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Ref MMCK/mm

Dear Kimberley

ED2 Share Based Payment: Basis for Conclusions

I am writing with comments on the draft Basis for Conclusions on the Exposure Draft on share-based payment, comments on which have been invited by 7 March. We have responded to the UK's Accounting Standards Board on the Exposure Draft itself, and a copy of this is enclosed herewith. This letter expands on our response by addressing in greater depth some of the technical considerations we have identified.

We agree with the bulk of the arguments advanced in the Basis for Conclusions. In particular, we would highlight our agreement with the scope of the draft FRS, and with the conclusions that it is flawed to argue that "the entity is not a party to the transaction", "there is no cost to the entity, therefore there is no expense" and that "earnings per share is hit twice".

As regards earnings per share, this is a memorandum item deriving from the recognised profit figure. Even it were thought (incorrectly) that the draft FRS would result in a double hit at eps level, this would not, in our view, have invalidated the decision to recognise an expense and charge this against profits. Rather, the definition of earnings per share under the relevant financial reporting standard should be specified on a basis that provided the meaningful outcome.

<u>Settlement of Awards out of Market Purchased Shares</u>

Share-based payment has, at least until now, typically been by way of options over shares which, in practice, are satisfied through new issues via a right to subscribe. Grant date measurement appears to us to be clearly the right form of measurement for the resultant expense and certainly so when the nature of the entitlement is a right to subscribe for new shares. However, a variety of other types of share-based payment transaction exists and these other types need to be properly catered for under the applicable financial reporting standard. It is notable that many of these give rise to obligations which seem to be in the nature of liabilities for which, consequently, vesting date measurement is more appropriate to the economic substance of the transaction.

We are unconvinced that the fact of equity settlement of a share based payment transaction of itself evidences the existence of an equity instrument rather than a liability. From the entity's point of view, share based payment out of market-purchased shares is substantially identical to payment by way of cash-settled share appreciation rights. It is only from the recipient's perspective that settlement out of market-purchased shares leads to an effect substantially identical to the issue of new shares in settlement of the transaction. However, it is the entity's accounts and, therefore, perspective which the draft IFRS is addressing.

A company might choose to hedge, or alternatively choose not to hedge, the underlying obligation to deliver market-purchased shares or cash to the value of these, though there is no defining reason why mode of settlement should determine hedging strategy. Hedging may substantially alter the economic outcome but whether or not it is done, the ultimate net effect on assets, liabilities and shareholder funds under cash or second-hand share settled transactions is in principle identical.

Accounting Entries

Where shares are to be purchased in the market, this leads unambiguously to a reduction in the assets of the company through payment out of cash. This cost may be very significantly more or less than the original expense calculated on the basis of grant. It would indeed be fortuitous if the two amounts were identical and they should not notionally be presumed to be so.

The outflow of cash, and thus reduction of assets, to purchase shares must of course lead to a corresponding balancing accounting entry. Under the draft IFRS, there is no corresponding liability being discharged. Accordingly, the balancing effect must be either a through a further deduction against the profit and loss reserve, thereby double charging this reserve as the full grant based cost has already been expensed, or else as a deduction against equity which certainly at least partially reverses and, quite possibly more than reverses, the original amount added to equity.

If the draft IFRS intends that the cost of purchasing the shares be deducted against equity this would accord with the treatment of treasury shares the accounting for which is designed to avoid recognising holding gains and losses on treasury share operations. However, the validity of this proposition surely rests on the assumption that purchases and sales are to be made at prevailing fair value. Shares purchased for fair value with the intention of issue on a quite different basis is surely another matter. It is in any case difficult to see why an ownership interest recognised as created on its award should be treated as depleted consequent upon the sourcing of the shares to settle it.

Definition of liability and equity instrument

The glossary to the draft standard defines equity instrument as, in essence, something that is not a liability but this fails to provide a basis for distinguishing between the two. We note, however, as per paragraph BC93, that the definition of a liability under the IASB framework is "a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits". It seems clear to us that settlement of share-based payment through market purchases of shares must result in such an outflow, reflecting the cash to be expended. Even in the case of the exercise of a share option, the holder will only exercise if the value of resultant shares is greater than the total exercise cost. Hence there must be a net outflow of resources if shares are purchased to effect settlement.

