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Dear Kimberley

ED 2 : Share-based Payment

The British Bankers' Association (BBA) is the leading trade association in the banking and financial services industry for banks and other financial services firms operating in the UK. It represents about 300 banks from 60 different countries, the majority of which are present in the UK in order to participate in the debt and equity capital markets of the City of London.

The British Bankers Association welcomes the opportunity to comment on the International Accounting Standards Board's proposed standard on Share-based Payment.

Although several member banks have indicated that they plan to expense share based payments, many others are opposed to the proposals in ED 2. The opposition of some banks is mainly on the grounds that recognising an expense on the basis of the proposals in ED 2 is inconsistent with IASB's Framework. They believe that the definition of expense in the Framework needs amendment to enable the case attempted to be made in paragraphs 40 – 46 in the Basis for Conclusions to stand. As stated, the banks believe that the case is not yet made.

The banks also believe that all-employee share option plans are typically not in return for services; they are set up in order to enable employees to share in the success of their employer company, and so align their long-term interests with those of the company. Moreover, even if the arguments in BC paragraphs 40–46 are accepted, valuing the 'benefit' of options granted to all employees (particularly under share purchase schemes) has to take account of the possibility of options expiring unexercised. In some cases, these options may have fallen out of the money, or some employees may just find the process of exercise too complex to be troubled with. Because of this, an employee is quite likely to perceive the value of the option as lower, possibly significantly lower, than the fair value produced by the IASB model.

There must be a case for IASB looking again at the possibility of scoping out all-employee share purchase plans, perhaps on a similar basis to that in SFAS 123.

The banks recognise, however, that – not least in view of the increasing numbers of companies which have indicated that they will start expensing share based payment transactions – there is a strong likelihood that ED 2 will proceed to a standard. They believe, however, that the case for asserting that the proposals are consistent with the Framework needs to be more convincingly made – and certainly without praying in aid aspects of other standard setters' conceptual frameworks.

The BBA's responses to the questions posed in ED2 are attached.

Yours sincerely

David Swanney
Director

IASB ED2 'SHARE-BASED PAYMENT' INVITATION TO COMMENT

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?

The banks believe that all-employee share option plans are typically not in return for services; they are set up in order to enable employees to share in the success of their employer company, and so align their long-term interests with those of the company. These schemes are typically not embodied within an employment contract and are not seen by either the employer or employee as part of a contract for services.

Moreover, even if the arguments in BC paragraphs 40–46 are accepted, valuing the 'benefit' of options granted to all employees (particularly under share purchase schemes) has to take account of the possibility of options expiring unexercised. In some cases, these options may have fallen out of the money, or some employees may just find the process of exercise too complex to be troubled with. Because of this, an employee is quite likely to perceive the value of the option as lower, possibly significantly lower, than the fair value produced by the IASB model.

There must be a case for IASB looking again at the possibility of scoping out all-employee share purchase plans, perhaps on a similar basis to that in SFAS 123.

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?

The banks mostly agree with the IASB proposal for the reasons given in the Basis for Conclusions. The banks are concerned, however, that recognising an expense on the basis of the proposals in ED2 is inconsistent with IASB's Framework. They believe that the definition of expense in the Framework needs amendment to enable the case set out in paragraphs 40 – 46 in the Basis for Conclusions to stand. As stated, the banks believe that the case is not yet made.

In addition, the wording of paragraph 5 would be improved by being inverted. It is more likely that the share based payment should be recognised as an expense unless it qualifies for recognition as an asset.

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?

The banks agree with the IASB measurement proposal for the reasons given in the Basis for Conclusions. The banks believe that there is a case for confining the application of the standard to consolidated accounts and exempting wholly owned subsidiaries where the parent, rather than the subsidiary, is issuing the equity

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?

The banks agree with the IASB proposal for the reasons given in the Basis for Conclusions.

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?

The banks agree with the IASB proposal for the reasons given in the Basis for Conclusions.

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?

The banks agree with the IASB proposal for the reasons given in the Basis for Conclusions.

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 not so?

The banks believe that the requirement across the board to measure the fair value of the employee services received by reference to the fair value of the equity instruments granted is too restrictive. There may well be cases where the employee services may be able to be valued directly – the banks therefore suggest that the draft IFRS be modified to make the proposed requirement a rebuttable presumption, and not a formal requirement.

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?

The banks do not believe that it is always reasonable to presume that the services rendered by the counterparty are received during the vesting period. There may well be cases where the services have been (substantially) received, and therefore should be recognised at grant date. An option award, possibly part of an annual bonus, which is explicitly stated to the employee to be a reward for services in the past year (even if there is a three-year vesting period attached), is a case in point. It would appear wrong not to expense such an award immediately, but the proposals in the draft IFRS would spread the cost of this award over the vesting period. The banks therefore believe that the proposed standard should be amended to require consideration to be given to the substance of the share based payment transaction in order to determine whether the services have been (substantially) received or not.

This would be consistent with IAS 19's requirement to attribute benefit to periods of service under the plan's benefit formula.

Question 9

If the services received are measured by using the fair value of the equity instruments granted as a surrogate measure, the draft IFRS proposes that the entity should determine the amount to attribute to each unit of service received, by dividing the fair value of the equity instruments granted by the number of units of service expected to be received during the vesting period (paragraph 15).

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

The banks believe that the method of calculating the fair value proposed by IASB is overly complex, and a simpler method should be followed. Arguably, it is not necessary to determine the amount to attribute to each unit of service received. IASB's calculation incorporates <u>actual</u> staff numbers and an estimate based on <u>assumed</u> staff numbers. A straight-line amortisation of the initial estimate would be one way of simplifying the calculation.

