CL 180

Exposure draft 2 Share-based payments

Old Mutual response

7 March 2003

1. Overall comments

We are pleased that the IASB have issued a standard on share-based payments on the basis that there has been no International Financial Reporting Standard on such transactions in place to date.

However, we have significant concerns with regard to the direction taken in the standard. These issues are summarised below, together with our response to a sample of specific questions on which you have sought feedback. Fundamentally we disagree with the proposals advocating moving to value based accounting (i.e. ascertaining the value of services provided) away from cost based accounting (i.e. reporting the cost to the company of settling a liability). This represents a fundamental shift in approach that is likely to increase 'accounting volatility' rather than reflect true economic volatility. We also do not support the differences in accounting for equity settled schemes compared with schemes that can be settled either by cash or equity.

In summary we would like to express our concern that:

- The proposals may result in a reduction in the availability of broad-based equity settled share incentive schemes, especially when there is a downward pressure on share prices as the income statement charge incurred by the company during the scheme period will be significantly higher than the benefit received by the employee.

- The proposals in the Exposure Draft are not consistent with other Standards, in particular the definition of fair values in IAS 39.

- The proposals are unduly complex, in particular for those many organisation that have a number of different types of share-based payment schemes in operation, including cash settled schemes.

- We believe that many users will not find the information in the financial statements on share-based payment schemes either understandable or relevant to their decision making.

- We believe that it will be extremely difficult and costly, if not totally impracticable to design an effective hedging strategy for equity settled share based payment schemes. This is largely due to the proposed prohibition on revaluing such schemes from one period to the next.

- There may be unintended consequences for the voluntary sector of these proposals combined with the proposed change to IAS 8 on the application of the hierarchy of IASB pronouncements and authoritative non-mandatory guidance. Essentially in the absence of any other IAS guidance will this standard require entities to try and determine the fair value of services received from volunteers? If so this will cause us significant concern especially in South Africa and our involvement in black empowerment initiatives.

- The proposals in the exposure draft try to ascertain the value of services received by employees, which is inconsistent, in our mind, with the recognition of expenses as set out in the Framework. We believe an approach based on measuring the cost to a company of share-based payment schemes is technically far more sound.

Our policy has been largely to settle obligations from share-based payment schemes by acquiring the stock either directly or indirectly on the open market rather than issuing more paper each period to settle any obligations. Considering the:

- Settlement basis for our share-based payment schemes;

- Disclosure requirements in IAS 1, IAS 32; and

- Principle that all derivatives should be reported at fair value in the financial statements.

the expected cost to us of these schemes will be reflected in the financial statements in a clear and transparent way.

The key issue seems to lie with those organisations that have not adequately disclosed the amount of any contingent or actual liability arising from such schemes when obligations are settled by issuing new share capital. We therefore believe that it would be far more useful to focus on the dilutive effect of these schemes on EPS and modify the EPS calculations. We believe this information would be far more useful and understandable to users of the accounts. In line with this view we disclose diluted EPS infomation that reflects the impact of our share-based payment schemes.

We would support an approach that:

- Requires disclosure of the nature of share-based payment schemes in operation within an entity.
- Provides guidance on the application of the disclosure requirements in IAS 1 to share-based payment schemes.
- Requires companies to disclose how the liability for the scheme will be settled, for instance by issuing additional share capital or by purchasing shares on the open market or by giving staff a cash option.
- Sets out how the impact of share-based payment schemes should be reflected in diluted BPS calculations.

2 Question 25— Any other comments on the Exposure Draft?

2.1 *Reduction in availability of broad-based share incentive schemes*

A key concern we have with regards to the decision not to rebase the fair value of equity settled schemes at each reporting date is that if the entities share price is high at the date the scheme is launched and subsequently drops the cost to the company will be far greater than the value the employee receives from the incentive. This is likely to cause companies to stop operating broad-based equity settled schemes.

Our view is that when share prices are perceived as likely to rise over the period to vesting date companies will be incentivised to offer equity settled schemes, as the expense recorded in the period to vesting will be low. There would be a strong disincentive to issue equity settled schemes when a downward trend in share prices is perceived as the cost to the company would be much higher than the value received by the employee.

Companies may either choose a strategy of not issuing broad based share option schemes when there are downward pressures on share prices or modify schemes to offer staff a cash alternative equal to the value of the share at vesting. This latter strategy may not be aligned with the reasons for offering share incentive schemes e.g. to provide staff with a reason for continued improvement. We do not believe it is appropriate for accounting standards to drive corporate or socio-economic behaviour in this way. Our view is that a key objective of accounting standards is to ensure transactions and balances are reported appropriately in a consistent manner both across entities, and the framework (including principles in other standards).

2.2 *Inconsistencies with other standards*

We are concerned that although an objective of the standard is to determine and report the fair value of the incentive scheme in terms of the service provided to the company by the employee it does not achieve this for equity-settled schemes.

IAS 39 defines fair value as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm's length transaction.

We do not believe there is any supporting evidence to indicate that if a third party assumed this obligation they would base their estimate of the fair value on the share price at the grant date rather than on the current share price.