Therefore, under the IASB framework it would seem that, where the obligation is genuinely expected to be satisfied through shares to be purchased from the market, the obligation is in the nature of a liability. It would also seem reasonable, however, to presume that unless such an expectation exists, the settlement of share awards will be made by way of new issues, this being the simplest means of discharging the obligation. A rebuttable presumption along these lines would seem in order. Indeed, where the entitlement is through a right to subscribe with no alternative (cash or second-hand shares) it must be an equity instrument. Where, though, awards are expected to be settled in shares to be sourced held, for example, through a vehicle such as an Employee Share Ownership Trust (ESOT) or employee benefit trust, the share-based payment award ought to be regarded as in the nature of a liability. Shares acquired by the ESOT should, correspondingly, be treated as assets held to match the liability.

Share and Cash Alternatives

The rationale advanced for the proposed accounting treatment in the event that the employee has the choice of settlement, seems appropriate. The genuine economic reality would seem to be that a liability does exist. However, where the entity has the choice of settlement, our view would be consistent with that we have advanced where the entity has the choice of delivery of new or market purchased shares i.e. that if a settlement is expected to be in the form of cash, a liability should be recognised, but otherwise, and in the absence of an expectation that shares will be market-purchased to satisfy settlement, an equity instrument should be recognised.

The optimum approach

The most logical answer to the market-purchased share conundrum is that if these have already been purchased, an equity instrument can reasonably be considered to be created. If these are accounted for as treasury shares a meaningful overall treatment follows naturally. The addition to equity offsets the deduction from equity arising from the purchase of shares into treasury.

It follows that if shares have not been purchased but, at point of grant, are anticipated to be so the liability could conceptually be considered at point of purchase, but not before, as converting into an equity instrument, the instrument then being measured at fair value at that point in time.

By contrast, there do not appear to be any obvious grounds for regarding purchases of shares to settle payment that were <u>unanticipated</u> at point of grant as invalidating the recognition of an equity instrument at the outset. Such purchases would, rather, seem to be in the nature of treasury share purchases. This is because a fall in share price should be associated with a reduction in the number of shares held if a hedge of the obligation is being maintained, not an increase. A purchase of shares in such circumstances therefore implies, if anything, a shift from liability to equity instrument, not the reverse.

In practice, it would be virtually impossible to earmark committed shares in this way for accounting purposes. The appropriately hedged position would need to be constantly rebalanced, not just once per accounting period. If full earmarking took place, how would shares be treated which were freed up through non-vesting of the share-based payment? Also, the cost of buying all such shares would, in the case of options, considerably exceed the grant-based measurement of its cost and would exceed the number of shares required to hedge the obligation under option valuation methodology. The value of shares required for the hedge (a function of the option delta) would itself also exceed the grant-measured cost at the outset and would require constant rebalancing.

Accounting instead for an asset and a liability until eventual vesting does not produce an incorrect outcome and indeed it will be a meaningful outcome to the extent that market-purchased shares are expected to be used. Indeed, the accuracy of the determination of the number of shares required for the purpose and of any hedging strategy employed will also then be reflected in the eventual recognised cost.

I do hope these observations will be of some value to you and the Board in taking forward your proposals. Let us know if there is any further assistance we can provide.

Yours sincerely

M W McKersie
Manager
Investment Affairs

Enclosure

[LM1 210203/INV/MMCK/LETTERS/FEB 03]

FRED 31: SHARE BASED PAYMENT – ABI RESPONSE TO ASB EXPOSURE DRAFT

INTRODUCTION

1.1 In November 2002, the Accounting Standards Board published in UK exposure draft form the draft International Financial Reporting Standard issued by the International Accounting Standards Board on share-based payment.

1.2 This paper is the response of the Association of British Insurers (ABI) whose 400 members have some £1,000 billion of assets under management including holdings in UK equities amounting to more than 20% of the total capitalisation of the market. Our Members have a keen interest in ensuring accurate and robust accounting for the cost of share-based payment. As users of accounts they wish to ensure that appropriate investment judgments can be made. Also, however, for investors in companies making use of share-based payment it is important that there should be fair and proper accountability by companies for their stewardship of shareholder resources.

