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NORSK REGNSKAPSSTIFTELSE

Sir David Tweedie

Chairman IASB

5 March 2003

Dear Sir David,

ED 2 Share-based payment

The Norwegian Accounting Standards Board is pleased to comment on the above document ("the draft IFRS"). The present lack of guidance regarding share based payment is a major obstacle in comparing the financial results of different enterprises. We therefore support IASB's efforts to develop a standard on this area.

In general, we were pleased to notice that the transaction principle is the underlying basis for the draft IFRS. This gives, in our opinion, a solid platform for the development of a standard that meets the qualitative requirements that an IFRS standard needs to have in order to improve financial reporting. Notwithstanding our support for this basic principle, we strongly believe there are important areas of ED 2 which should be revisited and improved. Our comments in those areas are incorporated in our attached answers to the questions raised in the draft IFRS. The most important areas are:

- Service date measurement when the transaction is measured directly (Q 4)
- Prescriptive use of indirect measurement for employee services (Q 7)
- Disallowing "true-up" if vesting conditions are not met (Q 9/10)
- Inclusion of performance based vesting criteria in measuring fair value of options granted (Q 13)
- Repricing and cancellation (Q 17/18)
- Cash settled transactions (Q 19)
- Disclosure requirements (Q21)

If you would like further clarification of our comments please contact Harald Brandsås or myself.

Yours sincerely,
Idar Eikrem
Chairman Norwegian Accounting Standards Board

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

We agree with the proposed scope. We do however suggest that the standard to a larger extent clarifies the scope regarding trusts and similar mechanisms that are set up to grant options or shares to employees.

Question 2
Paragraphs 4-6 of the draft IFRS propose requirements for the recognition of share-based payment transactions, including the recognition of an expense when the goods or services received or acquired are consumed. Are these recognition requirements appropriate? If not, why not, or in which circumstances are the recognition requirements inappropriate?

We agree with the provisions described in paragraphs 4-6 of the draft IFRS.

Question 3
For an equity-settled share-based payment transaction, the draft IFRS proposes that, in principle, the entity should measure the goods or services received, and the corresponding increase in equity, either directly, at the fair value of the goods or services received, or indirectly, by reference to the fair value of the equity instruments granted, whichever fair value is more readily determinable (paragraph 7). There are no exemptions to the requirement to measure share-based payment transactions at fair value. For example, there are no exemptions for unlisted entities. Is this measurement principle appropriate? If not, why not, or in which circumstances is it not appropriate?

We agree with the principle described in the draft IFRS.

Question 4
If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured directly, the draft IFRS proposes that fair value should be measured at the date when the entity obtains the goods or receives the services (paragraph 8). Do you agree that this is the appropriate date at which to measure the fair value of the goods or services received? If not, at which date should the fair value of the goods or services received be measured? Why?

In our opinion the grant date is the most appropriate date to measure the fair value of the goods or services to be received in almost all circumstances. Grant date is the date on which an agreement has been reached between the two parties regarding the value of the goods or services to be provided.

Question 5
If the fair value of the goods or services received in an equity-settled share-based payment transaction is measured by reference to the fair value of the equity instruments granted, the draft IFRS proposes that the fair value of the equity instruments granted should be measured at grant date (paragraph 8). Do you agree that this is the appropriate date at which to measure the fair value of the equity instruments granted? If not, at which date should the fair value of the equity instruments granted be measured? Why?

In our opinion, as stated and reasoned above, the grant date is the appropriate date to measure all equity instruments granted to both employees and nonemployees.

Question 6
For equity-settled transactions with parties other than employees, the draft IFRS proposes a rebuttable presumption that the fair value of the goods or services received is more readily determinable than the fair value of the equity instruments granted (paragraphs 9 and 10). Do you agree that the fair value of the goods or services received is usually more readily determinable than the fair value of the equity instruments granted? In what circumstances is this not so?

We generally agree with the approach proposed in the draft IFRS that there is a presumption that the fair value of the goods or services received is more readily determinable than the fair value of the equity securities granted. However, we believe that this presumption may be overcome in several circumstances. For example; services provided by consultants could be similar to services provided by employees. In such circumstances the fair value of the services received could be equally problematic to measure as if the employees had provided the same services. In some instances it could also be difficult to measure the fair value of the goods or services received due to the fact that the goods or services received are only delivered to very few enterprises. In such cases, it is our belief that the presumption that the fair value of the goods or services is more readily determinable than the equity instruments granted may be rebutted. However, our understanding is that the requirements of the standard are sufficiently flexible to accommodate these transactions.

