Investment Management Association

7 March 2003

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Mrs K Cook
The International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Dear Mrs Cook

Exposure Draft 2, Share-based Payment

The IMA is the trade body representing the UK asset management industry. IMA Members include independent fund managers, the asset management arms of banks, life insurers and investment banks, and occupational pension scheme managers. They are responsible for the management of over £2 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members manage 99% of UK-authorised investment funds.

In managing assets for both retail and institutional investors, IMA Members are major investors in companies whose securities are traded on regulated markets. Therefore, we have an interest in the requirements governing how such companies prepare their accounts and the information disclosed to our Members as users.

We strongly support a standard that addresses how share-based payments should be accounted for. Currently, there is no standard that covers this and we consider this unacceptable. It is essential that the effective cost to shareholders of all share options issued to directors, employees and others is properly recognised in the financial statements, as they can significantly dilute shareholders' assets. Directors' and employees' remuneration needs to be fully reported to allow shareholder scrutiny: all costs should be reflected in the profit and loss account and in any statement of remuneration. Existing practice whereby directors' and employees' share options are not reported means that boardroom and employee costs are understated in many instances, and we urge the adoption of the draft standard.

However, we have reservations about certain of the proposals in the draft standard and these are reflected in our answers to the attached questions. In summary, when equity options are granted to an employee conditional on the employee's performance, the proposals treat the fair value of the options as an increase in equity from the day they are granted. This value is charged to the profit and loss account over the time the "units of service" are actually received. As a result, there are a number of problems with measurement, expiry and compound instruments.

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For example, if options lapse or become worthless, the draft does not propose that the income statement is re–credited.

Whereas we support the profit and loss account being charged as the "units of service" are received, we do not consider that the option should be recognised as an increase in equity at the date granted. We believe the option is a liability to the employees that will be settled by a future issue of equity on pre-arranged terms. Thus the value of the option should be estimated at grant date, but recognised as a liability and only as an increase in equity when it is finally exercised and the precise value is known. Moreover, if the option lapses or proves worthless, then the liability does not crystallise and the income statement should be re-credited with previous charges. Indeed, if employees' options become worthless they could expect a bonus instead, in which instance under the current proposals the company would incur a double cost (the fair value of the options granted AND the bonus).

The treatment of a share-based payment such as an option as a liability would mean that a number of problems disappear. As well as there being no need to measure a precise value at the date the option is granted:

- prescriptive guidance on how to estimate fair values as implied in question 16 would not be necessary;
- the dependence of option pricing models on particular assumptions, especially volatility, would not matter;
- whether and what discounts need to be applied to reflect non-transferability would not need to be addressed;
- whether and what discounts need to be applied for the proportion that is expected to lapse would not need to be addressed; and
- assumptions would not need to be made for long periods until the option vests and between vesting and exercise.

It is proposed that the standard is applied to equity-settled transactions granted after 7 November 2002 and thus retrospectively. It is likely that companies will object to this - due to the fall in equity prices many of the plans made in the last few years could now be expiring worthless. If the share-based payment is recognised as a liability and not equity at the grant date any charge to the profit and loss for these plans would be reversed and companies would not have any grounds to object.

We appreciate the arguments in paragraphs BC 92-97 that when the framework was drawn up, liabilities were defined in terms of transferring assets and not equity. Therefore, equity options have to be classified as equity and not liabilities. However, we consider there needs to be an "equity/liability" rule and that the framework is compromised by its absence. The framework needs to be amended to address this.

Please do contact me if you require any clarification of the points in this letter or the attached or if you would like to discuss any issues further.

Yours sincerely

Liz Murrall
Senior Adviser – Regulation

Cc Mary Keegan, Chairman, Accounting Standards Board

ANNEX

THE IMA'S ANSWERS TO THE QUESTIONS IN ED2: SHARE-BASED PAYMENT

IASB question 1. Do you agree with the proposal that the standard should apply to all share-based payment transactions? Are there any other transactions that should be excluded?

We agree that the standard should be applicable to all share-based payment transactions. We consider attempts to differentiate types of transaction could confuse the user of the financial statements.

IASB question 2. Do you agree with the proposed share based payment recognition requirements whereby when goods and services are purchased by issuing shares or share options there is a charge to the income statement when those goods and services are consumed?

We agree with the proposed share-based payment recognition requirements whereby when goods and services are purchased by issuing shares or share options there is a charge to the profit and loss account when those goods and services are consumed.

