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Pinsent Curtis Biddle Response to the IASB Invitation to Comment on ED2 (FRED31)

March 2003

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Question 1

Paragraphs 1-3 of the draft IFRS set out the proposed scope of the IFRS. There are no proposed exemptions, apart from the transactions within the scope of another IFRS. Is the proposed scope appropriate? If not, which transactions should be excluded and why?

A. See 3 below.

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?

A. See 3 below.

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?

A. We do not agree with the recognition approach for share options and believe that the proposals are likely to give rise to distorted and misleading financial accounts. Where the options are satisfied by market purchase, the cost of providing the options is already reflected in the financial accounts in the form of the finance costs arising from the purchase of shares and any loss arising where the cost of purchase exceeds the exercise price. Where options are satisfied by new issue there is no cost to the company, but instead, a transaction with shareholders occurs diluting the interests of existing shareholders.

There may be room for improvement in the disclosure of the impact of this dilution, including changing the basis of calculating fully diluted EPS to better reflect the impact of options.

When the bargain between an employee and his employer company is that the employee receives for his services a salary of (say) 100, but that the company will discharge its liabilities to pay (say) 30 of that by the grant of a right to acquire shares, then the proper analysis is that the company should account for its liability of 30, notwithstanding the fact that it has chosen to discharge that liability by some means other than cash.

That said, this is not the way in which the overwhelming majority of UK share option and other share-based incentive schemes have worked. The grant of a right to subscribe for new shares is made by, or on the authority of, shareholders in the hope or expectation that it will afford a "carrot", incentivising the employee to work over and above his contractual obligation under his service agreement. The "hope" is that such enhanced commitment will

be reflected by growth in shareholder value, the benefit of which outweighs the "dilution" of shareholders' interests.

In addition to our general opposition to the recognition principle, we have concerns about the validity of Black Scholes and its current derivatives for the calculation of the proposed accounting expense.

We believe that all employee schemes which set a relatively low maximum participation threshold should, in any event, be exempt from the proposals in the UK as such schemes are not introduced as a form of remuneration but for broader corporate objectives.

In particular, UK Save-As-You-Earn (SAYE) schemes should be exempted as participation in these schemes is linked to a monthly savings scheme. Many employees choose to participate because of the savings scheme, and the number of options awarded is linked to the amount saved rather than an individual's earnings or contribution to the business. Participation is an investment decision of the employee, not consideration (or a quid pro quo) for a given quantum of services.

Unquoted companies should also be exempt from the standard. Small holdings in a privately owned company are generally recognised as having little or no value. Even the Shares Valuation division of the UK's Inland Revenue accepts that discounts in the region of 80% to 90% are appropriate for the valuation of such shares unless a sale or flotation is imminent. Options are even less valuable than shares, having no voting or dividend rights, and so their value in a private company is likely to be negligible. However, to demonstrate this in each case may involve companies in considerable trouble and expense and it would be sensible to protect companies from this by affording such companies an exemption. There should also be an exemption for companies reporting under the UK's FRSSE.

If there is no exemption for unquoted companies such companies are likely to be deterred to some extent from establishing share-based incentive schemes. This would set back the UK government's efforts to encourage wider share ownership.

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?

A. See 5 below.

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 IRFS 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?

A. It is the "cost" (if any) to the company which should properly be recognised when the instrument is created (granted). The fact that it may thereafter rise or fall in value is

irrelevant. The likelihood of fluctuation in value and the risk of it having no value, should be taken into account in determining such "cost" at grant.