Question 7
For equity-settled transactions with employees, the draft IFRS proposes that the entity should measure the fair value of the employee services received by reference to the fair value of the equity instruments granted, because the latter fair value is more readily determinable (paragraphs 11 and 12). Do you agree that the fair value of the equity instruments granted is more readily determinable than the fair value of the employee services received? Are there any circumstances in which this is not so?

We do agree with the general view that the fair value of equity instruments often will be more readily determinable, however we believe that examples of the opposite do exist.

As long as such examples may exist, we believe that it is not proper to supersede the general principle stated in paragraph 7, "whichever fair value is more readily determinable", by disallowing the use of direct measurement for transactions with employees.

We believe that one example would be where an employee, a group of employees or all employees are offered to substitute a portion of their cash salary against compensation in equity instruments. If, in such case there is evidence that, in the views of the employees, one alternative is not clearly better than the other, using the alternative cash salary as an measure on both sides of the transaction would seem appropriate. Such evidence could be that a significant portion of the employees chooses either of the two alternative methods of compensation. In this example it might be argued that employees are not fully able to appreciate the value of equity instruments. However, even if this was the case, it would be irrelevant to the question of measuring the value of services received since a lack of ability to appreciate the value of equity instruments would only highlight an issue related to the effectiveness of equity instruments as a form of payment.

If, in the example above, equity instruments are issued by a company which is not listed, this will also contribute to a conclusion that the value of the employees services are more readily determinable.

We propose to maintain the discussion in paragraph 12, but to delete the prescriptive conclusion that indirect measurement should always be used. As a minimum the assumption that fair value of equity instruments granted is more readily determinable should be modified by "in absence of evidence of the contrary".

Question 8
Paragraphs 13 and 14 of the draft IFRS propose requirements for determining when the counterparty renders service for the equity instruments granted, based on whether the counterparty is required to complete a specified period of service before the equity instruments vest. Do you agree that it is reasonable to presume that the services rendered by the counterparty as consideration for the equity instruments are received during the vesting period? If not, when are the services received, in your view?

We agree that it is reasonable to presume that services received in exchange for the equity instruments granted are received during the vesting period.

Question 9
If the services received are measured by using the fair value of the equity instruments granted as a surrogate measure, the draft IFRS proposes that the entity should determine the amount to attribute to each unit of service received, by dividing the fair value of the equity instruments granted by the number of units of service expected to be received during the vesting period (paragraph 15). Do you agree that if the fair value of the equity instruments granted is used as a surrogate measure of the fair value of the services received, it is necessary to determine the amount to attribute to each unit of service received? If not, what alternative approach do you propose? If an entity is required to determine the amount to attribute to each unit of service received, do you agree that this should be calculated by dividing the fair value of the equity instruments granted by the number of units of services expected to be received during the vesting period? If not, what alternative method do you propose?

The fair value of the equity instrument should be attributed to the goods or services received. However, we believe the proposed method (units of service approach) is to complex to be practical, and could give the wrong information, unless trued up (fully) for actual units of services received. We also believe that it could be questioned whether it is appropriate to recognise services received from employees in exchange for equity instruments that do no vest. We believe there is an important difference between share based payment for employee services and share based payment for goods and services in general that are of importance. The employee has the right to "walk-away" from the arrangement (for example quit, or renegotiate), while a supplier of goods or services needs to deliver even if the options are not exercised due to unfavourable conditions. It could therefore be argued that the employee would not consider equity instruments granted which have a small possibility of vesting as a payment for his or her services. The "surrogate measure" could in such circumstances lead to recognition of employee services received which are not supported by the value of the services the entity actually receives.

We therefore propose an alternative method; straight-line amortisation of the initially determined fair value at grant date of the services received, trued up at each reporting date for units of services received.

Question 10
In an equity-settled share-based payment transaction, the draft IFRS proposes that having recognised the services received, and a corresponding increase in equity, the entity should make no subsequent adjustment to total equity, even if the equity instruments granted do not vest or, in the case of options, the options are not exercised (paragraph 16). However, this

requirement does not preclude the entity from recognising a transfer within equity, i.e., a transfer from one component of equity to another. Do you agree with this proposed requirement? If not, in what circumstances should an adjustment be made to total equity and why?

