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Kimberly Crook
Project Manager
International Accounting Standards Board
30 Cannon Street, London EC4M 6XH
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Dear Ms. Crook:

Re: ED 2 *Share-based Payment*

I am pleased to see that the International Accounting Standards Board ("IASB" or "Board") is considering the issue of share-based payments and that the US Financial Accounting Standards Board (FASB) is reconsidering FASB Statement No. 123 ("SFAS 123") with an eye on harmonization with the forthcoming international standard on this subject. However, I was very disappointed to see that the IASB has in substance opted to employ the grant date to measure the ultimate compensation under such plans, as does the FASB.

Clearly, the FASB took a practical approach in SFAS 123 in not requiring the recognition of compensation expense under the so-called pure vanilla stock option plans and in permitting the measurement of compensation under such plans by use of the fair value of the option on the grant date. I say practical in that the former decision was taken to avoid the political ramifications of mandating the recognition of compensation expense under such plans and the latter decision was taken to assuage the concerns that the ultimate measurement of compensation would vary based on future events.

Grant Date Based Accounting is Flawed

In the years following the issuance of SFAS 123 the financial reporting of enterprises has faced severe criticism as being too inclined to support the objectives and desires of management and too cookbook in nature. The IASB and the FASB have an opportunity to respond to such concerns and issue standards that are transparent and reflect the substance of transactions. Continuation of the use of a grant date measurement approach for such share-based compensation plans doesn't do the job. I ask that the Board reconsider its approach, and adopt the exercise date approach to ultimately measure compensation.

Recognition of a fixed amount of compensation at the date of grant for such plans fails to recognize that these are in substance variable compensation plans and that the grant of an option is the inception of a transaction, not the settlement of a transaction.

The use of the grant date measurement approach has only one beneficial aspect, and that is a suspect benefit—the determination of a fixed cost at the inception of the transaction. Unfortunately, this *benefit* is at the cost of relevance and representational faithfulness of the measurements recognized in the financial statements. Grant date measurement locks in the ultimate recognition of expense based on a highly subjective approach that estimates future events without subsequently adjusting the amount to reflect what actually transpires. While many transactions are initially recorded based on estimates of future events and costs (superannuation accounting being a prime example), those estimates are ultimately adjusted to the actual amount based on the settlement of the transaction. However, under the grant date measurement approach there is no so-called truing up to the actual cost of the transaction.

In reality, a share-based compensation plan is a contingent variable compensation plan, the cost of which mimics the volatility of the underlying security to ultimately be issued under the plan. That reality should not be obfuscated by the accounting employed. Neither the relevance requirement nor the representational faithfulness requirement is satisfied by adopting an accounting convention that ignores the underlying substance of the transaction.

An option pricing model is just that, a model. Just as actuarial assumptions are assumptions as to the outcome of a transaction, not the ultimate outcome. Both form a basis to make economic decisions and to establish initial accounting for transactions, but the final accounting should recognize what has transpired.

Exercise Date Accounting Provides Requisite Representational Faithfulness

The ultimate measurement of compensation under such plans should be based on the excess of the market price over the exercise price on the date that both the enterprise and the individual have unequivocally met their commitments to the other party to the transaction (for the sake of simplicity, the term "exercise date" will be used in this letter to represent this event, qualified with the understanding that delivery of notes by the individual in exchange for the underlying equity security is not an unequivocal settlement). The enterprise is committed to deliver a specified number of equity units (usually common shares) to the grantee for a stated price during a specified period of time. The individual must provide services or deliver goods to the enterprise over a given period of time and to pay a specified amount to the enterprise in exchange for a specified number of equity units.

The marketplace has been clamoring for recognition of expense under share-based compensation plans. And, for a period of time (especially given the currently declining market), the marketplace may not notice that the grant date accounting does not deliver the answer that they expect. At first blush, many may think that the grant date method does the job, because expense will be recognized. But as time passes I believe there will be a cry to reassess the grant date approach because it will result in:

- recognizing compensation expense when in some cases there ultimately is none (e.g., cases in which the market price is such that the option is never exercised because it is not in the money at some point in the exercise period so as to be sufficient appealing to the option holder to exercise their rights), and
- understating the ultimate compensation expense when there is a considerable excess of the market price of the equity units on the date of exercise over the exercise price when compared to the amount attributed to expense using the grant date option pricing approach.