IASB question 3. Do you agree that for equity-settled share-based payments that the goods and services received and the increase in equity should be measured either directly, at the fair value of the goods and services or indirectly, at the fair value of the equity instrument? Do you agree that there should be no exemptions from this?

We agree that for equity-settled share-based payments the goods and services received should be measured either directly, at the fair value of the goods and services, or indirectly, at the fair value of the equity instrument. However, we do not agree that equity settled share-based payments such as options should be treated as an increase in equity. We consider an option is a liability that will be settled by a future issue of actual equity when the option is exercised and that it should be recognised as such.

IASB question 4. If measured directly, should this be at the date the entity obtains the goods or receives the services? If not which date should be used and why?

We agree that if measured directly, this should be at the date the entity obtains the goods or receives the services. However, as stated in our answer to question 3, we consider that equity-settled share-based payments such as options are not increases in equity but are liabilities that will be settled by a future issue of actual equity when the option is exercised.

IASB question 5. If measured indirectly, should the fair value be measured at grant date? If not which date should be used and why?

We believe that if measured indirectly that the fair value should be measured at the grant date. In the case of equity-settled share-based payments such as options, a liability arises at grant date the true cost of which will only be known when the option is exercised.

IASB question 6. Do you agree that for equity-settled transactions with parties other than employees the fair value of the goods and services is more readily determined than the fair value of the instruments? Are there any circumstances where this is not the case?

We agree that for equity-settled transactions with parties other than employees, the fair value of the goods and services is more readily determined than the fair value of the instruments.

IASB question 7. Do you agree that for equity-settled transactions with employees the fair value of the employees' services should be measured as the fair value of the instruments as this is more readily determined? Are there any circumstances where this is not the case?

We agree that for equity-settled transactions with employees, the fair value of the employees' services should be estimated, as opposed to measured, as the fair value of the instruments as this is more readily determined – see question 5.

IASB question 8. Do you agree that it is reasonable to presume that services rendered by the counterparty as consideration for equity instruments are received during the vesting period? If not, when are the services rendered?

We agree that it is reasonable to presume that services rendered by the counterparty as consideration for equity instruments are received during the vesting period.

IASB question 9. Do you agree that if the fair value of equity instruments 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? Do you agree that this should be calculated by dividing the fair value of the equity instruments by the number of units of service expected to be received during the vesting period? If not, what alternative approach do you propose?

We agree that if the fair value of equity instruments 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. However, we do not consider that an option should be recognised as an increase in equity at the date granted but as a liability that will be settled at a future date.

IASB question 10. Do you agree that having recognised the services received and the corresponding increase in equity, no subsequent adjustment should be made even if the instruments granted do not vest or in the case of options, the options are not exercised? However, this does not preclude the entity from recognising a transfer within equity, i.e. a transfer from one component to another.

We do not agree that there should be a corresponding increase in equity when services received are recognised. We consider that the option is a liability to the employee that will be settled by a future issue of equity and should only be recognised as an increase in equity when it is finally exercised. Treating a share-based payment such as an option as a liability would mean that if the option does not vest or is not exercise, the liability would not crystallise and should be reverse and the income statement recredited.

IASB question 11. 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 impractical to take into account any of the factors listed above in applying an option-pricing model?

We agree that an option-pricing model should be used as this would preclude subjective judgments being made. We consider that there could be a clear conflict of interest if a board of directors had to make subjective judgements on the value of an amount reported in the accounts that represented payments made to themselves.

IASB question 12. 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?

We consider that the option is a liability to the employee that will be settled by a future issue of equity and should only be recognised as an increase in equity when it is finally exercised. Treating a share-based payment such as an option as a liability would mean that adjustments to reflect non-transferability do not need to be addressed.

IASB question 13. 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?

We believe that the option is a liability to the employee that will be settled by a future issue of equity and should only be recognised as an increase in equity when it is finally exercised. Treating a share-based payment such as an option as a liability would mean that vesting conditions do not need to be taken into account.

IASB question 14. Do you agree with the proposed requirement for options with a reload feature, that feature should be taken into account, where practicable, when an entity measures the fair value of options granted? If the reload is not taken into account do you agree that the reload option should be accounted for as a new option grant? If not, what requirement would be appropriate?

We consider that treating a share-based payment such as an option as a liability would mean that difficulties over reload features disappear.