GENERAL COMMENTS

2.1 Our Association strongly supports the efforts of the IASB to bring forward proposals that will enable the costs of share-based payment to be recognised as an expense and properly accounted for. We also support the key proposition now advocated in the exposure draft that the cost of share-based payment in the nature of equity instruments should be measured by reference to fair value at point of grant. This is the point at which contractual terms are committed to.

2.2 The FRED demonstrates the considerable amount of thought that has taken place and progress made since the earlier discussion paper on the complex issues that this project raises. We consider it essential that these complexities are fully addressed in order to ensure that the resultant standard is one which is meaningful and workable and which provides a basis that maximises the likelihood of buy-in and acceptance, and particularly from the USA. It will be vital that a full measure of international acceptance and implementation of accounting on share-based payment is achieved.

2.3 There are certain aspects on which we believe careful further thought needs to be expended. These all relate to the matter of "truing-up" where we believe that the economic substance of transactions requires some modification of the IASB's approach.

2.4 Firstly, we consider that vesting conditions attached to share-based payment, whether they relate to service obligations or performance criteria which need to be satisfied, represent a contingency which if fully satisfied ensure the release of payment in full. We consider it appropriate that the full expense should then be recognised, and not a lesser amount (as per the IASB's proposals if performance conditions govern vesting) and not a greater amount as would be likely under the vesting date measurement approach which was proposed by the IASB in the earlier discussion paper.

2.5 Adopting the principles of arbitrage pricing (consistent with the proposals in the FRED for use of option pricing methodology which itself derives from arbitrage pricing) these costs should then be discounted in the case of ultimate vesting of less than the whole of such awards. This could lead to considerably smaller charges being recognised when awards do not vest, but significantly, not a zero expense. This reflects the costs that the issuer would theoretically face if attempting to hedge the obligation. The fact that there would be no obvious purpose served by so hedging, at least in the case where the award is to be satisfied in new-issued shares and there is no cash cost to the company in settling at point of vesting and therefore no liability to be discharged, does not invalidate the pricing methodology.

2.6 Secondly, we believe that the definition of equity instrument, which the FRED uses to define whether grant date, vesting date or (in the case of options) exercise date measurement of the value is to be charged, needs to relate at least to an expectation of creation of an ownership interest in the company. Unless satisfied through the <u>issue</u> of shares an entitlement to have shares delivered in satisfaction of share-based payment does not of itself create such an interest – it can only ever lead to a transfer of ownership interest.

2.7 We consider that vesting (or, in the case of options, exercise) date measurement may be appropriate for certain types of share-settled transactions in just the same way as this accounting treatment applies under the FRED to the settlement of share appreciation rights. This does not invalidate the conclusion that grant date measurement is right in most circumstances and certainly is where the benefit conferred on the recipient is purely and simply through the grant of a right to subscribe for shares.

2.8 We outline in greater detail in a response to the IASB's invitation to comment on their Basis for Conclusions our thinking on this matter. Our concerns are not simply theoretical, though. Companies may have good practical reasons for wishing to adopt an approach to share-based payment that is best accounted for through liability recognition. There do not appear to be any obvious concerns regarding accounting arbitrage that would result from such a choice of approach being available.

2.9 Further consideration needs to be given also to accounting for the hedging of share-based payment transactions. The potential need to hedge arises where the obligation is in the nature of a liability, which will certainly be the case where it is to be cash-settled. Transactions to source shares to be used to settle or otherwise hedge share-based payment obligations are conceptually quite different from unencumbered treasury share transactions.

SPECIFIC COMMENTS

<u>ASB Questions</u>

Q1

The ASB is proposing to require the adoption in the UK of a standard based on the proposed IFRS from the effective date in the IFRS (which is expected to be accounting periods beginning on or after 1 January 2004). Do you agree with this approach?

Yes, though we are also concerned to ensure that this is introduced pursuant to an internationally harmonised approach.

Q2

The IASB has concluded that its standard should apply to all entities. The ASB does not believe there are any conceptual or practical reasons why that conclusion should not apply equally in the UK. It is therefore proposing that all UK entities, other than those that are applying the FRSSE, should be required to prepare their financial statements in accordance with the proposed standard. Do you agree with this proposal?

