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Sir David Tweedie

Chairman of the
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Exposure Draft: "ED 2 Share-Based Payment"

Dear Sir David,

We are pleased to learn that you are offering us an opportunity to comment on the Exposure Draft "ED 2 Share-Based Payment".

As the significance of share-based payment has been on the increase recently, it is vital that there should now be some clear accounting standards on this issue. We are therefore very pleased that, with ED 2, the IASB is endeavouring to set up comprehensive accounting principles for share options and for similar forms of remuneration.

Our comments on Exposure Draft ED 2 are largely of a conceptual nature. As we see it, the model underlying the proposed principles mainly leads to reasonable solutions, particularly with regard to the recognition rules. However, we believe that a consistent application of this model would lead to a different, more expedient solution, above all with regard to measurement.

We agree with the principle whereby work received by a company and remunerated in the form of share-based payments should figure on the balance sheet. Whether work that has been received is included on the balance sheet is an issue that should not depend on the form of remuneration whether remuneration takes the form of cash payment, of payment dependent on share prices, or of actual shares. The principle implies that any services that have been received and for which recognition criteria are not fulfilled should be accounted for as expenses. This means that the work of a company's own staff should also be recorded as expenses. Such work has been received by the company and used immediately, i.e. it does not form part of some future benefit and cannot therefore be carried as a an asset.

We also agree that increases in equity should figure on the balance sheet when share options are issued. In return for receiving work, a company undertakes to issue shares at a later stage, on the provision that certain conditions are met. The fulfilment of this commitment, however, leads not to financial outflow (when issuing new shares under a capital increase), but to an increase in equity. It follows that it is not a liability, but it is equity. If, on the other hand, work that has been

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received is remunerated through cash-settled share-based payments (share appreciation rights), then this is indeed a matter of outgoing resources. The work which constitutes incoming resources is matched by outgoing resources in the form of a cash payment, so that a liability has to be recognised.

In its measurement, IASB assumes that measurement should always be based not on granted option or share appreciation right, but on the work that has been received. As work cannot be measured in any reliable way, it is the option that should be measured instead. Basically, we agree with this procedure, though we believe that, for the following reasons, the IASB is inconsistent in its application:

Whereas with share appreciation rights, the proportionate fair value needs to be determined from scratch on each balance sheet date and the expenses/liabilities need to be adjusted accordingly, the measurement of the increase in equity is final at grant date, so that later changes to the fair value do not affect the expenses shown for each of the periods or the counter-entry in equity.

If, however - as intended by the IASB - measurement is to be applied not to the resulting remuneration, but to the work that has been received, then there should be no difference here. In either case the employee renders the same work which is remunerated in different forms. Whereas the IASB argues in the case of a share option that, if, say, the fair value of an employee's option is doubled, this does not also lead to the doubling of his deployment (ED 2 BC89), in the case of share appreciation rights, the doubling of the fair value leads to a corresponding increase in expenses and liabilities even though here, too in accordance with the line taken by the IASB there should be no difference to the employee's deployment.

Conversely, the final measurement of share options on the grant date takes no account of actual changes to the work that is rendered. If, for instance, the actual work is more than expected because fewer people than expected are leaving the company, then although the change to the rate of fluctuation is taken into consideration when calculating the number of units of service per period, the fair value is not adjusted correspondingly. This results in too little expenses being shown. The problem can be illustrated with example no. 1 in appendix B, scenario 2. Here actual fluctuation is only 10%, though 20% was assumed. As only 10% of the options lapses, overall expenses of 675,000 CU[1] has to be shown. Unless the fair value is adjusted to the change in fluctuation, the expenses that are recorded are only 644,444 CU.

As we see it, according to the accounting method proposed by the IASB, either all changes to the fair value, i.e. changes to the fair value resulting from changes of share prices and changes to the fair value resulting from fluctuation etc., or no changes to the fair value are taken into account. The consequence is that the expense for the work or services received (personnel expenses) is not measured appropriately in both cases. Additionally, the accumulation of the increase in equity and the liability respectively implies that the obligation of the entity is recognised

[1] 500 staff x 100 options x 15 CU fair value x 90% = 675,000. The number of units of service is 1,450 (450 staff x 3 years + 50 staff x 2 years), so that the fair value per unit of service is 465.5 CU. Accordingly, in the first and second year the expense should be 232,759 CU, and in the third year 209,482 CU.

only partly during the vesting period. These problems can be solved as follows:

1. The increase in equity and the liability are initially measured at the fair value of the option or share appreciation right at grant date. In order to ensure that the obligation of the entity is recognised completely, the increase in equity and the liability are measured at the *full* fair value. Additionally, the same amount is recognised as deferred expenses, because if the options are granted as remuneration for services received in the future the personnel expenses cannot be recognised completely at grant date.

2. The personnel expenses shall be recognised when services are received during the vesting period with a corresponding reduction of the deferred expenses.

3. When accounting for share options, changes to the fair value are only taken into account if they result from actual changes to the the services received (e.g. fluctuation, cf. the above example). Other changes to the fair value, e.g. changes in share prices, do not have any influence on the value of the work received from the employee and on the obligation of the entity. Therefore, they must not be taken into account.

4. When share appreciation rights are granted, changes in share prices have an influence on the obligation of the entity directly. In order to recognise the obligation of the entity completely, the liability has to be increased in the case of increases in share prices. As the service received from the employee does not change accordingly, the expense may not be recognised as personnel expense, but included in the financial result. This method ensures that irrespective of the form of remuneration the same personnel expense is recognised. Additionally, the equity increase and the liability show the different obligations and risks of the entity connected with share options and share appreciation rights.

The following example illustrates this method:

An entity grants stock options or share appreciation rights respectively to its employees. The fair value at grant date is 100 CU; the options or share appreciation rights may be exercised after a vesting period of two years. At the end of the first year, the fair value is 120 CU, at the end of the second year 150 CU. For the reason of simplification, fluctuation is not taken into account (cf. the above example).

In the case of share options, an increase in equity and deferred expenses are recognised at grant date and measured at the fair value of 100 CU. At each of the following balance sheet dates the deferred expenses are reduced by 33.33 CU with a corresponding recognition of personnel expenses. The changes to the fair value are not taken into consideration.

If share appreciation rights are granted, a liability and deferred expenses are recognised at an amount of 100 CU. As in the case of share options, the deferred expenses are reduced against personnel expenses at an amount of 33.33 CU at the following balance sheet dates. As the obligation of the entity is not 100 CU, but 120 CU and 150 CU at the end of the second and third year, the liability must be increased by 20 and 30 CU. The additional expenses are not recognised as personnel expenses, but included in the financial result. Thus, in both cases the personnel expenses amount to 100 CU, according to the measurement of the service received at grant date. At the same time, it is ensured, that the obligation of the entity is recognised completely with changes to the fair value only taken into account in the case of share appreciation rights.

Yours sincerely,

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