Tredje AP-fonden

6 March, 2003

Sir David Tweedie
International
Accounting Standards
Board
30 Cannon Street
London
EC4M 6XH

Exposure draft of share-based payment

Dear Sir David,

We appreciate the opportunity to respond to the International Accounting Standards Board's exposure draft of its proposed IFRS *Share-based Pqyment.*

This letter represents the views of the Third Swedish National Pension Fund (AP3), one of four buffer funds in the public Swedish pension system. The Riksdag (Swedish Parliament) has given each of the four funds a mandate to generate the best possible long-term return on capital, in relation to the funds' liabilities in the pension system. The market value of fund assets as of 31 December 2003 was SEK 120.2 bn (EUR 13.1 bn), of which 55 percent was invested in a global equities portfolio. The overall return target, mentioned above, constitutes the basis of the Fund's activities in the Corporate Governance arena.

Summary of views

Our response should be seen as an owner's point of view and therefore we do not cover all technical aspects of the proposal. Our comments also focus on the situations where share-based payments are used in exchange for employee services.

In general we agree strongly with the IASB's requirement that share-based payments, granted at less than fair value, must be recorded as an expense in the financial statements. We also strongly agree with the requirement to measure the transactions at fair value and to use grant date measurement. However, we believe that the standard is in some respects too complex, particularly the calculations in paragraph 15 and Appendix B. We also find the disclosure requirements too extensive.

The subject of management remuneration is highly sensitive in the public opinion. Therefore, in order to improve transparency and credibility, it is of vital importance to avoid overly complex accounting practices in this area. There is no reason why the calculation of the cost for equity settled share-based transactions should be any more complex or handled in any greater detail as, for example, depreciation of fixed assets. We are also concerned that too much complexity will lead to poor applications.

In our opinion, the calculations in paragraph 15 are overly detailed. Our preference for principles that are easy to use and understand also leads us to prefer straight-line depreciation of fixed assets. Not because it is a superior method, but simply because the method is easier to use than other, more accurate, methods.

We also suggest that the IASB recommend one of the option pricing models and to require the companies to comply with that model or else explain why they use a different one. Neither do we believe that it is necessary in general to require unlisted companies to use the standard.

The Fund's detailed comments on the exposure draft have been prepared in collaboration with the consultant Peter Malmqvist. If you wish to discuss more issues raised in our commentary, please contact Mr. Malmqvist. See contact details below.

Yours sincerely,

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CEO

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EXPOSURE DRAFT OF SHARE-BASED PAYMENT: DETAILED COMMENTS

Our comments refer to the questions we find relevant to share-based payments where employee services are received.

QUESTION 3

For an equity-settled share-based payment transaction, the draft JFRS 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?

We believe enterprises that are not public Exulted liability companies or subsidiaries of such companies and which do not have long term plans to become a listed company could be excluded from the standard. However, should an enterprise change its plans and elect to publicly offer its shares, it should be required to restate the income statement with regard to share-based transactions for the two years prior to the listing.

We believe that there are serious problems inherent in calculating a fair value for unlisted companies. Information regarding share-based payments will therefore be of little value to stakeholders. Such companies usually have few shareholders and in most cases the shareholders are represented on the board.

If the company intends to offer its shares publicly at some point in the future there will be a focus on the value of the company. Commonly, companies invite institutions or private equity funds to become shareholders a year or two prior to the listing. Market value derived from those transactions could be used as a fair value approximation when measuring share-based payments.

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?

We agree

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 counter party as consideration for the equity instruments are received during the vesting period? If not, when are the services received, in your view?

We agree.

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 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 methods do you propose?*

The calculation proposed in ED2 is overly complex and is based on the presumption that all employees that participate in a share-based payment plan have been granted an equal number of rights. This is usually not the case.

Let us look at the example in ED 2, paragraph 15. A company grants 50000 options valued at CU 15 per option to 500 employees. Each grant is conditional upon the employee working for the entity over the next three years. The company estimates that 20 percent of the employees will leave during the three-year period and that employee departures will be distributed evenly over three years. In that case the total number of working years (units of service) is 1350 and the total fair value as of the date options are granted is CU 600000 (adjusted for employees estimated to leave the company). The cost for each unit of service is CU 444.44 (CU600000 divided by 1350 units). The annual cost is calculated as the number of units of service multiplied by the average cost per unit, CU 444.44.

The estimated cost using a straight line method is CU 200000 (CU 600000 divided by three years).

In Scenario I we apply the method given in paragraph 15.

In Scenario 2 we use the same method, but with fewer employees leaving the company than estimated.

In Scenario 3 more employees leave the company than estimated.

