The Hundred Group
of Finance Directors

CL 114

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30 Cannon Street
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7 March 2003

Dear Ms Crook,

ED2 Share Based Payment

I am pleased to submit the response of the Technical Committee of the 100 Group of Finance Directors in the UK to ED2 Share Based Payment.

Our responses to the specific questions asked in the exposure draft are set out in the attachment to this letter. Our principal comments are as follows:

1. We do not believe the IFRS should apply to subsidiary companies that are members of a group for which consolidated financial statements are prepared which comply with the requirements of the IFRS. Nor do we believe that the IFRS should apply to parent company financial statements where the parent company complies with the IFRS in its consolidated financial statements. The accounting and financial information required by the IFRS is mainly relevant to users of consolidated financial statements. In the case of subsidiary companies, no equity instrument will ever be issued by these companies. In the case of parent companies, although equity instruments will be issued, frequently there are few services consumed by such companies.

2. We do not agree with the "mixed measurement" approach of the draft IFRS, whereby share based payments to employees are measured differently to other share based payments. We believe the fair value of equity instruments issued, for both employee services and other goods and services, should be measured using whichever of the "direct" or "indirect" methods is most reliable. We do not agree that the fair value of equity instruments granted to employees is necessarily more readily determinable by reference to an option pricing model than to an other, direct indicator of fair value, for example a cash equivalent amount of salary foregone.

3. We also have reservations about whether standard option pricing models, such as the Black-Scholes model, give a reliable indicator of the fair value of employee options. Anecdotal evidence suggests that the cash equivalent value of an option to an employee would be significantly less than the value indicated by the (modified) option pricing model proposed by the draft IFRS. We believe this is an area that requires further research.

4. We believe the unit of service method of allocation is unnecessarily complex and would prefer amortisation of the fair value of equity instruments issued on a straight line basis over the vesting period.

5. We do not agree with the extent of disclosure required by the draft IFRS. We would understand the extensive disclosure requirements if an accounting charge were not proposed. But given that an accounting charge is required, the extensive disclosure requirements should be simplified. In particular, the requirement to disclose commercially sensitive information (such as the estimated probability of meeting performance conditions) should be removed.

6. Given the complexities of applying the IFRS, we believe a slightly delayed implementation date would be welcomed by many companies and would improve the quality of compliance. An effective date of 1 January 2005 would give companies more time to prepare for adoption of the standard. We also believe the standard should not be applied to options granted before the standard is finalized but should be applied with prospective effect.

We support the objective of convergence of accounting standards that the IASB is seeking to achieve. ED2 should be a positive step towards meeting that objective. We would be concerned, however, if ED2 were implemented in a way that did not create a "level playing field" for UK and US companies. We would encourage the IASB to work in tandem with the FASB in the US to harmonise the accounting in this area before finalising the standard.

Yours sincerely,

Rosemary Thorne
Chairman
Technical Committee of the 100 Group of Finance Directors

100 Group Response to the IASB Invitation to Comment on ED2

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?

A. We do not believe the IFRS should apply to subsidiary companies that are members of a group for which consolidated financial statements are prepared which comply with the requirements of the IFRS. Nor do we believe that the IFRS should apply to parent company financial statements where the parent company complies with the IFRS in its consolidated financial statements. The accounting and information required by the IFRS is mainly relevant to users of consolidated financial statements. Furthermore, the accounting required by the IFRS would be inappropriate for subsidiaries where options are granted over the parent company's shares, since no equity instrument will ever be issued by those subsidiary companies.

There should also be some clarification of how the IFRS would apply to all employee share schemes, such as the "Save As You Earn" schemes common in the UK. All employee share schemes are not typically part of employment contracts and the share-based payments involved are not seen by either employers or employees as payments for services. Accordingly, an expense in respect of such schemes, on the grounds that services have been acquired and consumed, would appear to be inconsistent with a basic premise of the IFRS.

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?

A. The recognition requirements are appropriate. However, as noted in the response to Question 1, the IFRS should clarify the accounting for share-based payments that do not relate to goods or services consumed by the business.

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?

A. Measurement at fair value is appropriate. However, we do not agree with the "mixed measurement" approach of the draft IFRS, whereby share based payments to employees are

measured differently to other share based payments. We believe the fair value of equity instruments issued, for both employee services and other goods and services, should be measured using whichever of the direct or indirect methods is more reliable. We do not agree that the fair value of equity instruments granted to employees is necessarily more readily determinable by reference to an option pricing model than to an other, "direct" indicator of fair value, for example a cash equivalent amount of salary foregone.

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?

A. As noted in our response to Question 2, we do not agree with the "mixed measurement" approach of the draft IFRS, whereby share-based payments to employees are measured differently to other share-based payments. We believe all share-based payments should be measured at grant date, using the indirect valuation of the equity instrument only where a direct valuation is not ascertainable.

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?

A. We agree that grant date is the appropriate date at which to measure the fair value of equity instruments granted, under both the direct and indirect valuation methods.

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?

A. We agree that the fair value of the goods or services received from parties other than employees is usually a more reliable indicator of the fair value of the equity instruments granted than an estimate based on an option pricing model.

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?

A. As noted in our responses to Questions 1 and 4, we do not agree with the "mixed measurement" approach of the draft IFRS. We believe the indirect valuation method should be used only where a direct valuation is not ascertainable. We do not agree that the fair value of equity instruments granted to employees is necessarily more readily determinable by reference to an option pricing model than to an other "direct" indicator of fair value. In circumstances where employees can elect to receive part of their salary either in cash or in the form of share options, and there is evidence of employees actually electing to be paid in cash rather than options, we believe the value of cash salary foregone is a better indicator of fair value than the estimated value based on an option pricing model. We do not see any reason in these circumstances to make a distinction in the basis of valuation between employee services and other goods or services. We believe it is equally appropriate in both cases to use the fair values of goods and services received when these can be reliably determined.