I believe that the relevance and representational requirements are best met by the use of the exercise date approach. For interim reporting purposes under this approach the accumulated cost of such plans for outstanding options would be the excess of the period end market price of the underlying equity securities over the exercise price. Clearly, this will result in volatility/variability of the costs reported in the financial statements, but that is the substance of these plans. Locking in on a fixed amount under the grant date approach provides misleading measurements in the financial statements because it fails to recognize that variability and volatility are inherent aspects of such plans.

Additionally, the use of an exercise date approach for the ultimate measurement of compensation is evenhanded because it provides the same charge to earnings whether the obligation is ultimately settled by the delivery of the underlying securities or is settled in cash.

According to BC92-97 the principal reason that the exercise date approach has been rejected is that its use would require recognition of a liability in the financial statements of an enterprise and that such liability would not meet the *Framework* definition of a liability. This view ignores that in many cases the resultant credit from use of the exercise date approach would be treated as an element of equity and not as a liability, recognizing that what has been measured is the impending redistribution of equity from existing equity holders to contingent equity holders who possess options or similar rights under share-based payment plans. The item would only be treated as a liability if conditions were such that a liability was deemed to exist that met the *Framework* definition. Clearly, if a transaction calls for ultimate settlement in cash or the company has the option to settle in cash and has indicated its intent to do so or has historically done so, then the underlying commitment should be accounted for as a liability. In all other cases the measured effect of the commitment should be treated as a component of equity.

Scope of Response Limited

Attached are some abbreviated responses to the questions raised in the Invitation to Comment. I have not provided exhaustive responses because I feel that the use of the grant date measurement approach is so flawed that fine tuning it will not provide a substantially better measure than is currently in place. In general my responses point out why the exercise date approach is the best answer.

I have previously responded to the FASB in my January 30, 2003 letter regarding their November 18, 2002 Invitation to Comment; in my December 13, 1993 letter to the FASB in response to the then proposed standard on stock-based compensation; in my remarks at the March 7, 1994 FASB public hearings on this subject; and in my March 8, 1994 letter to Timothy S. Lucas following up on my remarks at the FASB public hearings. While I have subsequently modified some of my implementation views contained in the earlier materials, the substance of my position is unchanged. I presume that the IASB has access to all of these materials. If this is not the case and the IASB would like copies, please contact me.

If the IASB concludes to adopt an exercise date approach, such position will clearly require re-exposure and I will be happy to provide more detailed views at that time regarding implementation.

Restore Public Confidence in Standards Setting Process and Financial Reporting Model

To be credible and restore public confidence in the establishment of accounting standards in the private sector, the IASB should reconsider the share-based compensation measurement principles it has espoused in ED 2 and adopt the exercise date as the ultimate measurement approach as described above. I'll be happy to expand on my views, if the Board wishes further input in this regard.

Very truly yours,

Michael P. Bohan

Responses to Specific Questions

Note—all of the following responses are made in context that the exercise date is the appropriate approach for the measurement of share-based payments.

Question 1

The proposed scope is appropriate.

Question 2

I agree with the basic recognition requirements.

Question 3

If the equity instruments involved are publicly traded, there should be a presumption that the market value thereof is the most readily determinable for purposes of measurement and recognition.

Question 4

Costs should be recognized over the period of time the enterprise is committed to deliver the equity instrument (or equivalent value), but the aggregate cost under such plans should always ultimately be measured by the excess, if any, of the market price of the equity instrument over the exercise price. See comment letter.

Question 5

I disagree that the grant date is the appropriate measurement date. The transaction is not complete until the commitments of both parties are satisfied.

Question 6

I do not agree that the value received by the enterprise is more readily determinable than the value of the equity instrument, particularly if the equity instrument used to settle the transaction (generally, the delivery of shares of the enterprise as distinguished from the option equity instrument that comes into being at the inception of the transaction) is a listed security.

Question 7

I disagree with the use of grant date based accounting. See comment letter.

Question 8

I disagree that the vesting period is the only period in which compensation is to be measured. Compensation should be measured through the date of settlement of the transaction (generally the exercise date). Failure to do so ignores that at a minimum the granting enterprise continues to have an open commitment until exercise and often the optionee has obligations through the exercise date, such as continued service.

Question 9

Not applicable if exercise date approach used with interim costs measured by fluctuation of market price of underlying equity security.

Question 10

Disagree. Under the exercise date approach the final effect on the components of equity, including the effect on retained earnings resulting from the truing up of the charge to earnings, is not determined until the commitments of both the grantor and grantee are met (generally upon exercise).

Question 11

I disagree with the use of the grant date as the ultimate measurement of the cost of such plans. See comment letter.

