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Hewitt Bacon & Woodrow
Limited
Parkside House
Ashley Road  Epsom
Surrey  KT18 5BS
Tel +44 (0) 1372 733000
Fax +44 (0) 1372 733991
www.hewittbaconwoodrow.co.uk

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| Prepared for: | International Accounting Standards Board |
| Prepared by: | Martin Lowes, Alan Judes |

## Comments on ED2 - Share-based payment

**Summary**

We welcome the opportunity to comment on ED2 – Share-based payment.

We agree that an entity should be required to recognise all share-based payment transactions, including the grant of options to employees, in its financial statements.

Our comments on a number of the issues are set out below.  However, as we are not accountants, we have not commented on the other issues including those we considered as technical accounting issues.

**Question 1 Scope**

We agree that there should be no exemptions from the scope of the standard.  In particular, we agree that it is appropriate for an entity to recognise in its financial statement the grant of options to employees.  These are granted to employees because they have a value to employees.  This must be at someone's cost, and can only be at shareholder's cost.  The issue of options to employees is directly equivalent (and substitutable by) other employee remuneration that would be recognised in the financial statements.

**Question 11 Valuation of Equity Instruments**

We believe that the only objective way to value options in the absence of market price is to use an option pricing model as described in the Exposure Draft.

**Question 12 Allowing for Expected Life**

We agree that the application of the option pricing model should reflect the expectation that for a number of reasons options are likely to be exercised before the contracted life.

However, the value of an option over an average period is generally more than the average of the values at each underlying period.  For example, the value of an option over 6 years will generally be more than the average of options over 5 and 7 years.  Valuing the option over the (average) expected period for all employees or for each distinct group of employees as illustrated in paragraphs 10 to 13 of the Implementation Guidance will therefore overstate the value of the options granted.

Instead, the entity should

- Estimate the proportion of options likely to be exercised at each duration
- Estimate the option value for each duration

- Derive the value by multiplying the proportion and value for each duration and totalling across the durations.

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**Question 12**
**Allowing for vesting period**

We agree that the requirement to allow for the inability to exercise the option during the vesting period is appropriate.

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**Question 13**
**Allowing for vesting conditions**

We agree that vesting conditions should be taken into account in estimating the value of equity instruments granted. To do otherwise would overvalue the grant.

The generally worded requirement in paragraph 24 of the Exposure Draft is appropriate.

However, the examples set out in Appendix B and referred to in the Implementation Guidance are misleading and inappropriate. Where the satisfaction of the vesting conditions is not correlated with the share price, it is reasonable to estimate the percentage probability that the conditions will not be satisfied and apply this reduction to the option value. However, meeting the conditions is often correlated with the share price, e.g. where there is a requirement that the share price increases by a threshold amount over a specified period. For such conditions it would never be appropriate to estimate the percentage probability that the condition will not be met and apply this reduction to the option value. For example, suppose the performance condition is that the share price must be above a threshold price which happens to equal the share price. There might be a 10% probability that the share price will lie below the option strike price throughout the exercise period. However, there should be no reduction in the option value for such a condition, as the option is not worth exercising in the scenarios where the condition is not met, and this is already reflected in the option value.

Where there is correlation between the vesting conditions and the share price, the conditions must therefore be reflected directly in the option pricing model.

You should note that, for example, even the probability that (senior executive) employees remain with the entity to the end of the vesting period is almost certainly correlated with the share price, although it is arguable how strong the correlation is.

Paragraph 24 allows use of a “correct” adjustment. However, the Examples and Illustrative Guidance appear to condone flawed approaches and should be revisited.

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**Question 14**
**A Reload features**

From a pragmatic perspective we suggest that the reload option is treated as a new option grant rather than a feature of the first option. UK compensation practice permits the grant of options after an exercise rather than obliges the company to grant an option in replacement of an exercised option, and treating the second option as a new option is a satisfactory way to deal with the matter.

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**Question 15 Valuation Guidance**

We agree with the approach of not giving prescriptive guidance on the models to be used. However the Board must be alert to the possibility of this lack of prescription being abused and values being put on options that are inconsistent with market values. Such values could not then be described as “fair value”. We suggest that whatever pricing methodology is used must pass the test of being consistent with current option market practice. Options would then be valued in a manner that was consistent with comparable traded options. Ideally all option values should be compatible with market instruments. However, where differences occurred (for example an exercise feature that was not available in traded options) these should be reflected in terms of whether they increase or decrease the value of the options and the magnitude of the difference, rather than by adopting a completely different and incompatible approach.

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**Signed on behalf of Hewitt Bacon & Woodrow Limited**

Martin Lowes
01372 733716
martin.lowes@hewittbaconwoodrow.com