IASB question 15. Are there any other features other than non-transferability, inability to exercise the option during the vesting period, and vesting conditions where the IFRS should specify conditions?

We consider that treating a share-based payment such as an option as a liability would mean that these types of problems disappear.

IASB question 16. Do you agree that there is no need for prescriptive guidance on the estimation of the fair value of options, consistent with the Board's objective of setting principles based standards and to allow for future developments in methodologies?

We consider that treating a share-based payment such as an option as a liability would mean that there would be no need for prescriptive guidance on how to estimate fair values.

IASB question 17. Do you agree that if an option is repriced, or the terms and conditions are otherwise modified, the incremental value on repricing should be measured and included when measuring the services received? If not, how should repricing be dealt with?

We consider that treating a share-based payment such as an option as a liability would mean that issues over repricing would disappear.

IASB question 18. Is it appropriate that if an entity cancels a share or option grant during the vesting period, it 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? Are the proposals for dealing with any payment made on cancellation or grant of replacement options, and for the repurchase of vested equity instrument appropriate? If not, please explain why not and provide details of your suggested alternative approach?

We believe that a share-based payment such as an option should be treated as a liability and an adjustment made if the option is cancelled such that the liability will not crystallise.

IASB question 19. Is it appropriate that for cash-settled share-based payment transactions, the goods and services acquired and the liability incurred should be measured at the fair value of the liability? Until the liability is settled, should the entity remeasure the fair value of the liability at each reporting date, with any changes in value being recognised in the income statement? If not, please provide details of you suggested alternative approach?

We agree that for cash-settled share-based payment transactions, the goods and services acquired and the liability incurred should be measured at the fair value of the liability.

IASB question 20. Are the proposed requirements appropriate? If not, please provide details of your suggested alternative approach?

We believe that a share-based payment such as an option should be treated as a liability thus regardless of the nature of the consideration, it should be treated as a liability.

IASB question 21. Is it appropriate to require the following disclosures:

- *(a) the nature and extent of share-based payments during the period;*
- *(b) how the value of the goods and services received, or the fair value of the equity instruments granted, during the period was determined;*
- *(c) the effect of expenses arising from share based payment transactions on the entity's profit and loss account?*

If not, what disclosure requirements do you think should be added?

We welcome the level of disclosures set out in paragraph 46 of the draft standard and believe this will help users gain an understanding of the accounts and of the figures presented. However, we consider that certain additional disclosures would be helpful, for example:

- an estimate of the fair value of all options outstanding at the balance sheet date – the so called "overhang;
- under b(iv) of paragraph 46 the market price of the shares when exercised; and
- the amount charged to the income statement in respect of these shares.

IASB question 22. Do you agree with the proposal that the standard should apply to equity-settled transactions granted after 7 November 2002 but had not vested by the effective date of the standard and that full retrospective and prospective application would not be permitted? Do you agree that the standard should be applied retrospectively to liabilities arising from share-based payment transactions that existed at the effective date of the standard, with full retrospection, except that vested share appreciation (and similar) rights would not be measured at fair value but at their settlement amount?

We believe that it is likely that companies will object to the standard being applied to equity-settled transactions granted after 7 November 2002 and retrospectively. In this respect, due to the fall in equity prices many of the plans made in the last five years could now be expiring worthless. If the share-based payment is recognised as a liability and not equity at the grant date any charge to the profit and loss account for these plans would be reversed.

IASB question 23. Is it appropriate for the draft IFRS to proposed a consequential amendment to IAS 12, Income Taxes, to illustrate how to account for the tax effects of share-based payment transactions (that they should be recognised in he income statement?

This question is beyond the IMA's remit.

IASB question 24. In developing the ED, the Board considered various issues in the US standard SFAS 123, Accounting for Stock-Based Compensation. There are however, certain differences and views are asked on the preferred treatment.

In the US, we understand that fair value charges have been permitted for some time but the majority of companies opt to disclose fair value in the notes and charge on a different basis. Recently an increasing number of US companies have indicated that they intend to start charging the fair value of a share-based payment to the profit and loss account. We believe that the US is seeking to move to a mandatory approach whereby share-based payments are expensed. We consider that whatever the US chooses to do in the future, it is important that there is a common position internationally.

IASB question 25. Do you have any other comments on the Exposure Draft?

We have no further comments to make.