For acquisition of goods and services in general we believe the proposed requirement is appropriate. However (as stated above) we believe this requirement needs to be amended regarding services from employees where equity instruments granted do not vest. The reason for this is that we question whether the indirect method ("surrogate measure") gives an appropriate measurement of the actual value received in such circumstances.

Question 11

The draft IFRS proposes that the entity should measure the fair value of equity instruments granted, based on market prices if available, taking into account the terms and conditions of the grant (paragraph 17). In the absence of a market price, the draft IFRS proposes that the entity should estimate the fair value of options granted, by applying an option pricing model that takes into account various factors, namely the exercise price of the option, the life of the option, the current price of the underlying shares, the expected volatility of the share price, the dividends expected on the shares (where appropriate) and the risk-free interest rate for the life of the option (paragraph 20). Paragraph 23 of the proposed IFRS explains when it is appropriate to take into account expected dividends. Do you agree that an option pricing model should be applied to estimate the fair value of options granted? If not, by what other means should the fair value of the options be estimated? Are there circumstances in which it would be inappropriate or impracticable to take into account any of the factors listed above in applying an option pricing model?

Option-pricing models are not developed for measuring share based payments to employees. However, even if we are concerned whether values determined using an option-pricing model are appropriate for employee stock options, we believe that such models represent the most reasonable method available to value options granted in exchange for goods or services. Provided that the final standard allows reasonable adjustments to the output of option pricing models, we believe that such models can be used to derive appropriate values within reasonable limits.

Question 12

If an option is non-transferable, the draft IFRS proposes that the expected life of an option rather than its contracted life should be used in applying an option pricing model (paragraph 21). The draft IFRS also proposes requirements for options that are subject to vesting conditions and therefore cannot be exercised during the vesting period (paragraph 22). Do you agree that replacing an option's contracted life with its expected life when applying an option pricing model is an appropriate means of adjusting the option's fair value for the effects of non-transferability? If not, do you have an alternative suggestion? Is the proposed requirement for taking into account the inability to exercise an option during the vesting period appropriate?

Our concern is that option pricing models are not developed to measure stock options granted to employees. However, we believe the proposed approach is one example of taking into consideration the diminution in value resulting from the non-transferability of employee stock options. It is possible that valuation experts come up with a better model at a later stage. We believe the final standard should not prescribe the expected life approach as the only way of dealing with the non transferability issue.

Question 13

If a grant of shares or options is conditional upon satisfying specified vesting conditions, the draft IFRS proposes that these conditions should be taken into account when an entity measures the fair value of the shares or options granted. In the case of options, vesting conditions should be taken into account either by incorporating them into the application of an option pricing model or by making an appropriate adjustment to the value produced by such a model (paragraph 24). Do you agree that vesting conditions should be taken into account when estimating the fair value of options or shares granted? If not, why not? Do you have any suggestions for how vesting conditions should be taken into account when estimating the fair value of shares or options granted?

With the exception of performance based vesting conditions we generally agree that vesting conditions should be considered in the estimate of fair value of an equity instrument granted in exchange for goods or services. We also believe the vesting conditions should not be incorporated into the option pricing model since this would probably be confusing. It is our view that it is better to adjust the output (value) from the
option pricing model instead.

Our concern with respect to performance based vesting conditions is that the element of variability in employee compensation is not reflected in the recognised expense under the treatment proposed in the ED. Although this may be conceptually correct in some respects, we feel that the result is counter-intuitive and may not always reflect economic realities.

Our experience is that entities, especially technology companies and companies where the human capital element is essential, often put a lot of efforts into establishing compensation elements which are variable to reflect the entity's and individual employees performance. Such arrangements may, in addition to work as an incentive, be targeted to share upside and downside with employees to secure a low cost base if performance falls below certain levels, reflect variances in the level or value of services received from employees, and similar.

In the above cases, regardless of the performance criteria are collective or individual, we are of the opinion that the variability should be reflected in the recognition of compensation expense since this would reflect both a planned and realised outcome. In addition we believe, in the case of individual performance criteria, the success level compared to the criteria may often reflect actual variances in the value of services received by the entity.

We also like to express our concerns regarding the challenges related to estimating the likelihood of vesting conditions that are performance related. We believe that such estimate will be very arbitrary in practice.

Therefore we propose to amend the ED to the solution described in FASB 123; no compensation cost is recognized if the performance conditions are not achieved, and 100% is recognized if they are.

Question 14

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

We are not familiar with the concept of reload feature. In light of this we believe that it would be appropriate to clarify the the definition further and develop examples of how reload features should be measured.

