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International Accounting Standards Board
30 Cannon Street
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RE: Comments on ED2 Share Based Payment

Dear Sirs,

This response represents the views of the Accounting and Valuation Group of UBS Warburg Equity Research. The Accounting and Valuation Group provides advice on financial accounting and equity valuation methodology to UBS Warburg equities clients and to equity analysts within UBS Warburg Equity Research. The views expressed are provided from an equity analysis perspective and are independent of, and may not necessarily coincide with, the views of UBS Warburg or of UBS.

We support the approach of ED2 in expensing the fair value of equity based compensation, including stock option grants, based upon a grant date valuation. We believe that a failure to expense equity based compensation severely distorts the reported profitability of many companies. We do not believe that any substantive argument has been put forward that justifies the continued non-recognition of an expense in relation to equity based compensation.

We have a number of specific comments on the approach of ED2 we would like to emphasise:

The valuation of option grants: We support the use of an options pricing model approach to determining the expense in respect of option grants, including the use of expected life of options to allow for the effects of non-transferability. We also agree that the effect of performance conditions should be dealt with in the valuation of these instruments. However, we have concerns over the guidance given in ED2 in respect of performance criteria and believe that there is a danger that option values may be materially understated in practice. ED2 states that vesting conditions shall be taken into account when measuring value. We agree that the standard should not specify in detail how this should be done. However, we believe that the approach illustrated in example 2 of appendix B may falsely give the impression that an acceptable answer can be obtained by simply adjusting the options value by the probability of vesting due to satisfying performance criteria. This approach can understate the value of the options since there may be positive correlation between the performance criteria and the stock price change that determines the realised value from the option. We believe that the standard should make clear that the valuation of the option should take account of this correlation. This could mean the option valuation model used is complex. An approximation through a simplified approach may well be acceptable, but this should result in an unbiased approximation of the value of the option. We believe that the approach illustrated in appendix B could lead to a systematic understatement of option expenses if applied in a naive manner.

Cash settled stock appreciation rights: We note that the measurement of the compensation expense and associated balance sheet entries are very different depending upon whether options are cash settled or equity settled. We not believe that the economic differences between these transactions are sufficient to justify such a significant difference in accounting. We recognise that a consistent treatment of cash and equity settled options is incompatible with current definitions of assets and liabilities, but we believe that this indicates that these existing definitions are flawed. Given the approach of ED2 we strongly support the proposal to separately identify the grant date value of cash settled options and the impact on reported profit in any given year of the remeasurement of those options (para. 52(b). We would also like to see a similar analysis of the tax impact of options so that we could calculate a net income figure that excludes the effect of remeasurement of cash settled options.

Deferred tax: We do not agree with the methodology outlined in ED2 for the treatment of deferred tax in respect of stock option expenses. If a tax allowance is based upon exercise date value then a deferred tax asset that reflects the current estimate of that future tax saving should indeed be included in the balance sheet. However, we do not believe that the income statement will provide users with useful and relevant information if the full extent of the annual changes in that deferred tax item are passed through the tax line. We believe that for the purpose of measuring performance it is the tax effects of the grant date cost that is important. Subsequent changes in this tax amount are relevant but are of an entirely different nature. At the very least there needs to be separate disclosure of this remeasurement effect and identification of what tax and earnings would have been if this remeasurement item were excluded. Ideally we would prefer an approach similar to that of FAS 123, where generally the remeasurement element taken to comprehensive income. We recognise that this item may well be easier to accommodate in the income statement under proposals outlined in the IASB performance reporting project.

Amortisation over vesting period: We understand the motivation for amortisation over the vesting period, however, we believe that in many cases this is inappropriate and can also produce misleading performance measures. We believe that most employees regard the grant of an option is compensation of services rendered in the period of grant, or services rendered in periods prior to grant, and not necessarily as a payment for future services. It would therefore be inappropriate to amortise the grant date value over the vesting period but this amount should instead be recognised immediately. The fact that an employee loses the right to the options (in many, but not all cases) if they leave employment before vesting could be regarded as simply a penalty for leaving (and hence a gain for the employer) and not as evidence that the compensation is actually being earned over the vesting period. If the amortisation approach is to be adopted than we would like, at the very least, a clear statement of the value of options granted in the period, after allowing for expected forfeit and for performance conditions. This should be given as an aggregate number such that users can easily adjust the reported stock option expense to one that reflects the value of options actually granted in the period. One argument for amortisation over the vesting period is that options incentivise employees over that period. This may well be the case but we do not believe that this is sufficient justification for amortisation. It could well be justification for recognising part of the grant date value as an asset (a pre-paid expense) if the appropriate recognition criteria are met; but we believe this is unlikely.

