295 Whether expenses arising from share-based payment transactions are deductible, and if so, whether the amount of the tax deduction is the same as the reported expense and whether the tax deduction arises in the same accounting period, varies from country to country.

BC296 If the amount of the tax deduction is the same as the reported expense, but the tax deduction arises in a later accounting period, this will result in a deductible temporary difference under IAS 12 (revised 2000) *Income Taxes*. Temporary differences usually arise from differences between the carrying amount of assets and liabilities and the amount attributed to those assets and liabilities for tax purposes. However, IAS 12 also deals with items that have a tax base but are not recognised as assets and liabilities in the balance sheet. It gives an example of research costs that are recognised as an expense in the financial statements in the period in which the costs are incurred, but are deductible for tax purposes in a later accounting period. The standard states that the difference between the tax base of the research costs, being the amount that will be deductible in a future accounting period, and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset (IAS 12, paragraph 9).

BC297 Applying this guidance indicates that if an expense arising from a share-based payment transaction is recognised in the financial statements in one accounting period and is tax-deductible in a later accounting period, this should be accounted for as a deductible temporary difference under IAS 12. Under that standard, a deferred tax asset is recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be used (IAS 12, paragraph 24).

BC298 Whilst IAS 12 does not discuss reverse situations, the same logic applies. For example, suppose the entity is able to claim a tax deduction for the total transaction amount at the date of grant but the entity recognises an expense arising from that transaction over the vesting period. Applying the guidance in IAS 12 suggests that this should be accounted for as a taxable temporary difference, and hence a deferred tax liability should be recognised.

BC299 However, the amount of the tax deduction might differ from the amount of the expense recognised in the financial statements. For example, the measurement basis applied for accounting purposes might not be the same as that used for tax purposes, eg intrinsic value might be used for tax purposes and fair value for accounting purposes. Similarly, the measurement date might differ. For example, US entities receive a tax deduction based on intrinsic value at the date of exercise in respect of some share options, whereas for accounting purposes the recognised expense might be based on intrinsic value or fair value, measured at the date of grant or at some later date. There could also be other differences in the measurement method applied for accounting and tax purposes, eg differences in the treatment of forfeitures.

BC300 SFAS 123 requires that, if the amount of the tax deduction exceeds the total expense recognised in the financial statements, the tax benefit for the excess deduction should be recognised as additional paid-in capital, ie as a direct credit to equity. Conversely, if the tax deduction is less than the total expense recognised for accounting purposes, the write-off of the related deferred tax asset in excess of the benefits of the tax deduction is recognised in the income statement, except to the extent that there is remaining additional paid-in capital from excess tax deductions from previous share-based payment transactions (SFAS 123, paragraph 44).

BC301 At first sight, it may seem questionable to credit or debit directly to equity amounts that relate to differences between the amount of the tax deduction and the total recognised expense. The tax effects of any such differences would ordinarily flow through the income statement. However, some argue that the approach in SFAS 123 is appropriate if the reason for the difference between the amount of the tax deduction and the recognised expense is that a different measurement date is applied.

BC302 For example, suppose grant date measurement is used for accounting purposes and exercise date measurement is used for tax purposes.

Under grant date measurement, any changes in the value of the equity instrument after grant date accrue to the employee (or other party) in their capacity as equity participants. Therefore, some argue that any tax effects arising from those valuation changes should be credited to equity (or debited to equity, if the value of the equity instrument declines).

BC303 Similarly, some argue that the tax deduction arises from an equity transaction (the exercise of options), and hence it should be reported in equity. It can also be argued that this treatment is consistent with the treatment required by IAS 12 for the equity component of compound financial instruments. Others disagree, arguing that the tax deduction relates to employee remuneration expense, ie an income statement item, and therefore the tax effects of the deduction should be recognised in the income statement. A further argument is that this treatment is consistent with the *Framework*, because reporting amounts directly in equity would be inappropriate, given that the government is not an owner of the entity.

BC304 The Board noted that, if one accepts that it might be appropriate to debit/credit to equity the tax effect of the difference between the amount of the tax deduction and the total recognised expense where that difference relates to changes in the value of equity interests, there could be other reasons why the amount of the tax deduction differs from the total recognised expense. For example, grant date measurement may be used for both tax and accounting purposes, but the valuation methodology used for tax purposes might produce a higher value than the methodology used for accounting purposes (eg contracted life could be used in an option pricing model when valuing an option for tax purposes while expected life is used when valuing an option for accounting purposes). The Board saw no reason why, in this situation, the excess tax benefits should be credited to equity.

BC305 The Board concluded that the tax effects of share-based payment transactions should be recognised in the income statement by being taken into account in the determination of tax expense. It agreed that this should be explained in the form of a worked example in a consequential amendment to IAS 12.

Accounting for own shares held

BC306 SIC-16 *Share Capital – Reacquired Own Equity Instruments (Treasury*

Shares) requires the acquisition of treasury shares to be deducted from equity, and no gain or loss is to be recognised in the income statement on the sale, issue or cancellation of treasury shares. Consideration received on the subsequent sale/issue of treasury shares is credited to equity.

BC307 This is consistent with the *Framework*. The repurchase of shares and their subsequent reissue or transfer to other parties are transactions with equity participants that should be recognised as movements in equity. In accounting terms, there is no difference between shares that are repurchased and cancelled, and shares that are repurchased and held by the entity. In both cases, the repurchase involves an outflow of resources to shareholders (ie a distribution), thereby reducing shareholders' investment in the entity. Similarly, there is no difference between a new issue of shares and an issue of shares previously repurchased and held in treasury. In both cases, there is an inflow of resources from shareholders, thereby increasing shareholders' investment in the entity. Although accounting practice in some jurisdictions treats own shares held as assets, this is not consistent with the definition of assets in the *Framework* and the conceptual frameworks of other standard-setters, as explained in the Discussion Paper (footnote to paragraph 4.7 of the Discussion Paper, reproduced earlier in the footnote to paragraph BC68).

BC308 Given that treasury shares are treated as an asset in some jurisdictions, it will be necessary to change that accounting treatment when an IFRS on share-based payment is introduced, because otherwise an entity would be faced with two expense items—an expense arising from the share-based payment transaction (for the consumption of goods and services received as consideration for the issue of an equity instrument) and another expense arising from the write-down of the 'asset' for treasury shares issued/transferred to employees at an exercise price that is less than their purchase price.

BC309 At present, SIC-16 does not apply to the acquisition, sale or issue of treasury shares in connection with employee share plans, because IAS 19 (revised 2000) *Employee Benefits* does not deal with the recognition and measurement of equity compensation benefits. Therefore, the scope exclusion in SIC-16 should be removed once an accounting standard on share-based payment comes into effect.

BC310 However, it is likely that, by the time the IFRS on share-based payment comes into effect, SIC-16 will have been withdrawn and its

requirements incorporated into IAS 32, as proposed in the Exposure Draft published in June 2002. Hence, the Board concluded that the requirements in the relevant paragraphs of IAS 32 regarding treasury shares should also be applied to treasury shares purchased, sold, issued or cancelled in connection with employee share plans or other share-based payment arrangements.