	Straight line	Scenario 1		Scenario 2		Scenario 3	
Year	Cost*	Units	Cost*	Units	Cost*	Units	Cost*
1:	**200000**	483.50	**214889**	500.00	**222222**	462.50	**205554**
2:	**200000**	450.00	**200000**	500.00	**222222**	368.75	**163887**
3	**200000**	416.50	**185111**	450.00	**200000**	330.00	**146667**
Total	**600000**	1350.00	**600000**	1450	**644444**	1161.25	**516108**

* Measured in "currency units", as used in the standard.

If we compare the scenarios we see that the annual cost varies according to the actual number of employees (units) still in service during the vesting period, as well as according to how each unit of service is calculated. We believe the differences are small, given that the option package is only a minor part of total remuneration. We would argue that a simple straight line cost allocation method is sufficient, rather than the method suggested in paragraph 15.

If we compare scenario 1 to scenario 2 and 3 we can see that the costs vary according to the actual number of employees (units) still in service during the vesting period. We can see a problem with this approach.

How will the costs change the first year if only one person leaves the company and that individual, e.g. the CEO, was granted 20000 out of the 50000 options? As far as we can see costs in the calculation will increase as in Scenario 2 because the calculated units of service will increase compared with the estimate. this is the case because only one person left, rather than the estimated 33.33 persons. We would argue that the actual cost for services received has decreased.

In our opinion the problem occur in par; because the company is required to use the unit of service method under the assumption that all employees are granted an equal number of options. We suggest that the calculation focus on the number of options still in place at the end of each year, because different groups of employees are normally granted different number of options.

Consider the example mentioned above,: where the CEO leaves the company at the beginning of the first year and 20000 options will be forfeited. In our opinion, the yearly cost of services received must be reduced by an amount calculated as follows:

- The number of options forfeited (20000),

- multiplied by the calculated fair value of each option (CU 15),

- reduced by the estimated options forfeited at fair value and (3333,33 x CU 15),
- divided by the number of years in the vesting period (3).

In our example the reduction of the annual cost will be CU 83333 (((20000 x CU 15) – (3333.33 x CU 15)) / 3).

As mentioned above, we suggest a straight line method for allocation of the estimated cost. In this example, the annual cost each year will be equal to CU 116667 (CU 200000 - CU 83333) from the year after the individual leave the company.

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 agree.

QUESTION 11

The draft IFRS proposes that the entity should measure the fair value of equity instruments granted, based on market prices 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?

We agree, but we suggest that the IASB recommend one of the option pricing models and require companies to comply with that model or to explain why they use a different one.

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?*

We agree.

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?

We agree.

QUESTION 14

For options with a reload feature, the draft IFRS proposes that the reload feature should be taken into account, where practicable, when an entity measures the fair value of the options granted. However, if the reload feature is not taken into account in the measurement of the fair value of the options granted, then the reload option granted should be accounted for as a new option grant (paragraph 25).

Is this proposed requirement appropriate? If not, why not? Do you have an alternative proposal for dealing with options with reload features?

We believe the requirement is appropriate.

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?

In Sweden, companies are required to pay social charges on employee stock option programs. Further guidance on accounting for social charges would be appropriate.

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?

We agree.

QUESTION 17

If an entity reprices a share option, or otherwise modifies the terms or conditions on which equity instruments were granted, the draft IFRS proposes that the entity should measure the incremental value granted upon repricing, and include that incremental value when measuring the services received. This means that the entity is required to recognise additional amounts for services received during the remainder of the vesting period, ie additional to the amounts recognised in respect of the original option grant. Example 3 in Appendix B illustrates this requirement. As shown in that example, the incremental value granted on repricing is treated as a new option grant, in addition to the original option grant. An alternative approach is also illustrated, whereby the two grants are averaged and spread over the remainder of the vesting period.

We support the position to account for the repricing of options in the same way as for new options schemes. We see no good reason why a repricing should be accounted for differently than a new option and therefore do not support the alternative method as proposed in appendix B to ED 2.

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 far 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.

We believe the requirements are appropriate. 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.

Paragraph 34 states that services rendered by employees shall be measured, not at grant date but at the fair value of the share appreciation rights at each reporting date. We do not see the need for this departure from the basic principle that applies to share-based payment transactions. We would prefer that entities determine the amounts to be attributed to each unit of service at grant date and that these amounts be allocated over the vesting period. The liability should be accounted for independently of what is recognized when the employees render their services, with gains and losses reported as financial items.

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.

We believe the requirements are appropriate.

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 equip 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 lass.

Are these disclosure requirements appropriate? If not, which disclosure requirements do you suggest should be added, deleted or amended (and how)?

We find the disclosure requirements excessive. What is important to the user is paragraph 47, i.e., that an entity discloses information that makes it possible for users of financial statements to understand how the fair value during the period was determined. A reference to an example illustrating the kind of disclosures likely to be useful when analysing how the fair value of the share-based payments was determined could be added to this paragraph.

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.

We consider the requirements appropriate.

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?

We find the requirements appropriate.