For the reasons given above we do not believe it is correct, either in logic or as a matter of principle, to assert that a share-based incentive has a value and that this equates to the fair value of the employee services received. We say this because:-

1. **A market-value share option has no intrinsic value at grant. If it is to subscribe for new shares, its "cost" is the potential dilution. If it is to acquire existing shares, its "cost" is the funding cost of a loan to buy such shares or acquire a call option over such shares.**

2. **Such "costs" bear no relationship to the value of the services which the employee is contracted to provide over the option period, and for which the company is in any event liable to pay salary, pension, benefits etc.**

3. **As a matter of logic, the fact that I give to you something which may prove to be of value to you, does not mean that its immediate (or ultimate) value to you is a cost to me of equal worth. Example: I give an employee a premium bond which ultimately generates a cash price of £1 million. It has cost me £1. The proper amount to be recognised as my expense is £1, not the present "hope value" attaching to it, and certainly not the £1 million!**

For well rehearsed reasons, accounting standards do not recognise the value of services contracted to be provided by employees on the balance sheet. (NOTE: under UK law, employees contract to provide services under a contract of employment. In the US, it is a relationship determinable at will.)

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 vale 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?

A. We do not see why different bases are appropriate for non-employees and employees. If the employee basis is sufficiently strong, surely it should be applied to all transactions. However, the question is misconceived. For the reasons given above, it is the agreed liability of the company in securing the provision of the goods or services which should be recognised. The actual market value to the company of the goods or services to be provided then becomes an asset to be recognised, if at all, on the balance sheet.

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 is not so?

A. For the reasons given above, this question is misconceived.

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?

A. The proper question to ask is: what is the value of the liability of the employer incurred to secure the employee's services? In the UK this would not, for the reasons given above, normally include any form of share-based incentive. It is not reasonable to assume (because it is rarely, if ever, the case) that the services rendered by an employee are given as consideration for the grant of any such equity instrument except as specifically mentioned at 3 above.

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, 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?

A. Although the expected units of service approach may be intellectually valid, we are concerned that it would make the operation of the standard too complicated and vulnerable to distortions (eg if expected units of service were overestimated at the outset).

We would suggest that the use of rather artificial concepts such as 'units of service' and 'surrogate measures' makes the entire proposal rather artificial and unlikely to produce a true and fair result.

Question 10

In an equity-settled share-based payment transaction, the draft IFRS proposes that having recognised the services received, and 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?

A. We disagree. Until shares are issued there is no increase to equity. The mere existence of an option does not increase equity. Until shares are issued, the balance sheet entry arising from the accounting expense should be an adjustable provision.

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?

A. We agree that currently an option pricing model is the most appropriate basis of estimating the fair value of traded options. However, we are concerned that the current generation of option pricing methodologies is not appropriate for untradeable employee share options.

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?

A. We agree that options should be valued using the expected life of the option rather than its contracted life as the contracted life is simply a legal maximum and actual lives are often much shorter. However, we do not believe using expected life deals adequately with the non-transferability of employee share options. We would suggest that a discount for non-transferability would be more appropriate. The issue of non-transferability is fundamental to our concerns about the relevance of the current generation of option pricing models.

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?

A. We agree that vesting conditions should be taken into account when estimating a fair value of options or shares granted, including:

- **the inability to access the option gain during vesting and subsequently because of closed periods; and**
- **the risk of forfeiture for not meeting vesting conditions including:**
  - **an assessment of the risk of forfeiture due to staff turnover;**
  - **the probability that the option will lapse unexercised (or become unexercisable) due to the operation of any performance conditions.**

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, 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?

A. No comment.

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?

A. Employees are often prevented from trading in black out or closed periods – when share volatility may be at its greatest because of speculation in the run up to a company issuing its results. Formal and informal corporate pressures may also prevent employees exercising options and selling shares and there can also be significant delays between an employee exercising an option and being in a position to sell the shares.

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?

A. The Board's intention of not being prescriptive is commendable but we are concerned that by requiring volatility to be used, the potential development of more appropriate models for employee share options will not be encouraged and that Black Scholes and its derivatives are being imposed as a de facto standard.

We are concerned that a primarily volatility driven measure, which is relevant for a short term trader who seeks profit out of short term positions and can hedge, is inappropriate for employee share options. The holder of an employee share option does not generally regard his interest as valuable because it gives him an opportunity to exploit the volatility of a share to make a profit. In practice the holders of employee share options are not able to trade in options to reduce their exposure (directors are even forbidden from trading in options in shares of their companies by s323 of the 1985 Companies Act) and tend to regard volatility as more of an irritant or friction in the system than a source of value.