Question 15
The draft IFRS proposes requirements for taking into account various features common to employee share options, such as non-transferability, inability to exercise the option during the vesting period, and vesting conditions (paragraphs 21- 25). Are there other common features of employee share options for which the IFRS should specify requirements?

To the best of our knowledge we are not aware of any other common features of employee share options for which the final standard should specify requirements. However, we do believe that tax issues in some circumstances could affect the value of the option. It is not common, but in some instances the employee have to cap the value of the option in order to "share" the increased salary tax due to increased value of the options.

Question 16
The draft IFRS does not contain prescriptive guidance on the estimation of the fair value of options, consistently with the Board's objective of setting principles-based standards and to allow for future developments in valuation methodologies. Do you agree with this approach? Are there specific aspects of valuing options for which such guidance should be given?

We generally agree with this approach. This is because it allows possible future developments in option pricing models to be incorporated into valuation methodologies without requiring a change to the standard.

Question 17
If an entity reprices a share option, or otherwise modifies the terms or conditions on which equity instruments were granted, the draft IFRS proposes that the entity should measure the incremental value granted upon repricing, and include that incremental value when measuring the services received. This means that the entity is required to recognise additional amounts for services received during the remainder of the vesting period, i.e., additional to the amounts recognised in respect of the original option grant. Example 3 in Appendix B illustrates this requirement. As shown in that example, the incremental value granted on repricing is treated as a new option grant, in addition to the original option grant. An alternative approach is also illustrated, whereby the two grants are averaged and spread over the remainder of the vesting period. Do you agree that the incremental value granted should be taken into account when measuring the services received, resulting in the recognition of additional amounts in the remainder of the vesting period? If not, how do you suggest repricing should be dealt with? Of the two methods illustrated in Example 3, which is more appropriate? Why?

We disagree with the proposed treatment since in a lot of circumstances it will produce a result that conflicts with the main purpose of the ED and result in recognition of an expense that do not reflect value of services received. We believe that there is a significant risk that the proposed treatment will be perceived as prioritising "punishment" over relevant measurement.

The proposed treatment of repricing is consistent with an underlying assumption that repricing normally will occur to reflect a change (normally increase) of the value of services received. We believe that this is rarely the circumstance. We believe that repricing in nearly all circumstances are made in situations where the fair value of equity instruments offered to employees has been significantly reduced or lost in full.

Indirect measurement is a “surrogate” measure used to estimate the value of services received. In repricing situations a direct application of the same “surrogate” measure will not necessarily represent a meaningful method, since repricing often will be motivated by changes in value of the equity instrument which do not correspond with changes in the services received by the company.

An equity based compensation arrangement for employees do not represent a “binding agreement” for both the employer and the employees. In normal circumstances the employee may at any time terminate his payment of the option price (through contribution of services). The fact that employees do not have an obligation to complete the vesting period is a very important attribute of such arrangements and has several implications.

To the extent employees have alternatives or negotiating power, they do in fact have a possibility to renegotiate the terms of the arrangement if it becomes significantly less attractive than initially expected.

When an entity elects to use share based compensation it elects to use a form of compensation that is highly volatile, and accepts the risk that the elected compensation will not be effective for the full vesting period and may have to be revised. There is a potential that, before the completion of the vesting period, the equity instruments may appreciate to a tremendously high value or become close to worthless. In the case of a positive development of values, the company is normally legally obliged to deliver the agreed compensation. In the opposite situation the entity will often be in a situation where it is economically rational to revise the original terms to ensure that it do actually receive the services that it intended to acquire through the original grant.

A revision of the original compensation package can be made through repricing, through cancellation and establishment of a compensatory plan, through increase of cash salary, bonuses or similar. If the revision is due to the fact that the original plan has lost significant parts or all of its value to the employees, and not due to an increased value of services received, continued recognition on a revised or cancelled plan combined with recognising additional amounts will result in the recognition of an arbitrary expense which do not reflect any estimate of the value of services received by the entity. In the prescribed method for repricing an incremental amount is computed based on the differential between fair value of the original option and the repriced option at the time of repricing. This causes the computed fair value of the “new” repriced option to be “topped up” by the “value reduction” of the original grant. The first element is relevant. The latter is not.