The Board should consider whether the principles of using the fair value of the equity instrument as proxy can be better expressed without requiring a particular calculation method and whether certain types of adjustments should be permitted. Practically, allowing changes in assumptions with regard to the achievement of performance conditions in particular would be of assistance since it would reduce the motivation to under or over estimate assumptions.

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, ie 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?

Since equity settled share-based payment transactions do not give rise to liabilities, they must result in a credit to equity. Legal considerations govern what constitutes the consideration for the issue of shares and it would be unhelpful for an accounting standard to require particular transfers within components of equity. However, the banks agree that the accounting standard should allow entities to recognise transfers within equity so that they can meet their legal requirements.

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?

In most instances, a market price of an option will not be available, so there seems no alternative but to use an option pricing model to estimate fair value. The model should take into account all the special characteristics of employee options, for example, non-transferability.

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?

The banks agree with the IASB proposal for the reasons given in the Basis for Conclusions.

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?

The banks agree that vesting conditions should affect the expense recognised. However, the banks believe it is more logical to adjust the calculated fair value for performance conditions than to include assumptions on the discharge of these within the calculation of fair value. Those adjustments and assumptions can be very arbitrary and judgmental, and it is better to make a single adjustment for these at the end of the process. The banks believe that it is wholly inappropriate for a standard to prescribe the documentation requirements necessary to support its provisions. Standards should set out the accounting requirements, not the evidential requirements.

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?

The banks agree with the IASB proposal for the reasons given in the Basis for Conclusions.

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?

The Banks are not aware of any other features requiring specific requirements.

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?

The banks agree with the IASB proposal for the reasons given in the Basis for Conclusions. While additional guidance is not needed, it would be helpful if paragraph 24 made it clear that vesting conditions should be taken into account based on the entity's best estimate of their likely outcome at the time of determining the fair value.

Question 17

If an entity reprices a share option, or otherwise modifies the terms or conditions on which equity instruments were granted, the draft IFRS proposes that the entity should measure the incremental value granted upon repricing, and include that incremental value when measuring the services received. This means that the entity is required to recognise additional amounts for services received during the remainder of the vesting period, 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?

The banks agree that where a share option is repriced, the entity should measure the incremental value on repricing, and include that incremental value when measuring the services received during the vesting period. The alternative method illustrated in example 3 in Appendix B is better than the original, as it better matches the total expense of the services received with the periods in which the services are actually received. Also, it does not contain the rather odd assumption that the original option grant is still in place.

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.

In the banks' view, it looks odd to prescribe that an option that has been forfeited should continue to be accounted for as though it still existed, especially in circumstances where no compensation has been given to the counterparty. The banks therefore believe that the standard should include a requirement that some consideration should have been given for the forfeiture in order to continue to account for it; in other circumstances, the entity should cease to recognise the services rendered.

In the banks' view, it would be inappropriate for an option that has been forfeited to continue to be accounted for as though it still existed. If the cancellation reflects the fact that arrangements have altered so that services are no longer being received, it seems wrong to continue to account for their cost. If the option has been settled net in cash, for example as part of compensation for loss of office, it seems wrong not to recognise this cost. The banks therefore believe that the standard should ensure that the accounting for the cancellation reflects its substance.

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.

The banks agree with the IASB proposal for the reasons given in the Basis for Conclusions.

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.

The banks agree with the IASB proposal for the reasons given in the Basis for Conclusions.

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)?

The banks believe that the minimum disclosures required, particularly those set out in para 48, are excessive. In particular, the banks strongly believe that the object of disclosure should be to support the understanding and interpretation of the amounts recognised, and are not intended to enable users to check the calculation made by the entity. The proposed level of disclosure is not only considered burdensome for the preparers, but might also obscure the key messages to the users of financial statements. The banks believe that the required disclosures should be limited to:

- Costs relating to options charged to profit and loss account
- Costs relating to options granted not yet charged to the profit and loss account, and the periods in which they are expected to be charged, together with details of the arrangements under which these costs arise
- Share capital – options and other rights to subscribe for shares in the company (not restricted to share based payment options)
- Effect of options on diluted earnings per share calculations
- Directors' remuneration – details of options granted etc in the context of total remuneration for directors

Question 22

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

Are the proposed requirements appropriate? If not, please provide details of your suggestions for the IFRS's transitional provisions.

Where it involves the use of hindsight to measure the fair value of options granted before the publication date of the ED, the banks agree that entities should not have to restate their accounts as if the standard had always been in force. However, such restatement is conceptually correct and entities that have this information available, for example, entities that have been fully complying with similar US requirements when they were first introduced, should not be prevented from restating.

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?

The banks agree with the IASB proposal for the reasons given in the Basis for Conclusions.

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).**

(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.**

(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.

(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.**

(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).**

(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.**

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?

In respect of case (a) above, the banks believe, for the reasons set out in response to Question 1 above, that all-employee share purchase schemes should be excluded from scope, on the basis set out in SFAS 123. In respect of case (b) the banks refer to the responses to Questions 9, 10 and 13 above. In respect of (c) the banks believe that the accounting treatment in SFAS 123 is preferable to that proposed by IASB.

In the other cases set out above, the banks agree with the IASB proposed treatment.

Question 25

Do you have any other comments on the Exposure Draft?

The banks have no further comments.

British Bankers Association
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