Question 12

I disagree with use of the contract life. Under the exercise date method costs are re-measured continuously until the commitments of both the grantor and grantee are met.

Question 13

Vesting conditions should not be taken into consideration. While they may provide an incentive for an employee to stay with the enterprise, the underlying cost relates to the outstanding commitment, irrespective of vesting.

Question 14

Existence of a reload feature would not affect the basic measurement principle under the exercise date approach.

Question 15

No special consideration should be given to non-transferability features and similar limiting features in existence during the period the options are outstanding, as long as the equity instruments ultimately issued upon exercise of the option have no limiting features compared to other securities of the same class.

Question 16

While the use of a principled based approach is an admirable goal, the Board is not doing its constituency a favor in this case, given the complexity of the issue. As noted in the comment letter, the use of the exercise date approach removes the need for such subjective estimating and provides an easily understood and objectively measurable compensation amount.

Question 17

See my response to Question 14 regarding the reload feature.

Question 18

If an entity can legally cancel an option without being required to provide some other form of settlement, then there is no cost and none should be recognized in the financial statements. Any associated costs previously recognized should be reversed so that the financial statements reflect that there has been no aggregate cost to the company under the option.

Question 19

The amount of compensation cost reflected in financial statements should be the same whether the transaction is ultimately settled in cash or in shares. Use of a methodology for measurement that results in two different amounts for the same basic transaction is flawed and cannot be said to be principle based. Such a flaw does not exist in the exercise date approach.

Question 20

If a transaction calls for ultimate settlement in cash or the company has the option to settle in cash and has indicated its intent to do so or has historically done so, then the underlying commitment should be accounted for as a liability. In all other cases the measured effect of the commitment should be treated as a component of equity.

Question 21

The financial statements should provide sufficient disclosure for readers to understand the share-based payment commitments that were in effect during the reporting period, the amounts charged to income during the period, the outstanding commitments at period end, and how the amounts charged to earnings were determined.

Question 22

I would prefer that the financial statements be restated for all periods presented using the exercise date approach, as this would provide for the best comparability. I am concerned that if a cutoff date is provided, enterprises may rush to grant share-based items in the intervening period before measurement is required and thus avoid recognition. If it is concluded that a specific type of accounting is good, then why should it not be employed in all comparative statements presented? Interestingly, if the grant date approach is used and is required to be applied retroactively, there will surely be a move to measure the cost considering subsequent events (given the general deterioration of the equity markets). This will highlight one of the major problems with the use of the grant date method.

Question 23

The tax effects recognized in the income statement should be only those that correspond with costs recognized in income. If the tax authorities permit some other methodology for measurement in the determination of income taxes, the effect of that difference should be reflected as an equity transaction.

Question 24

(a) Commentary on SFAS 123 exemptions:

- I agree with ED 2, there should be no exemption given to employee discounts.
- Intrinsic value at the exercise date should always be the point of measurement of the ultimate amount of compensation under share-based plans.
- Extreme care must be taken with respect to share-based plans of unlisted enterprises. The measurement should be based on the same principle as used for listed companies. Accordingly, there will be the need to develop a surrogate to fair value for such enterprises with the ultimate amount of compensation measured at the exercise date. As this is a relatively uncharted area, there likely will be a period of experimentation to come to a generally accepted method.

(b) Commentary on certain accounting differences between SFAS 123 and the provisions of ED 2.

- Possibility of forfeiture should not be considered. Under the exercise date approach, no expense is ultimately recognized when there is a forfeiture.
- I disagree with the presumption that the value of the employee services is more measurable than the value of what

is ultimately given up. If the approach is to measure based on the value of employee service, then if this is to be a principle based standard, should not all costs be measured in this fashion, even when paid in cash? Under a principled based standard, value should always be measured by the market value of the listed equity instrument used to ultimately settle a transaction; the fair value of the non-financial instrument component of an exchange transaction should be used only if a listed equity instrument is not involved in the transaction.

(c) If neither party has a continuing obligation of substance, then the total amount of compensation related to the transaction should be recorded by the settlement date. Failure to do so, fails to recognize that there has been a change in the underlying transaction.

(d) The exercise date approach should be used here as well.

(e) If this is to be a truly principles based standard, then the cost should be recognized on the same basis for all transactions. This is best accomplished by the use of the exercise date method for the measurement of ultimate compensation.

(f) SFAS 123 should be the basis for recognition of tax effects. The income statement should never recognize more tax benefits than the related pretax income statement charge would garner under existing tax regulations.