

UK ASB staff response to April 2010 NSS agenda paper 3

Project: IFRS 2 “Share-based Payment” review project

Respondent: Grant Chatterton, UK ASB Project Director

The comments made in this paper represent the views of the respondent, Grant Chatterton, and are not necessarily those of his colleagues or of the ASB.

ISSUE 1:

- (a) Do you agree that the modified grant date method as presented in IFRS 2 does not enable a consistent representation of services received or paid in exchange for share-based payments?
- (b) Do you agree that it is unclear what concept of services received IFRS 2 aims to represent (services received irrespective of whether they give rise to payment or only services that give rise to payment), and that this point should be clarified?
- (c) In your view, which of the 2 concepts of services received (paid for or not) seems more appropriate as an accounting objective for representing share-based payment transactions?

Please explain your answers to these three questions.

ISSUE 1 – Response:

- (a) Agree – The respondent considers that the modified grant date method as presented in IFRS 2 does not enable a consistent representation of services received or paid in exchange for share-based payments, for reasons which are aligned to those set out by the ANC in their April 2010 paper – particularly the ANC comments concerning forfeitures, cancellations and instruments expected to vest.
- (b) Partially agree – It is apparent from paragraph 7 of IFRS 2 that the standard aims to represent services received. However, this objective is not achieved (refer to the respondent’s response to issue 1a) and the objective should be stated more prominently, perhaps by including it in the ‘Objective’ section (paragraph 1) of the standard.
- (c) The respondent considers that an objective of representing ‘services received’ is preferable to one of representing ‘payment’, for the following reasons:
 - i. Representing ‘payment’ is inconsistent with the accruals basis of accounting as set out in paragraph 22 of the IASB Framework.
 - ii. When an employee is, on grant date, granted the right to exercise a share option in x years time if he meets contractually agreed service and

performance criteria, the employer has given that employee ‘something’. In particular, the employee has been given the opportunity to earn the right to exercise a share option in x years time by meeting requisite service and performance criteria. If, in x years time, the employee has not met the requisite service and performance criteria, such that he does not receive the right to exercise a share option, it is incorrect to say that the employee was never given ‘something’. The ‘something’ that the employee was given, x years ago, was the opportunity to earn the right to exercise a share option in x years time by meeting requisite service and performance criteria. In providing the employee with this ‘something’, x years ago, the employer took a risk (and the employee was given an opportunity), namely the risk that a share option and exercise rights might have to be provided to the employee in x years time. Just because the risk did not, in the case of this employee, subsequently materialise and result in the provision of a share option and exercise rights to the employee, this does not change the fact that the employer took a risk x years ago. Successful companies do not generally take on additional risks for no reason; they usually want something in return, in this case the services of the employee. For this reason, the ‘payment’ approach is not appropriate, as it only ultimately records an expense in the income statement for services corresponding to share options that vest (exercise rights earned and provided); any expense that was recorded in the income statement for services corresponding to share options that do not vest (exercise rights not earned and not provided) is ultimately reversed under the ‘payment’ approach.

ISSUE 2:

- (a) Do you agree that the “unit of service” method provides the most relevant representation of services received in a share-based payment transaction? If not, why and what alternative would you propose?
- (b) Do you consider that the “unit of service method” should be applied if the objective is to represent services received even if it is complex? If not, which alternative approach to achieving this objective would you propose? Do you consider that the “prospective modified grant date method” developed in part 5 of Appendix 4 of the main Report back paper could be an alternative in this respect?
- (c) Do you agree that the “payment approach” provides the most relevant representation of services effectively paid in a share-based payment transaction. If not, why and what alternative would you propose?

ISSUE 2 – Response:

- (a) Partially agree – The respondent considers that, of the methods that the ANC has set out in their April 2010 paper, the “unit of service method” will theoretically provide the most relevant representation of services received in a share-based payment transaction. However, the respondent considers that the “unit of service method” as presented by the ANC is complex and would suggest that the ANC should explore possibilities for simplifying that method. If the finalised method is too complex, there is a risk that preparers of financial statements will not be able to apply it in practice in a way that generates sensible numbers at reasonable cost. Further relevant comments are set out in the respondent’s response to issue 2b), below.
- (b) Partially agree – It is a judgement call as to whether the “unit of service method” that the ANC has put forward in their April 2010 paper is so complex that preparers of financial statements would not be able to apply it in a way that generates sensible numbers at reasonable cost. The respondent’s personal view is that the “unit of service method” will be burdensome for companies but that it is not so complex that it should not be introduced, provided that the final revised accounting standard is supported by clear guidance and examples. As noted above, however, the respondent considers that the ANC should explore possibilities for simplifying the “unit of service method”, although the respondent also considers that the “prospective modified grant date method” is not a satisfactory theoretical alternative for representing services received.

One possibility for simplifying the “unit of service method” may be to make the following amendments to proposal 4.2 (on page 8) of the ANC paper issued in April 2010 (new text is underlined and deleted text is struck through):

A fair value per unit of service is determined by dividing the grant date fair value of the equity instruments to be issued, ~~ignoring allowing for~~ all vesting conditions and excluding including the expected rate of forfeiture, by the maximum number of units of service that could ~~expected to~~ be received.

This change simplifies the “unit of service method”, but the respondent has not performed a comprehensive analysis of this simplified method and has concerns that it may give rise to unsatisfactory results when performance vesting criteria are involved. In particular, the respondent is concerned that this simplified method may give rise to inconsistent results for share options which have different legal criteria but which are in substance the same. The respondent would like to suggest that the ANC consider this simplified method further, as well as other suitable variations to it, by performing a comprehensive analysis of the method when applied to different types of share option.