Employee optionholders tend to see value in an option being derived from the share's long term growth potential. However under Black Scholes and the accounting proposals, the expected return on a share and the actual growth in its value after the option is granted are considered to be completely irrelevant. We suggest that this paradox needs to be reconsidered. Employee share options are fundamentally different from the options that are traded in the derivatives market and some new, original, thinking is needed. As yet there is very little published material on employee share options, reflecting the fact that as they were non tradeable there was no incentive to properly research and analyse them. We believe that the IASB, in bringing forward their proposals, has a responsibility to encourage the development of new methodologies which may be more relevant for employee share options and should be less prescriptive in its required inputs.

Question 17

If an entity re-prices 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?

A. Where options are surrendered and replacement options granted in their place, new accounting charges should be calculated for the replacement options by reference to the relevant factors of the replacement grant, and charges for the original options discontinued. We believe there is a need for the IASB to issue some informed guidance as to the accounting treatment of options where there are corporate reorganisations, takeovers and demergers, as such events are quite common and guidance is likely to be necessary.

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.

A. No. Cash paid to an employee should pass through the profit and loss account and not the remaining value of an equity instrument that no longer exists.

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.

A. No. The use of fair value and therefore an option pricing model to calculate the year end provision should not be prescriptive. Cash settled payments are already reflected as expenses in accounts and we do not see why the year end liabilities should necessarily be calculated using an option pricing method when simpler methods already being used are sufficient.

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.

A. No comment.

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)?

A. The disclosure requirements in paragraphs 45 to 53 inclusive are excessive and should be simplified and, specifically, the standard should not require the disclosure of any price sensitive information. In particular, we are concerned that companies might be discouraged from setting meaningful corporate performance targets if they are required to disclose the assumptions that were made about their attainability.

In the UK, standard setters need to be mindful of the recent Director's Remuneration Reports Regulation and not add unnecessarily to the existing onerous reporting requirements.

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 (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.

A. We believe that the transitional arrangements are reasonable.

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?

A. No comment.

Question 24

In developing the Exposure Draft, the Board considered how various issues are dealt with under the US standard FAS 123 Accounting for Stock-Based Compensation, as explained further in the Basis for Conclusions. Although the draft IFRS is similar to FAS 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. FAS 123 contains the following exemptions, none of which is included in the draft IFRS:

- employee share purchase plans are excluded from FAS 123, provided specified criteria are met, such as the discount given to employee is relatively small;

- FAS 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 shares 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).

A. (a) We agree with FAS 123 exempting non compensatory plans from the accounting requirements – recognising the economic reality of broad-based plans.

Like FAS 123 we think unlisted companies should be permitted to assume volatility of zero or be excluded from the scope of the proposed standard entirely.

(b) For transactions in which equity instruments are granted to employees, both FAS 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 FAS 123, the estimate of the fair value of an equity instrument at grant date is not reduced for the possibility of forfeiture due to the 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 FAS 123, the transaction is measured at the fair value of the equity instruments issued. Because the 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.

A. (b) No comment.

(c) If, during the vesting period, an entity settles in cash a grant of equity instruments, under FAS 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.

A. (c) No comment.

(d) FAS 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.

A. (d) We agree with SFAS 123.

(e) FAS 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).

A. (e) No comment.

(f) For a share-based payment transaction in which equity instruments are granted, FAS 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.

A. (f) No comment.

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. (Respondents may wish to note that further details of the differences between the draft IFRS and FAS 123 are given in the FASB's Invitation to Comment.)

Question 25

Do you have any other comments on the Exposure Draft?

A. The standard should contain explicit guidance on the balance sheet treatment of employee share schemes and employee benefit trusts rather than address these matters indirectly in the Basis of Conclusions. In respect of the UK, guidance on the distributability of amounts included within equity should be obtained and published by the ASB or IASB, as the proposed standard has created considerable uncertainty which needs to be clarified.

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Should you have any further questions, please contact David Pett, Judith Greaves, or your usual Pinsent Curtis Biddle adviser, who will be able to assist you further.