

## ICAEW REP 34/06

### AMENDMENTS TO IFRS 2 'SHARE-BASED PAYMENT'

*Memorandum of comment submitted in May 2006 by the Institute of Chartered Accountants in England and Wales, in response to the International Accounting Standards Board's exposure draft of proposed amendments to International Financial Reporting Standard 2 'Share-based payment', published on 2 February 2006.*

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## INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the International Accounting Standards Board's exposure draft of proposed amendments to International Financial Reporting Standard 2 *Share-based payment*, published on 2 February 2006. We have reviewed the proposals and set out below our major points and our responses to the specific questions raised in the exposure draft.

## WHO WE ARE

2. The Institute of Chartered Accountants in England and Wales (the 'Institute') is the largest accountancy body in Europe, with more than 127,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

## MAJOR ISSUES

### Overall response

4. We disagree with the proposals in the exposure draft. The IASB has rightly concluded that the proposed consensus in IFRIC D11 could not be implemented without amending IFRS 2. However, in electing to make a limited amendment to the standard simply to implement D11, the IASB has failed to address the deficiencies in IFRS 2. We oppose the exposure draft and recommend that the IASB should either leave IFRS 2 open to interpretation as it stands, or embark on a more measured reassessment in order to account properly for Employee Share Purchase Plans (ESPPs).
5. If the IASB presses ahead with an amendment to IFRS 2 at this time, it should be only on the basis that:
  - vesting conditions can be limited to service and performance conditions only if performance conditions include non-financial performance targets and performance targets for both employees and the entity itself;
  - there is a distinction for accounting purposes between cancellations by the entity and cancellations by the employee; we suggest that a rebuttable presumption that a cancellation is by the entity could overcome any concerns about abuse; and

- in the case of cancellation by the employee, the Board mandates that the entity ceases to charge (with no reversal).

These issues are discussed in our responses below to the specific questions raised by the Board.

### **Share plans with cash alternatives at the discretion of employees**

6. We are concerned at the implications of the proposals for share plans with cash alternatives at the discretion of employees. Such arrangements are very common and have been considered by the IFRIC, which has published a tentative decision not to take the issue on to its agenda. The IFRIC's tentative conclusion is that such plans have both an equity and a liability component with different vesting periods.
7. Under the proposals, the employee's choosing the cash alternative would lead to cancellation of the equity component and require acceleration of the related charge. This does not reflect the economic substance of the transaction. An employee will often choose the cash alternative because he or she does not intend to remain with the employer for the full vesting period. If an employee takes the cash alternative and subsequently leaves, under the proposals it seems that the entity will have been required to recognise both the full cash amount and the full grant-date fair value of the equity component. As the employee has neither received the equity component nor provided the services required to earn it, recognition of the full amount is clearly inappropriate.

### **Modifications**

8. In the case of UK Save As You Earn (SAYE) schemes, employees very often withdraw in order to take advantage of new options at a lower price than the existing options (because the share price has fallen). In our view, the economic substance of the arrangement in these circumstances is that the employee continues in the scheme under modified terms, as set out by the IFRIC, in paragraph 5 of D11:

‘If an employee changes from one ESPP to another, the entity shall account for this event in accordance with paragraph 28(c) of IFRS 2. If the entity identifies the equity instruments granted to the employee under the new ESPP as replacements for the equity instruments granted to that employee under the original ESPP, the entity shall account for this event as a modification of the original grant of equity instruments.’

We believe that this interpretation is uncontroversial and we presume that this is why the material in D11 has not been reproduced in the exposure draft.

### **Convergence with US GAAP**

9. Paragraph BC 20 states that the proposals are the same as the relevant requirements of SFAS 123. We are not convinced that this is true - for example, in relation to the definition of vesting conditions - and we understand

that the FASB does not believe that the two approaches are consistent. We suggest that amending the standard in a way that does not converge with US GAAP is undesirable and unnecessary. We would not wish it to be amended so as to converge in this area.

## **SPECIFIC QUESTIONS**

### **Question 1 – Vesting conditions**

*The Exposure Draft proposes that vesting conditions should be restricted to performance conditions and service conditions.*

*Do you agree? If not, what changes do you propose, and why?*

10. The definition of vesting conditions in IFRS 2 is not sufficiently clear for us to understand fully the implications of the proposal that vesting conditions should be restricted to performance conditions and service conditions. In our view, performance conditions include non-financial performance targets and performance targets for both employees and the entity itself.
11. There are many performance conditions that do not relate to financial performance, such as
  - (a) an employee achieving a personal target such as a particular grade in an appraisal, or delivering an agreed number of presentations; or
  - (b) the entity achieving an Initial Public Offering.

In our view, such conditions qualify as vesting conditions under IFRS 2. The personal target, for example, is clearly linked to the provision of services required to ‘pay’ for the equity instruments, and meets the ‘quality of service’ test to be regarded as a performance condition. And although achieving an IPO is not a financial target, it constitutes a commercial goal of the entity, against achievement of which it is perfectly legitimate to reward employees. We therefore agree with the proposal, if such conditions qualify as vesting conditions.