The calculations for Example 1 from Appendix 4 have been amended to apply the simplified “unit of service” method described above (it is assumed that the 15€ ‘estimated fair value of option’ assumption has been determined on the amended basis set out above):

IG Example 1:

- Fair value = 500 x 100 x 15€ = 750,000€;
- Number of UoS = 500 x 3 = 1,500;
- Value of a UoS = 750,000 / 1,500 = 500€.

<i>Scenario 1:</i>	<u>for period</u>	<u>cumulative</u>
Year 1 : (467 + (33 x 0.5)) x 500€ =	241,750€	241,750€
Year 2 : (433 + (34 x 0.5)) x 500€ =	225,000€	466,750€
Year 3 : (400 + (33 x 0.5)) x 500€ =	208,250€	675,000€

<i>Scenario 2:</i>	<u>for period</u>	<u>cumulative</u>
Year 1 : (480 + (20 x 0.5)) x 500€ =	245,000€	245,000€
Year 2 : (458 + (22 x 0.5)) x 500€ =	234,500€	479,500€
Year 3 : (443 + (15 x 0.5)) x 500€ =	225,250€	704,750€

<i>Scenario 3:</i>	<u>for period</u>	<u>cumulative</u>
Year 1 : (460 + (40 x 0.5)) x 500€ =	240,000€	240,000€
Year 2 : (410 + (50 x 0.5)) x 500€ =	217,500€	457,500€
Year 3 : (380 + (30 x 0.5)) x 500€ =	197,500€	655,000€

- (c) Partially agree – The respondent considers that, of the methods that the ANC has set out in their April 2010 paper, the “payment approach” will theoretically provide the most relevant representation of services effectively paid in a share-based payment transaction. However, the respondent has not considered this matter in detail as the respondent considers that an objective of representing ‘services received’ is preferable to one of representing ‘payment’, for the reasons set out in the respondent’s comments for issue 1c).

ISSUE 3:

Do you agree

- (a) That it is necessary to change the rule that remuneration expense should represent as a minimum the initial grant date fair value of instruments granted in order to obtain a principles-based representation of modifications and cancellations in conformity with the seven accounting principles identified?
- (b) With the proposals of the working group in respect of the accounting treatment of forfeitures, modifications and cancellations in the “unit of service” approach? If you consider that modification or cancellation should not result in negative expenses to be recognized, what alternative approach would you propose?
- (c) With the proposals of the working group in respect of the accounting treatment of forfeitures, modifications and cancellations in the “payment” approach? Which of the two alternatives proposed would you favour and why? If you favour the alternative taking into account only the fair value difference at the

date of modification or cancellation and consider that modification or cancellation should not result in negative payment to be recognized, what alternative approach would you propose?

- (d) That the “payment approach” is effectively a “vesting date measurement approach” and as such represents an exception to the reference to the initial grant date fair value? As a result, the adoption of this approach would not be compatible with the terms of reference initially agreed with the IASB?

ISSUE 3 – Response:

- (a) Agree – The respondent considers that it is necessary to change the rule that remuneration expense should represent as a minimum the initial grant date fair value of instruments granted in order to obtain a principles-based representation of modifications and cancellations in conformity with the seven accounting principles, for reasons which are aligned to those set out by the ANC in their April 2010 paper – particularly the ANC comments concerning the inconsistent accounting treatment of advantageous modifications and disadvantageous modifications (and cancellations).
- (b) Agree – The respondent considers that the accounting treatment of forfeitures, modifications and cancellations in the “unit of service method” should be in line with that set out by the ANC in their April 2010 paper.

The respondent would not agree with a supposition that modifications or cancellations should never result in a credit entry in the financial statements, nor with any attempt to limit this credit amount. However, the respondent would suggest that the ANC should give further consideration to where this credit entry should be recorded (e.g. equity, income or expense) and how it should be characterised. The respondent considers that a cancellation or modification that is disadvantageous to the employee is advantageous to the company in that the company no longer has to pay the full amount for services that it has already received. The respondent therefore agrees with the ANC’s suggested characterisation of the credit entry as similar to “the action of a creditor (the employee) that is prepared to write off a part of the debt of its debtor (the entity) as part of an ongoing relationship”. However, the company has already received the services of the employee, so it may be more appropriate to record this credit entry as income (an increase in economic benefits) than as a negative expense. Furthermore, characterising the credit entry as a reduction in debt may imply that it should be recorded as financial income, rather than as operating income.

- (c) Partially agree – If a ‘payment’ objective were to be adopted, the respondent would in this case agree with the proposals of the working group in respect of the accounting treatment of forfeitures, modifications and cancellations in the “payment” approach. However, the respondent has not considered this matter in detail as the respondent considers that an objective of representing ‘services received’ is preferable to one of representing ‘payment’, for the reasons set out in the respondent’s comments for issue 1c). For the same reasons, the respondent has not considered in detail the two alternatives that the ANC has put forward for

adjusting remuneration expense under the ‘payment’ approach, so the respondent has consequently not reached a conclusion in this regard.

- (d) Disagree – Although not in favour of the “payment approach”, the respondent does not consider it accurate to describe it as purely a “vesting date measurement approach”, nor to say that it “represents an exception to the reference to the initial grant date fair value”. If a share-based payment does not vest, any service expense is reversed such that the net amount recognised is nil, so the “payment approach” is a “vesting date measurement approach” in that sense. However, it is still the case, as set out in proposal 5.1 (page 15) of the ANC paper, that “the fair value and the number of instruments expected to vest is determined at grant date” (except where there is a modification or cancellation). In theory, therefore, the adoption of the “payment approach” would not necessarily be incompatible with the terms of reference that were initially agreed with the IASB.