In an economy with increasingly volatile financial markets repricing situations should be expected to occur more often than in rare situations. It is therefore important that the accounting for repricing produces results that are meaningful to users of financial statements and reflect economic realities. The proposed treatment may:

- cause financial statements to be less informative
- reduce the relevance of amounts recognised as expense in the financial statements because historical and no longer relevant compensation arrangements do affect future reporting
- reduce comparability since entities with different historical and no longer effective arrangements (either through repricing or cancellation), will recognise different amount as expense even if all effective arrangements are equal
- force financial statement users to adjust reported amounts to be able to use reported figures to estimate future financial performance

We believe that the ED currently does not have a proper solution in situations where the value of equity instruments granted to employees are reduced to an extent where the entity elects or is forced to or elects to improve the compensation to its employees. In our opinion IASB should evaluate alternatives such as:

- Include the "repricing" nature of employee options in the valuation of the original grant
- Measure the incremental amount by comparing the "per unit amount" under the original grant at grant date and the "per unit amount" under the repriced option
- Disregard cancelled options or the remaining "per unit amount" under the original grant and treat the new or repriced options as a new grant

Question 18

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

With respect to cancellation in combination with replacement options or other forms of compensatory arrangements we do not agree with the proposed treatment. Reference is made to Our comments on Q 17, as such changes are not fundamentally different from repricing.

Paragraph 29(b) of the draft IFRS indicates that "any payment made to the counterparty on the cancellation of the grant shall be accounted for as the repurchase of an equity interest." We believe that the exchange resulting in the cancellation represents a new agreement and the value of that agreement should be attributed to the goods or services provided to earn the consideration under the agreement

Question 19

For cash-settled share-based payment transactions, the draft IFRS proposes that the entity should measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity should remeasure the fair value of the liability at each reporting date, with any changes in value recognised in the income statement. Are the proposed requirements appropriate? If not, please provide details of your suggested alternative approach.

We believe the entity should measure the goods or services acquired according to main principles in the standard for share based payment transactions, regardless of whether the settlement is in cash or shares. The proposed treatment is in conflict with this basic principle as it does prescribe a remeasurement that, if the remeasurement amount is reported as compensation expense, will cause different amounts to be recognised depending on how the compensation is settled.

The liability should of course be measured at fair value, but we believe that subsequent measurement of the liability after goods and services have been received represents a finance cost and should be presented as such. This will give a consistent measurement of goods and services acquired.

Question 20

For share-based payment transactions in which either the entity or the supplier of goods or services may choose whether the entity settles the transaction in cash or by issuing equity instruments, the draft IFRS proposes that the entity should account for the transaction, or the components of that transaction, as a cash-settled share-based payment transaction if the

entity has incurred a liability to settle in cash, or as an equity-settled share-based payment transaction if no such liability has been incurred. The draft IFRS proposes various requirements to apply this principle. Are the proposed requirements appropriate? If not, please provide details of your suggested alternative approach.

We generally agree with the proposal in paragraphs 35 to 44. However, the bifurcating an award into equity and liability components can be difficult (measurement issues) and we therefore suggest to give some examples in implementation guidance. Otherwise we do believe this issue could lead to diversity in practice.

Question 21

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

(a) the nature and extent of share-based payment arrangements that existed during the period,

(b) how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined, and

(c) the effect of expenses arising from share-based payment transactions on the entity's profit or loss.

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

We strongly believe the disclosure requirements are to excessive. We do not believe the users of the financial statements would be mislead if the disclosure requirements are decreased.

Question 22

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

We do not agree with the proposed transition requirements. The proposed transition approach is in conflict with the intention of exposure drafts, since the draft is published for comments, not as an authoritative requirement. We also believe the exposure draft is yet not known among most listed entities, and such transition requirements would probably be viewed as complex.

In our opinion the transition requirement should be prospective from the effective date of the final standard.

Question 23

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

We generally agree with the proposed requirements on this issue.

Question 24
In developing the Exposure Draft, the Board considered how various issues are dealt with under the US standard SFAS 123 Accounting for Stock- Based Compensation, as explained further in the Basis for Conclusions. Although the draft IFRS is similar to SFAS 123 in many respects, there are some differences…For each of the above differences, which treatment is the most appropriate? Why? If you regard neither treatment as appropriate, please provide details of your preferred treatment. (Respondents may wish to note that further details of the differences between the draft IFRS and SFAS 123 are given in the FASB's Invitation to Comment.)

Differences between the draft IFRS and Statement 123 should be carefully considered since it is important to have as few differences as possible. We would especially draw attention to 24 b), c) and e) where we see no reason to have a different solution than SFAS 123.

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

No.