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CL 167

International Accounting Standards Board
30 Cannon Street
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Dear Sirs

IASB ED 2 Share Based Payments

We welcome the opportunity to respond to the Board's consultation and would make the following general points:

1. We continue to believe that shares issued in connection with share option schemes are not a cost to the company but a transaction with shareholders that dilutes their interest. Shareholders recognise this at the time of giving approval to the scheme and the impact is measurable from the figure for fully diluted earnings per share. However, in the light of calls for more prudent and conservative accounting practices following recent company failures, there is a growing opinion that a "cost" should be calculated and separately disclosed.

   We are of the opinion that this "cost" should be fully disclosed as a note to the accounts, but not reflected in the income statement itself.

2. Notwithstanding the above we consider that, unless cash payments are made, there remains good reason for all employee "share save" schemes to be excluded on the basis that they tend to be viewed by employees as savings opportunities rather than remuneration and are offered by the company to promote general interest in the future of the company rather than specific reward for services performed.

   Following the publication of the exposure draft we have evaluated its impact on our UK employee share save scheme. The cost was not material but the requirement to identify the units of service for each employee in every UK subsidiary would necessitate changes to computer systems and impose a significant on-going administrative overhead.

Successive UK governments have encouraged more widespread share ownership and there is a significant risk that the proposed accounting treatment will lead to the demise of such schemes. In our view this would be unfortunate.

3. We consider that where the award of shares under share option schemes is satisfied by the market purchase of those shares, it is the cash cost of that purchase which should be recognised in the income statement as being the true economic cost to the company. This cash cost should be written-off over the performance period of the scheme.

4. We are seriously concerned at the level of detailed disclosure requirements (some of which may be price sensitive – e.g. dividend growth rates) in respect of what, for many companies, will be an immaterial cost. We therefore suggest that a de minimis rule could sensibly be applied where the cost is less than a given percentage (say 5%) of that year's pre-tax profit, less detailed disclosure be required.

We hope you find these comments useful. The Appendix to this letter focuses on the particular questions contained in the draft standard.

Yours faithfully

Nigel Stein
David Rood

APPENDIX

IASB 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?

As noted above, we believe that the standard should not apply to Government (Inland Revenue) approved SAYE schemes.

IASB 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?

Agreed.

IASB 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) 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?

Agreed.

IASB 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?

No, we do not agree that the measurement date is when the entity obtains the goods or receives the services. On the basis of the principles applying to employee share based schemes, the measurement date should be the date the agreement is entered into. This is the date the company is contractually committed to issue the shares subject to the satisfactory delivery of the goods or services concerned. It is also consistent with the measurement date if the fair value of the equity instruments is used as the basis.

IASB 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 if 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?

Agreed.

IASB 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 that the fair value of the equity instruments granted? In what circumstances is this not so?

This is unlikely to appply to an industrial company and we have no view.

IASB Question 7

For equity-settled transaction with employees, the draft IFRS proposed that the entity should be measure 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?

Agreed.

IASB 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?

Generally we agree that the services rendered by the counterparty as consideration for the equity instruments will be received during the vesting period, but would not wish to see an inflexible rule that always required the cost to be expensed over the vesting period. The principle should be to recognise the expense over the period being rewarded.

IASB 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 service expected to be received during the vesting period? If not, what alternative method do you propose?

The proposal may have some theoretical attractions. However in practice it would require detailed calculations to be made in respect of individual employees. If the standard extends to all employee schemes this will be excessively onerous and add little to the "accuracy" of the income statement. For all share save schemes at least, a simpler time based method of allocation ought to be acceptable. In the case of executive share option schemes where fewer employees are involved and the sums are likely to be proportionally larger, then individual employee tracking becomes more practical, but again is likely to add little to the accuracy of the charge.

IASB 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?

We are concerned that if fewer employees leave than was anticipated, this can result in the total charge to the profit and loss account being greater than the fair value of the options granted. The converse can also apply leading to the charge to the profit and loss account being less than the fair value of the options granted. A straight line amortisation of the fair value of the option might be more preferable. This would make the spreading calculation less time consuming, as well as being consistent with the argument that a financial instrument (share or option) has been issued and so must be recognised and then expensed as the services that it is paying for are received.

IASB 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 option 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 with this approach where it is intended to issue new shares but are seriously concerned at the level of disclosure of the factors required since some of them may be price sensitive, e.g. dividends expected on the shares, or the directors view of the likelihood of vesting. (See also question 21)

Where it is intended that the award of shares be satisfied by market purchase we consider that the economic cost to the company is the cash cost of the market purchase and it is the cash cost which should be recognised.