Yes.

Q3

The IASB has concluded that its standard should apply to all types of share-based payment transactions, including SAYE- type share purchase plans. The ASB does not believe there are any additional UK considerations that would justify a different conclusion being reached in the context of UK accounting. Therefore, like the IASB and ASB is proposing that the standard should apply to all types of share-based payment transaction. Do you agree with this proposal?

Yes. We see no plausible arguments for treating SAYE schemes in a different manner to that which would otherwise apply under the international standard.

As institutional shareholders, our members recognise the value of schemes that encourage employee share ownership and thereby incentivise participants to work for the good of the company. The benefit to the company and its shareholders should manifest itself over time in enhanced corporate performance over and above that which would have pertained had no such scheme been in operation. Participation in SAYE schemes has, though, a corresponding cost to shareholders in just the same manner as for other types of option scheme. The correct accounting treatment will therefore be to recognise the costs and match these with the anticipated recognition of the benefits.

It will, of course, be important to ensure that prescribing a new accounting treatment would not lead to disproportionate administrative cost being imposed. Some companies may wish to operate such schemes through the use of an employee benefit trust as some already do. There is also, perhaps, a better case to argue for a simpler approach to option valuation at point of grant provided that the full outturn cost would in due course be properly recognised. This is a further argument for looking again at the proposal to change the accounting for ESOTs (see also our comments in response to ASB question 5 below).

Q4

The IASB is proposing that its standard should apply equally to all individual entity financial statements and consolidated financial statements, regardless of whether for example the reporting entity is a wholly-owned subsidiary of a group that prepares consolidated financial statements or a parent consolidation financial statements or a parent company that also prepares consolidated financial *statements. The ASB does not believe there are any additional UK considerations that would justify a different conclusion being reached in the context of UK accounting and is therefore proposing to adopt the same approach as the IASB. Do you agree with this proposal?*

Yes.

Q5

The ASB is proposing that, when the share-based payments standard is implemented in the UK, the ASB should withdraw UITF Abstract 10 'Disclosure of directors' share options' (if it has not already been withdrawn by then), UITF Abstract 13 'Accounting for ESOP Trusts', and UITF Abstract 17 'Employee share schemes'. It also acknowledges that consequential amendments may need to be made to UITF Abstract 32 'Employee benefit trusts and other intermediate payment arrangements'.

(a) *Will these amendments to existing UK requirements be sufficient to enable entities to adopt the proposed standard without being in breach of an existing requirements?*

(b) *Are any of the amendments unnecessary for this purpose?*

We agree that UITF Abstract 17 'Employee share schemes' should be withdrawn consequent upon introduction of the revised accounting regime for share-based payment.

Accounting for ESOTs, other employee benefit trusts and other intermediate payment arrangements needs careful consideration. We support the conceptual proposition that the company's financial statements should not record shareholdings in itself as assets of the company or transactions with shareholders, in their capacity as such, as generating profits and losses.

Such considerations do not appear to apply if shares are purchased and held to match liabilities and this is the fundamental distinction between Employee Share Ownership Trusts, with their defined role, and treasury shares where no such presumptions exist. We would be concerned at the removal of all aspects of accountability for ESOTs and suggest that the discipline presently provided through financial accounting of ESOTs needs to be retained.

Q6

The FRED proposes that entities should be required to apply the requirements of the standard to equity-settled share-based payment transactions that were granted after the publication date of the FRED but had not vested at the effective date of the standard. Full retrospective application would not be permitted (unless it can be achieved through early adoption) and nor would prospective application. Do you agree with this proposal?

This seems reasonable.

<u>IASB Questions</u>

Q1

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 believe so.

Q2

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 or in which circumstances are the recognition requirements inappropriate?

In principle we wish the cost of share-based payment to be recognised on basis that matches the recognition of expenses with the commensurate benefits anticipated to be received. However, it should be noted that contractual terms may be entered into which lead to an unambiguous transfer of value which, it may subsequently be recognised, does not match the value of services expected to be received. In the case of share-based payment for assets, the settlement date for delivery of those assets does not appear to be of any obvious or defining relevance to the economic substance of the transaction.