We therefore believe that all share based payment schemes should be revalued at each reporting date both to ensure consistency with concepts in other standards and to reduce the opportunity for different scheme structures to be incentivised depending on share price expected movements.

2.3 ***Undue Complexity***

As an international group we have a number of share schemes currently in operation:

- Equity settled schemes;
- Cash/equity settled schemes where the choice is at the option of the individual;
- Cash/equity settled schemes where the choice is at the option of the company.

Apart from being onerous, the proposed disclosure requirements in the standard will require extensive disclosures to be made which could run to several pages.

We question whether this meets the qualitative characteristics of information in the financial statements as set out in the TASB Framework, in particular:

- *Understandability* - will users actually understand the cost to the company of remunerating staff/directors via the use of share-based payments plans;
- *Relevance* — is it really relevant for users to understand the value of service received from an employee in carrying out their duties? Surely what is more relevant is what it will cost the company for the provision of these services. Does this information help users evaluate past, present or future events? What work has been done by the Board to substantiate this view?

If the standard required companies to estimate the cost to themselves of settling obligations under share based payment schemes, the disclosure requirements could be simplified, which would make them more understandable and relevant to users. As IAS 1 (as modified) has enhanced required disclosures around assumptions and judgements made by management this should also address the issues of comparability across entities and within an entity over time.

2.4 **Specific proposed disclosure requirements**

We are concerned as to the level of disclosure proposed in paragraphs 45-53 for individual share option schemes, on the basis that where companies have a wide variety of share schemes, each with differing settlement structures and conditions, there is a risk that the information provided in the financial statements becomes overly detailed and as such is no longer transparent to the end
user. As such the objective of 'the entity disclosing information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements' may not be achieved.

We find the following items of disclosure particularly detailed and complex:

- Paragraph 46 description of each type of share-based payment arrangement that existed at any time during the period, including details of when those rights were granted, to whom those rights were granted, description of the vesting requirements; and
- Paragraph 48 where the entity has measured the fair value of services received by reference to the fair value of the equity instruments granted, the entity must provide extensive disclosure relating to the options granted, including: details of the option pricing model used and the inputs into that model, the assumptions made with respect to vesting conditions and how these vesting conditions have been taken into account in measuring fair value.

3 Responses to other specific questions

3.1 ***Question 5 - For equity settled share-based payment transactions do you agree that the fair value at date of grant 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?***

We agree that it is appropriate to measure the fair value at date of grant. However, we believe that it is also appropriate to re-measure the fair value at each subsequent reporting date for the following reasons:

- It is consistent with the approach for optional cash-settled share based payments;
- It is consistent with the fair value methodology adopted in other standards e.g. IAS 39;
- It is not clear what 'meaning' will be ascribed to this element of equity in future years when the scheme has vested i.e. is it really a residual interest in the assets of the enterprise after deduction of liabilities and what 'residual asset' does this represent?

As currently proposed, where an entity has a combination of cash and share-based settled schemes, the financial statements may lack comparability and transparency. Whilst re-measuring the fair value at each reporting period is more onerous and introduces volatility into the income statement, we suggest that all share option scheme liabilities should be re-measured annually on the basis that we believe the financial statements would provide a more accurate and current reflection of share option obligations.

3.2 ***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 the options, the options are not exercised. Do you agree with this proposed requirement? If not, in what circumstances should an adjustment be made to total equity and why?***

We have some concerns regarding the proposal that where the entity has recognised services received and recorded a corresponding increase in equity, no further adjustment can be made to equity. We note the following specific points:

- Equity has been increased throughout the vesting period and is not reversed at the end of the vesting period or indeed on exercise of the options. This continuous increase in equity may result in a lack of transparency and comparability in the financial statements.
- The proposed treatment of equity-settled schemes is entirely inconsistent with the treatment of cash settled schemes whereby the liability created at each reporting date is reversed on settlement.

As such, companies may be discouraged from setting up equity settled schemes in preference to cash schemes, as the accounting for equity schemes is not intuitive and results in a permanent adjustment to equity irrespective of the ultimate impact on the shares.

We therefore suggest that, in line with the proposed treatment of cash settled schemes, these increases in equity should be reversed on settlement. Indeed we note that where the entity purchases 'own shares' to settle the share option obligation, these will be shown as a deduction from equity. We suggest that these should be offset directly against the share option credits recorded throughout the vesting period.

3.3 ***Question 18- The IFRS proposes that where an entity cancels a share or option grant during the vesting period, the entity should continue to recognise the services rendered by the counterparty in the remainder of the vesting period, as if the grant had not been cancelled. Are***

the proposed requirements appropriate? If not explain why not and provide details of your suggested approach.

We believe that where options have been cancelled or are unlikely to be exercised due to an adverse trend in the entity's share price, it is inappropriate to continue to recognise an expense for these options on the basis that the entity has no further obligation to the employee.

We also note that the proposed IAS treatment does not converge with the US approach outlined in SFAS 123 which requires the immediate recognition of the full compensation expense measured at grant date.

We suggest that the immediate recognition of the expense provides a more acceptable outcome on the basis that the liability relating to the cancelled options has been extinguished.