IASB 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?

Agreed.

IASB 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 option 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 share or option granted?

Agreed

IASB Question 14

For option 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?

Agreed.

IASB 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 (paragraph 21-25).

Are there other common features of employee share options for which the IFRS should specify requirements?

The draft standard should allow leeway for future developments in the valuation of employee share option grants. ED 2 explicitly identifies the Black-Scholes and binomial models and it further specifies the six key input variables that should be applied. The major problem with mandating inputs based on an existing pricing model to value employee share options is that the current models were developed to value something entirely different, i.e. they were developed to estimate the price of short-term, freely tradable options.

IASB Question 16

The draft IFRS does not contain prescriptive guidance on the estimation of the fair value of options, consistent with the Board's objective of setting principles-based standards and not to allow for future developments in valuation methodologies.

Do you agree with this approach?
Yes

Are there specific aspects of valuing options for which such guidance should be given?

We support the publication of some general implementation guidance from which companies make a judgement as to how they will implement the principles set out in the standard. We do not support a more prescriptive rule based approach.

IASB 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 the incremental value when measuring the services received. This means that the entity is required to recognise additional amounts of 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?

Agreed. We prefer option 1.

IASB 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.

Agreed.

IASB 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.

Agreed. Further, where share awards are settled by market purchase of shares, we consider that it is the cash impact which should be reflected in the profit & loss account over the appropriate period. The consequence of this would be to enable companies to hedge their commitments by purchase of shares and since this is the true economic cost to the company, it appears sensible that it is this cost which should be charged to earnings.

IASB 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 of 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.

Agreed.

IASB 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 payments 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)?

Whilst we broadly support a disclosure approach to accountability, there are too many disclosure requirements, in the current ED 2. There needs to be a more proportionate approach to disclosure to ensure that the overall number and extent of disclosures are not so voluminous as to be read by no one.

The descriptive disclosures proposed in paragraph 48 (a) are excessive. It should simply be required to summarise the main quantitative assumptions. A reader will be able to judge the appropriateness of these assumptions by comparison with peer companies without the need for superfluous justification by the company concerned.

For any company with a large number of employees owning share options in the company the disclosure proposed in paragraph 46(c) of the weighted average share price at the date of exercise would be not very different from requiring disclosure of the weighted average share price during the year; for many multi-national groups options could be exercised almost continually throughout the year.

The disclosure required by paragraph 52(b) appears to be excessive. If cash-settled, rather than equity-settled, share-based payment transactions have been entered into and accounted for appropriately it seems unnecessary to require disclosure of the difference between the actual charge to the profit and loss account and the charge that would have arisen had the transaction been structured differently, namely had it been structured as an equity-settled share-based payment transaction.

IASB 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 the Exposure Draft and had not vested at the effective date of the IFRS. It also proposes that an entity should apply retrospectively the requirements of the IFRS to liabilities existing at the effective date of the IFRS, except that the entity is not required to measure vested share appreciation rights (and similar liabilities) at fair value, but instead should measure such liabilities at their settlement amount (ie the amount that would have been paid on settlement of the liability had the counterparty demanded settlement at the date the liability is measured).

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

Agreed.

IASB 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?

Agreed.

IASB 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 transaction 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 are relatively small;**

- **SFAS 123 encourages, but does not require, entities to apply its fair value measurement method to recognise transaction 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 BC75-BC74 in the Basis for Conclusions give an explanation of minimum 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 transaction in which equity instruments are granted to employee, both SFAS 123 and the draft IFRS have a measurement method that is based on fair value of those equity instruments at grant date. However:

- **Under SFAS 123, the estimate of the fair value of an estimate instrument at grant date is not reduced for the possibility for 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 at grant date. Hence, any amounts recognised for employee services received during the vesting period will be subsequently reversed if the equity instruments granted for 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 services 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 96-19 *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 require 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 on 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 compensations 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 treatments as appropriate, please provide details of your preferred treatment.

No opinion.

IASB Question 25

Do you have any other comments on the Exposure Draft?

Work carried out by GKN to evaluate the impact of the proposal has shown up the practical difficulties when dealing with a large employee base and the subjectivities involved in arriving at option values. As noted above, we are concerned at the level of overhead cost which would be introduced by the proposals, their impact on all employee share schemes and the level of disclosure required which may be regarded as excessive in relation to the figures which, at least in our circumstances, are not material in the context of group results. We urge that the Board carefully considers the practical consequences of its proposals before reaching a conclusion on any of these points.