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Ms K Crook
Project Manager
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BY EMAIL AND POST

Dear Mr Ebling/Ms Crook

FRED31/ED2 - Share based payment
Lane Clark & Peacock LLP (LCP) response

LCP is pleased to submit its comments on the draft accounting standards FRED31 and ED2 relating to accounting for share-based payment.

Lane Clark & Peacock is one of the leading firms of consulting actuaries in the UK. The Firm has 46 partners and over 250 staff, operating out of offices in the West End of London and Winchester. The Firm provides actuarial advice including employee benefit, investment, insurance and risk management related advice.

We welcome the proposed introduction of increased disclosure of information regarding share-based payment and the recognition of expense in company accounts. These proposals will make the accounting treatment of these plans consistent with other forms of remuneration.

There are some areas of detail where we believe the standard should be amended from the draft, and I enclose in an appendix our responses to the specific questions raised in the consultation. Please note that we have only responded to questions in the consultation that directly affect our own areas of expertise.

We would be happy to expand on the answers to any of these questions if you wish. If you have any queries please do not hesitate to contact Alex Waite or myself.

Yours sincerely

{Sent as an attachment to an e-mail on 7th March 2003 at 12:59}

Matthew Pearlman FIA
Partner

Enc: Appendix

LCP response to consultation on FRED31/ED2

ASB Question 1

We agree that the new standard should be adopted in the UK at the same effective date as the proposed IFRS, as international consistency in this area is particularly important. However, we would question the need for the new standard to take effect from 2004. With so many changes envisaged from 2005, we have sympathy for the view that the FRS/IFRS should be deferred until 2005.

ASB Question 6

We believe that companies should have the option to apply the standard retrospectively. This will allow companies to demonstrate the true development of expenses over the years; otherwise, the pattern can look quite arbitrary as the charges build up through progressive tranches of grants.

We agree that, because of the additional work involved, retrospective application should not be compulsory.

As suggested above, we believe that serious consideration should be given to deferring implementation until 2005. It would still be appropriate for the effective date from which grants are included to remain November 2002. In this way, a large proportion of grants will be captured in the first full year of adoption (which favours a 2005 implementation over 2004).

IASB Question 5

We agree that it is appropriate to measure the fair value at the grant date.

IASB Question 8

We agree that the most practical method to expense the charges is over the vesting period.

However, we find it difficult to maintain that an employee's additional services will be spread uniformly over the vesting period, particularly if there is a sharp fall in the share price during the period, which means that the equity consideration will be less valuable. See also our response to IASB Question 10.

We recommend that the definition of "vesting period" should be tightened up, in particular where there are several possible vesting dates depending on performance criteria attaching to the option. The simple example below illustrates the issue.

Example

Consider a simple case that has a vesting period of 3 years and performance criteria that the option can be exercised after 3 years if criterion A is achieved, or 4 years if criterion B is achieved.

Vesting period is defined as "the period between grant date and the date upon which all the specified vesting conditions of a share-based payment arrangement are satisfied". Vesting conditions "include service conditions...and performance conditions, which require specified performance targets to be met..."

Given that the vesting period is defined such that **all** vesting conditions are satisfied, this implies in this case that the vesting period is 4 years.

However, in order to estimate the number of units of service the entity expects to receive during the vesting period, it would seem more appropriate to allow for the probabilities of meeting criterion A (with 3 years of service), but this is not mentioned at all in the relevant paragraph (15(b)).

Paragraph 15 deals with attribution over the period by reference to the actual number of units of service received during the vesting period, and the only way of ending service attribution it mentions is that the employee leaves service.

However, again it seems most logical, to maintain consistency, that attribution should refer to the performance criterion. So, if criterion A were satisfied after 3 years then the expense would cease after 3 years, but if performance criterion A were not satisfied, then it would be expensed over 4 years.

The calculation of fair value would have allowed for a probability of the option being exercised after 3 or 4 years. On average, allowing for the probability of meeting criterion A (and assuming experience in line with the assumptions), the weighted total expected expense charge should equal the fair value. But, the actual expense would be lower than the fair value if criterion A were satisfied, and greater than the fair value if criterion A were not satisfied.

We would like to see this clarified in the FRS/IFRS to avoid confusion. We would be happy to propose wording if this would help.

IASB Question 10/19/20

We understand the reasoning in the "Basis for Conclusions" behind the decision to account differently for equity and cash-settled payments. However, we do not believe that there should be a fundamental difference between the method of accounting for equity and cash-settled payments. Adopting the logic behind the proposals: these deliver the same value of benefit to the employee, and so the additional services provided by the employee in respect of each should be the same.

If we are to harmonise the approach, this leaves open the question of whether the common approach should be that suggested currently for equity-settled or cash-settled payment. Each of these has merits and de-merits. With the introduction of a new framework under IAS for recognising "P&L" and "STRGL" items, we would envisage a consistent method of recognising share-based payments with effect from 2005. We would expect this to be closer to the proposed method for cash-settled options than equity-settled options.

IASB Question 11

We strongly agree that an option pricing model should be used in the absence of a market price for an employee share option, as this is the only way in which a consistent and meaningful fair value can be placed on the options. However, models can be tested against the market price (where available) by removing those parameters dependent on the employee and we recommend that this test is applied to ensure consistency with market prices.

IASB Question 12

The method of allowance for the shorter expected life of the option will depend on the model used.

The binomial model allows explicitly for the theoretical optimal date of exercise of the option, and modifications can be made to allow for the expected non-optimal behaviour of an employee due to the non-transferability of the option. Even under a non-modified binomial model, the optimal date for exercise is not generally the final possible exercise date.

The Black-Schöles model cannot allow explicitly for the theoretically optimal exercise date of an option with an exercise period. Indeed, if the expected life is applied using the Black-Schöles model, the value of the option will typically be reduced. The value produced may be higher or lower than a more rigorous calculation using, say, the binomial approach.

We, therefore, disagree with this method of allowance and recommend that a more sophisticated and robust model should be used that can allow correctly for the factors underlying the shorter expected life of the option.

IASB Question 13

We strongly agree that vesting conditions should be taken into account as this is an integral part of the measurement of the fair value of the options.

The model used should therefore be sophisticated enough to allow for such factors rigorously, for example, by making modifications to the binomial model.

IASB Question 14

We would recommend that reload features be included within the original calculation of the fair value of the option as this is an integral part of the option.

IASB Question 15

We do not believe it is necessary to specify any further characteristics - these would be allowed for automatically because of the principles-based nature of the IFRS/FRS.

IASB Question 16

We agree that it is not necessary to give prescriptive guidance because of the principles-based approach. However, as prescribed in IAS19, we recommend that there is a requirement for actuarial advice to be obtained with regard to a number of the assumptions, such as withdrawal decrements. This will ensure that a robust approach to determining such assumptions is adopted, in line with other employee expense items, such as pension costs.

IASB Question 21

We agree that the disclosures are appropriate and necessary, as fairly small changes to some of the inputs to the model can alter the calculated fair value greatly. However, it should be recognised that non-material assumptions will not be disclosed.

IASB Question 22

We do not believe that the transitional treatment of vested share appreciation rights is appropriate as it does not fit in logically with the valuation treatment throughout the remainder of the standard. There should not be a significant overhead in placing a current fair value on such options, as they do not require the same retrospective analysis as equity-settled options.

IASB Question 25

We would recommend that the examples could demonstrate a wider range of possible outcomes. For example, Appendix C assumes that the fair value and intrinsic value increase steadily over time. The example could demonstrate the effect of a fall in fair value, which might show negative charges in certain years.