Q3

For an equity-settled share-based payment transaction, the draft IFRS proposed 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?

Yes.

Q4

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?

See our answer to Q2.

Q5

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?

Yes. Unless the payment is in the nature of a liability we consider that grant date measurement provides the only truly economically meaningful approach. Alternatives, in particular vesting date measurement and, in the case of options, exercise date, can lead to intuitively meaningless results in certain circumstances.

Q6

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?

Yes.

Q7

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?

Yes. The fair value of employee services will be less easy to determine than the value of the share-based payment

Q8

Paragraphs 13 and 14 of the draft IFRS proposes 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?

> Yes, this is so, though it will not necessarily follow that the benefits always accrue in a systematic and regular fashion. In practical terms, a strong case could be advanced that a material proportion of the payment can be considered to accrue at point of grant with the remaining portion then accruing over the period until the award finally vests.

Q9

If the services received are measured by using the fair value of the equity instruments granted as a surrogate measure, the draft of 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?

> We are not fully convinced that this is the right approach. As outlined below, we believe the nature of the contingent share-based payment transaction is best considered to relate to the expectation that the transaction will become fully effective and to reflect any variations in reality as they take place.
>
> The validity of the accounting effect proposed by the draft IFRS in respect of uncertainties as regards service and forfeiture rests on the apparent assumption that awards are forfeited in the event that the service condition is not fulfilled and that the likelihood of employee departure is independent of the embedded value of an individual's contingent share-based payment at the point where an individual takes a decision to leave. Neither assumption is necessarily well-founded.
>
> As regards failure to complete the service obligation, payment may nevertheless vest in cases of good leavers (e.g. upon death, illness, disability or early retirement). By contrast, in other cases, forfeiture of awards will be an automatic consequence of an employee leaving. However, the logic of imposing a service condition in the first place will have been to permit a clawing back of value to shareholders in just such circumstances and the accounting treatment ought to recognise this through a sensible approach to truing-up.

In still other circumstances, individuals may be induced to depart, for example because of failure to perform adequately. In such cases whether or not an award vests may turn on the legal settlement of the individual's departure. The draft IFRS would therefore provide companies with an accounting incentive to vest the share-based payment as there would be no adverse effect on profits, unlike any cash cost of severance. However, any value passing in such circumstances represents a cost to shareholders. To fail to recognise this also risks artificially encouraging payment for failure.

Q10

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?

As regards the failure of options to be exercised even though they have vested, we see no case for revaluation. The expense reflected fair value of the instrument which was created. That fair value already reflected the possibility of non-exercise by the end of the option life.

In respect of failure of share-based compensation to vest, quite different considerations apply. We recognise that the IASB's conceptual framework does not permit revaluation of equity subsequent to initial measurement. Within such a framework we consider that subsequent failure of equity instruments to vest is then best considered to reflect a variation in assumptions which creates some new equity instrument that in part reverses the effect of the earlier issue. This can be seen most clearly to be the case where an individual ceases to provide the service that is a contractual condition of the equity instrument vesting.

It can also be considered to apply where such other performance condition(s) governing vesting is/are not satisfied in full. The logic of imposing performance conditions on the vesting of share options is to claw back value in the event that such conditions, whether they relate to individual or corporate performance, are not satisfied. The accounting treatment ought to recognise this through truing-up.

Q11

The draft IFRS proposed 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 proposed 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 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?

> We agree that fair value of options should be accounted for through use of an option pricing model that takes account of at least all the factors mentioned. Black-Scholes and binomial models can provide an appropriate approach though the IFRS should not preclude other robust valuation processes from being used.

Q12

If an option is non-transferable, the draft IFRS proposed 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 requirement 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?

> The draft IFRS is correct in recognising that the absence of an ability to transfer the option to a party other than the original assignee will affect the fair value of the option. However, it is wrong to assume that an option's expected life should be directly substituted for its contractual life since the fair value of an option already assumes that in some cases the rational holder of the option will wish to exercise it early. Rather an appropriate means of discounting the value of the option of full contractual term must be found to reflect the undoubtedly correct view that the early exercise of an option with remaining time value because it cannot be sold does reduce the effective expense to the company.