We also have reservations about whether standard option pricing models, such as the Black-Scholes model, give a reliable indicator of the fair value of employee options. Anecdotal evidence suggests that the cash equivalent value of an option to an employee would be significantly less than the value indicated by the (modified) option pricing model proposed by the draft IFRS. We believe this is an area that requires further research.

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?

A. We agree that it is generally appropriate to presume that services are rendered during the vesting period, unless vesting takes place on the occurrence of a specific event.

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?

A. We believe the unit of service method is unnecessarily complex and would prefer amortisation of the fair value of equity instruments issued on a straight line basis over the vesting period.

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?

A. We agree with this proposed requirement. However, to the extent that a charge has been recorded in respect of equity instruments that do not vest or options that are not exercised, we believe the relating credit within equity should be transferred to the profit and loss reserve. Similarly, a transfer to the profit and loss reserve should be made where options exercised are satisfied not by new issue shares but by treasury shares.

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?

A. We do not agree that the fair value of employee share options should necessarily be estimated using an option pricing model. There may be circumstances where the fair value of employee services paid for by share options may be measured directly – for example, where employees forego cash payment and receive payment in share options instead. We see no reason why a transaction of this nature, provided the cash forgone reasonably approximates the value of the options and there is evidence of employees electing to be paid in cash rather than options, should be treated differently to similar transactions where non-employees receive payment in share options. We agree that, where the fair value of services received is not reasonably determinable either by reference to cash payment foregone or to a market price, an option pricing model should be used. However, we believe further research is necessary to ensure that the estimated fair value derived from the (modified) option pricing model proposed by the standard properly reflects the cash equivalent value to the employee. Anecdotal evidence suggests that the cash equivalent value of an option to an employee would be significantly

less than the value indicated by the (modified) option pricing model proposed by the draft IFRS.

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?

A. We agree that using an option's expected life, rather than its contracted life, is appropriate. We also agree with the proposed requirement to take into account the inability to exercise an option during the vesting period.

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?

A. We agree that vesting conditions should be taken into account when estimating the fair value of options using an option pricing model.

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?

A. We agree with the proposed treatment.

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?

A. It is common in the UK for performance conditions to be rolled over and re-tested if they are not met in one period. This raises the question of what is the vesting period over which the fair value of the options should be spread. Guidance in this area would be welcome.

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?

A. We agree with the principles-based approach adopted.

Question 17

If an entity re-prices 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, ie 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?

A. We agree that the incremental value granted on re-pricing of an option should be taken into account when measuring the services received. Of the two methods presented, we prefer straightforwardly assessing the incremental change in value and amortising that change over the remaining vesting period. We see no reason why the alternative method is necessary.

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.

A. We do not agree with this treatment. If an entity cancels a share or option grant (and does not grant replacement shares or options), we do not believe it is correct to continue recording a charge for the services received as no further value will be exchanged. Where an entity makes a cash payment to cancel a share or option grant, we believe the unamortised value of the original option grant plus any incremental value associated with the cash payment should be charged immediately to the profit and loss account.

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.

A. We agree with the proposed requirements.

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.

A. We agree with the proposed requirements.

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)?

A. We do not agree with the extent of disclosure required by the draft IFRS. We would understand the extensive disclosure requirements if an accounting charge were not

proposed. But given that an accounting charge is required, the extensive disclosure requirements should be simplified. In particular, the requirement to disclose commercially sensitive information (such as the estimated probability of meeting performance conditions) should be removed.

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 (ie 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.

A. We do not believe the standard should be applied to options granted before the standard is finalised. Rather, it should be applied with prospective effect. Also an effective date of 1 January 2005 would give companies more time to prepare for adoption of the 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?

A. We agree with the proposed requirements.

Question 24

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

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

- employee share purchase plans are excluded from SFAS 123, provided specified criteria are met, such as the discount given to employees is relatively small;
- SFAS 123 encourages, but does not require, entities to apply its fair value measurement method to recognise transactions with employees; entities are permitted to apply instead the intrinsic value measurement method in Accounting Principles Board Opinion No. 25

Accounting for Stock Issued to Employees (paragraphs BC70- BC74 in the Basis for Conclusions give an explanation of intrinsic value); and

- unlisted (non- public) entities are permitted to apply the minimum value method when estimating the value of share options, which excludes from the valuation the effects of expected share price volatility (paragraphs BC75- BC78 in the Basis for Conclusions give an explanation of minimum value).

A. We agree that there should be no exemption from the IFRS. However, as noted in our response to Question 1, we believe the application of the IFRS to all employee schemes that do not involve payments for services should be clarified.

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

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

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

A. We broadly agree with the approach in the draft IFRS. However, to the extent that a charge has been recorded in respect of equity instruments that do not vest or options that are not exercised, we believe the relating credit within equity should be transferred to the profit and loss reserve.

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

A. We prefer the approach taken by SFAS123. We do not believe that any further exchange of value arises after the cash settlement and, hence, the unamortised value of the original option

grant plus any incremental value associated with the cash payment should be charged immediately to the profit and loss account.

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

A. We agree that fair value should be measured at grant date.

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

A. We agree with the proposals in the draft IFRS.

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

A. We agree with the proposals in the draft IFRS.

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.)

Question 25

Do you have any other comments on the Exposure Draft?

A. No.