Disclosures: In addition to the disclosure related requests above we would also like information to be given by companies on the estimated fair value of options outstanding at the balance sheet date. The current value of outstanding options is an important input in methods used by analysts to determine the fair value of equity shares. We do not believe this to be an overly onerous additional disclosure since the necessary models and estimates would already be available due to the existing requirements of ED2. The information would however, be very useful for users since, although it is possible to update volatility and other parameters to estimate the current fair value of options, it is not possible for external users to update estimates related to performance criteria.

Responses to the specific questions in ED2:

Q1. Agree with proposed scope.

Q2. Agree the expense should be matched with consumption but we have reservations about whether it is appropriate to amortise stock option expenses over the vesting period (see above).

Q3. Agreed

Q4. Agreed

Q5. Yes we agree with grant date measurement

Q6. Yes we agree that the fair value of the goods or services received is likely to be more readily determinable. However, if the fair value of the equity instruments granted were to be greater or less than the fair value of the goods or services received then it is the fair value of the equity instruments that should be recognised as an expense. The fair value of the goods or services should only be used if this is indeed a reasonable proxy for the value of the instruments granted.

Q7. Agreed

Q8. No, as stated above, we do not believe that restrictions that apply in a vesting period automatically mean that the services received in respect of a grant of equity instruments are those during that vesting period. We believe that in the majority of cases these services are rendered in the year the option is granted (or prior years) and that consequently immediate expensing (after appropriate allowance for estimated forfeit and the effect performance criteria) is appropriate.

Q9. If the expense is to be recognised over the vesting period then the proposed unit of service approach would seem to give an adequate basis for that allocation. However, we believe that the methodology is complicated and may not be easily understood by users.

Q10. Agreed

Q11. We agree with the use of an option-pricing model.

Q12. Yes, we agree with the use of expected life. However, it should be recognised that this may well understate the true value of options since there is a tendency for employees to only exercise early those options that are deeply in the money. Those options that are only slightly in the money or those out of the money would tend not to be exercised early. It therefore is the case that employees lose less of the 'time value' available to them than the use of a single expected option life would assume.

Q13. Yes, we agree that vesting conditions should be taken into account in estimating fair value. However, we refer to our comments earlier where we highlighted that this adjustment should be more than just a simplistic reduction in the option value as is suggested by the example in appendix B.

Q14. Yes, this is appropriate.

Q15. No

Q16. Yes

Q17. Yes, the incremental value should be recognised. We have no view on the two alternative methods.

Q18. The problem of how to account for such a cancellation illustrates the weakness of the proposed method of expensing the option grant over the vesting period. If the value of option grants were fully recognised immediately on grant then a subsequent cancellation can easily be accommodated by recognising a gain equal to the fair value of the options at the time of cancellation (less any compensating payment).

Q19. We feel that such a major difference in accounting for cash settled and equity settled share based payments is not justified by the economic difference between these transactions. We explain our views in more detail above. We would emphasise the need to separate the effects of remeasurement in respect of cash settled payments within the income statement. Having such a remeasurement charge or credit in the income statement, that users would rightly regard as having little relevance in assessing the performance of the underlying business, could undermine the credibility of the share based payment charge and lead to users (incorrectly) ignoring the whole of the expense.

Q20. If the accounting for equity and cash settled payments were more consistent as we would wish then this problem would not arise.

Q21. Yes, all of the disclosures are appropriate and we believe necessary for full and meaningful interpretation by users of the impact of share based payments. In addition, we would also like to add a further disclosure of the fair value of all outstanding employee options at the balance sheet date, as discussed above. We believe that the illustrative disclosures in ED2 are poorly presented and that a more tabular format would greatly improve clarity. We recognise that companies will form their own basis for communicating this information to investors, but the illustrations in the standard do influence this and should be as clearly set out as possible.

Q22. We disagree. We believe that companies should at least be encouraged to apply the standard retrospectively and, as a minimum, should be permitted to adopt full retrospective application.

Q23. We disagree. As explained above, we believe that the proposals regarding deferred tax would lead to very misleading items in the income statement and would result in accounts that were less, rather than more useful, for users. As a minimum there should be clear separation of the tax effect of the grant date value from the deferred tax adjustments caused by subsequent remeasurement.

Q24. No comments beyond these above which relate to this.

Q25. No.

Sincerely,

Stephen Cooper
Managing Director
Accounting & Valuation Group
UBS Warburg Equity Research