Q13

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?

> As regards equity instruments of all sorts, we do not consider that fair valuation at point of grant should take into account contingencies relating to probability of vesting, although the amount recognised at points in time prior to vesting may be discounted to reflect expectations that some or all may not eventually vest. The full value should be measured with accrual of an appropriate proportion of this cost.
>
> At point of vesting, the full fair value of the award at point of grant should be recognised if the award vests in full. This value would be discounted if the full award did not vest to reflect the claw-back of value to shareholders, in a manner consistent with the original grant-based measurement of the value of the equity instrument. This should reflect a notional arbitrage-pricing approach.

Q14

For options with a reload feature, the draft IFRS proposed 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?

> Yes. Whether or not the reload feature should be valued up-front ought to reflect the implicit nature of the entitlement. If there is no such entitlement on the part of the recipient at the original point of grant, the reload feature should be treated as the subsequent issue of a new equity instrument, discounted if appropriate to reflect any remaining time value in the existing option being given up. In such circumstances, the surrender of the original option is itself an issue of an equity instrument.

Q15

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?

No.

Q16

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?

Yes. See also our response to Q11.

Q17

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 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 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 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?

The repricing of an option represents the effective grant of a new equity instrument which requires fair value of the incremental award to be measured. The additional expense of this grant, measured at point of grant, should make due allowance for the reduction in expense (measured at the same point in time) which would be recognised were the original instrument to left *in situ*.

Q18

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 proposed 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.

> If an entity is capable of cancelling an equity instrument it has already granted other than for non-performance of conditions specified at point of grant it is questionable whether that instrument had in fact been genuinely issued. It is reasonable to infer, if the holder accepts cancellation in such circumstances, that compensation will be made in some form and the cost of that compensation would fall to be charged as an expense. In such circumstances it would seem that some reversal of the measured cost of the original award ought to occur.

Q19

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.

> Yes, we see the obligation to make a cash payment as a liability and the full eventual cash cost of this needs to be recognised as an expense.
>
> However the ASB and IASB need to consider the overall coherence of accounting treatment, firstly,
>
> - in respect of an issuer of a share appreciation right that decides, perfectly rationally, that it wishes to hedge, wholly or partially, the risk of this open-ended liability, and secondly,
> - in respect of awards to be sourced from prospective purchases of shares already in issue.
>
> In both respects, an ability to recognise a liability and, if appropriate, a matching asset seem called for. Practical considerations would seem to call for an ability to use an accounting approach which permitted employee benefit trusts to be accounted for in such a manner.

Q20

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 proposed various requirements to apply this principle.

Are the proposed requirements appropriate? If not, please provide details of your suggested alternative approach.

If the beneficiary of the payment has the right to specify cash or any other mode of settlement that would lead to an outflow of economic resources from the entity, a liability would appear to exist. Where the entity has the choice of settlement, we consider that the economic substance of the transaction and also the definition of liability in the IASB's Framework makes the appropriate point of distinction the <u>expectation</u> or otherwise that settlement would involve an outflow of economic resources, whether through payment of cash in direct settlement or through purchase of shares from the market.

Q21

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)?

The proposed requirements seem in order.

Q22

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 proposed 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.

The proposed requirements seem appropriate.

Q23

The draft IFRS proposed 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?

No specific comment.

Q24

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.

Fore each of the differences, which treatment is the most appropriate? Why? If you regard neither treatment as appropriate, please provide details of your preferred treatment.

a) We can see no principled justification why an expense incurred in connection with an 'employee share purchase plan' or similar, should not be treated as such. Employment costs fall to be accounted as an expense irrespective of the individual recipient's status. We therefore support the approach taken in the draft IFRS.

b) and following aspects

We support fair value measurement of awards at point of grant in accordance with the draft IFRS. However, our suggestions of different implementation within such a framework than those proposed in the IFRS, provides, we believe, a position conceptually rather closer to that prescribed under SFAS 123. Modification of the draft IFRS's proposals along the lines we suggest may therefore provide a more promising basis for achieving genuine convergence between the IASB and FASB approaches.

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