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Human Resource Consulting

Mercer Human Resource Consulting Limited's Response to the IASB Invitation to Comment on ED2

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?

A. **Employee share plans required to be broad-based by legislation, which require employees to save for the cost of shares or invest their own money in shares to qualify for company matching shares should be excluded from the scope. These plans are introduced by companies not as a reward for services but as a savings facility to encourage employee share ownership which can lead to higher productivity.**

These plans can involve the employee in real risk to his own savings invested in shares under Share incentive Plans and the loss of options where savings are not continued under Savings Related Share Option Plans.

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. **The recognition requirements are appropriate.**

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. The measurement principle is appropriate.

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. **The date when the entity obtains the goods or receives the services is appropriate.**

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 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. **Grant date is the appropriate date to measure the fair value of the equity instruments granted.**

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

A. **We agree fair value of the goods or services is usually more readily determinable than the fair value of the equity instruments granted for equity-settled transactions with parties other than employees.**

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. **We agree the fair value of the equity instrument is more readily determinable than the fair value of the employee services received.**

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. **We agree it is reasonable to presume services are received during the vesting period.**

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

A. **We agree with the proposals to measure of the fair value of each unit of service received during the vesting period.**

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, i.e. 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. **When options are granted, equity is inflated and yet when options are exercised there is no adjustment to equity to reflect there will then be no cost to the company in the issue of shares for less than market value. Adoption of an option pricing model such as Black-Scholes is not**

an appropriate measure for employee share options, even where it is adjusted for the various factors in the draft IFRS.

This all seems far removed from financial reality.

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 consider Black-Scholes, the most likely pricing model to be used, as inappropriate to measure the cost of employee share options. The estimated equity growth given to employees and discounted to estimate the fair value at grant would be more appropriate.

Some of the factors listed are too commercially sensitive to be disclosed. These are expected dividend yield, expected volatility and expected probability of attaining certain types of performance conditions.

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 it is appropriate to replace an option’s contracted life with its expected life when applying an option pricing model for non-transferable employee share options. We agree with**

the proposed requirement for taking into account the inability to exerciáe an option during the vesting period.

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 the fair value of options or shares granted. Our suggestions on how this should be done are:**

i) **For non-transferable options, take account of the option-holder's inability to access the gain in the vesting period;**

ii) **Estimate risk of forfeiture through employees leaving, performance criteria not being met and lapsing of options.**

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?

A. **We agree that a reload feature should be taken into account when the company measures the fair value of options granted. We see no need for any alternative approach.**

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. **The other features relate to broad-based all employee option share plans to which we believe the IFRS should not apply. These include:**

- **i) The risk of employees' options lapsing under Savings Related Share Option plans if their savings fall more than 6 months into arrears;**
- **ii) The risk of employees options lapsing under Savings Related Share Option Plans if an employee needs to withdraw his savings through financial hardship;**
- **iii) The risk that upon early exercise, Savings Related Share Option Plans can be exercised only to the extent of SAVE savings and interest with the balance of Savings Related Share Option plans lapsing — for example, on a takeover.**

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 weakness of the prescriptive guidance is that it represents neither the ultimate cash cost to the company nor the dilution impact on existing shareholders. It is likely to produce a meaningless figure based upon mathematical formula highly inappropriate for pricing employee share options. The flexibility will lead to very subjective estimates and make it difficult to compare the profit and loss charges in different companies' accounts.**

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. **We prefer averaging the two grants and spreading over the remaining vesting period: this avoids a disproportionately high charge in the first year of repricing (year 3 in the worked example in Appendix B).**

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. **The proposed requirements are inappropriate as they are complex and move away from reflecting the true cost of the transactions. The expense to the date of the option cancellation should be reversed and the cash payment for cancellation charged to profit and loss account in the year of the reversal. Replacement options should be charged to profit and loss account over their vesting period but the expense already charged to the profit and loss account for the options cancelled should be reversed.**

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. **We agree with the proposed requirements.**

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. **We agree with the proposed requirements.**

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. **We agree with the disclosure 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. **The requirements of the IFRS should not apply until the IFRS becomes a standard and preferably there should be an adequate lead in time from that date to give companies time to plan and prepare for the changes. 1 January 2005 would seem a more sensible date from which to apply the new proposals.**

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. **We agree with the proposed requirements.**

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 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. 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 is relatively small;

- SFAS 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 BC7O- 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 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).

A. **(a) We agree with SFAS 123 exemptions:**

i) **Any broad-based employee share purchase or employee share option plans requiring, by legislation, employees to save from their own funds or invest their own funds** in **company shares should be exempt. This would include Savings Related Share Option Plans and Share Incentive Plans “Matching Shares”;**

ii) **Discloiure as an alternative to charging an expense to the profit and loss account should be permitted, given the figures charged to profit and loss account are likely to be largely estimates based on inappropriate option pricing models adjusted for factors which are highly subjective;**

iii) **Simplified valuation methods for unlisted companies would be appropriate, given the difficulty** in **valuing the shares of such companies.**

(b) For transactions in which equity instruments are granted to employees, both SFAS 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 SFAS 123, the estimate of the fair value of an equity instrument at grant date is not reduced for the possibility of 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 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. Under the draft 1FRS, 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 service 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.

A. ***(b)*** **We agree that the fair value of equity instruments should be reduced to reflect the possibility of forfeiture due to failing to meet vesting conditions.**

The failure to recognise that an entity has incurred no loss of cash where an equity instrument is forfeited is a fundamental weakness of ED2. As no future equity growth has been given to option-holders, the company can issue the shares for full value rather than for a lesser amount to option-holders.

(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.

A. ***(c)*** **A cash payment should be charged as an expense through profit and loss account and the expense charged to date for options cancelled should be reversed.**

(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- 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 support the SEAS 123 position on accounting for equity instruments issued to non-employees.**

(e) SFAS 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 BC7O- BC81 of the Basis for Conclusions for a discussion of intrinsic value, time value and fair value).

A. **(e) We agree with SFAS 123 that the intrinsic value measurement method is most appropriate.**

(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 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) We agree with the proposed IFRS treatment.**

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 SFAS 123 ‘are given in the FASB’s Invitation to Comment.)

Question 25

Do you have any other comments on the Exposure Draft?

A. **The lack of an adequate period to prepare for the new standard is unsatisfactory. The costs for companies of compliance is likely to be significant. The expense charged to profit and loss account is just an estimate and yet it involves very complex and subjective processes to be followed.**

If adopted, the principle-based approach of the draft IFRS will give rise to a wide variety of costs shown in financial statements recognising share-based payment transactions, based on a complex combination of factors and processes. Far from providing high quality transparent and comparable information to uses as of financial statements, it will further complicate and obscure the costs included for share-based transactions and add another costly compliance burden to companies. It is more likely that, when comparing financial statements for differently entities, financial analysts will strip out the costs included for share-based payments, defeating the fundamental objective of the draft IFRS.

Greater disclosure of share plans should meet the requirements of analysts and others interested in company accounts. *A* simpler basis for calculating the expense to be charged to profit and loss account to recognise the “cash cost” of granting options (other than Savings Related Share Option plans) would be more appropriate. Savings Related Share Option plans should give rise to no such charge for the reasons given in the answer to Question I