12. We note that paragraph BC4 states that ‘additional features’ of ESPPs (ie, conditions that are not vesting conditions) should be included in the fair value measurement of the equity instrument. This seems inconsistent with the Board’s conclusions in paragraphs BC178-184 of IFRS 2 about the practical difficulties of this approach for non-market conditions. In practice, the fair value estimates for such ‘features’ will be highly subjective. As adjustment of the grant date fair value as a result of subsequent experience is not allowed, we believe that the proposed accounting treatment will be less reliable and will fail to reflect the economic substance of transactions for a range of share based payments.
13. Paragraph BC4 asserts that ‘additional features’, such as a contribution requirement or a requirement to hold an initial grant of shares in a ‘Matching Share Scheme, cannot qualify as vesting conditions because they do not ensure

that the counterparty provides the services required to ‘pay’ for the equity instruments. We question the validity of this test. It is difficult to see that the profit target given as an example of a performance condition in IFRS 2 is a factor in ensuring that the counterparty provides services. If the test is merely meant to be a test of a service condition, then it should not be applied to the so-called ‘additional features’ considered in paragraph BC4. If the test is about quality of service, then the implications need to be explored further.

## **Question 2 – Cancellations**

*The Exposure Draft proposes that cancellations by parties other than the entity should be accounted for in the same way as cancellations by the entity.*

*Do you agree that all cancellations should be treated in the same way? If not, please specify the nature of any differences between types of cancellations and explain how they influence the selection of appropriate accounting requirements.*

14. We disagree with the proposals in the exposure draft regarding cancellation. There is a clear distinction between an employee’s voluntarily ceasing to contribute to an ESPP and a cancellation by the entity. It is therefore wrong to account for all cancellations as if they were cancellations by the entity.
15. We also disagree with the accounting that results under the proposals from treating all cancellations as if they were cancellations by the entity. Paragraph BC8 sets out four possible accounting treatments that could be adopted when an employee leaves an ESPP :
  - (a) reverse the expense charged to date (same as a forfeiture);
  - (b) cease recognising future expense from the date of cancellation;
  - (c) continue recognising the expense as if the cancellation had not occurred; or
  - (d) accelerate the recognition of the remaining expense (same as a cancellation by the entity).
16. The proposals as they stand would require immediate recognition of the full charge for the amount that otherwise would have been recognised over the remainder of the vesting period (option (d)). This does not reflect the substance of the transaction and leads to an unacceptable accounting result. For example, if an employee ceases to contribute to an ESPP a few months after joining the scheme, it seems perverse to require acceleration of the charge for services that have not been provided. The substance of the transactions is closer to the employee never having joined the scheme. This suggests that either no charge, or at most a charge reflecting the limited period of relevant service, is appropriate.

17. In our view, therefore, if an employee withdraws from an ESPP in circumstances where ceasing to meet a condition of the plan has real economic substance for the employee (for example, where the employee withdraws from the scheme early on, or where the options are in-the-money), the entity should cease recognising future expense from the date of withdrawal (option (b)). This accords with the underlying principle of IFRS 2, which is to use the cost of the share-based payment as a proxy for the cost of the services to be consumed by the entity over the vesting period. If there is no cost of consumption, then it is correct to discontinue the charge.
18. We agree that the previously recognised charge should not be reversed, because the employee has already provided services in anticipation of the award vesting. Nor would recognising further expense (either immediately or over the course of the original vesting period) be appropriate, because the employee is no longer entitled to the award of shares and will not therefore be providing further services in anticipation of the award vesting.
19. If no distinction is made between a withdrawal from an ESPP and a cancellation by the entity, entities will be required to recognise a charge relating to shares that will never be purchased, as the employee has chosen to withdraw from the plan. Withdrawal is different from a cancellation, in that it may be motivated by factors other than the price of the entity's shares that nevertheless have real economic substance for the employee (such as pressure of other financial commitments).
20. We note that the Board's proposed accounting treatment appears not to be based on conceptual grounds, but only that it is (a) too difficult to distinguish between cancellations by the employee and cancellations by the entity and (b) likely to lead to structuring of transactions to achieve a desired result (in paragraphs BC13 to BC15).
21. We specifically disagree with the contention that distinguishing between entity and employee cancellations is necessarily impracticable. In the case of UK SAYE schemes, for example, the necessary criteria are in place.
22. In our view, the proposals conflict with the principle of IFRS 2, which is to require immediate recognition of the charge in the case of a cancellation by the entity on the assumption that the employee will be obtaining some alternative benefit. In the case of a cancellation by the employee, there is no alternative benefit.
23. The proposals appear therefore to be motivated solely by concerns over the possibility of abuse, as suggested in paragraph BC15. We accept that there may be grounds for fearing that if employee cancellations were treated differently from entity cancellations, transactions could be structured so as to achieve a desired accounting result. However, we believe this threat is overstated, because it is unlikely to be arise in the generality of, for example, SAYE schemes.

24. In any event, anti-avoidance could be achieved with a presumption that a cancellation is by the entity unless the particular circumstances make it clear that it is by the employee. Where the assumption of entity cancellation is rebutted, the entity would not accelerate the charge. We believe that in practice abuse would be easy to identify and it will be possible to identify what is driving the withdrawal. The rebuttable presumption allows judgement to be applied in the specific circumstances.
25. Paragraph BC 10 states that the expected level of employee cancellations should be taken into account in determining the fair value of the options at their grant date. We suggest that the impact of the proposals would be to force entities to make highly subjective estimates that might in practice attempt to take account of expected future fluctuations of the share price. Such an approach would undermine the reliability of the financial statements in this regard.

### **Question 3 – Effective date and transition**

*The proposed changes would apply to periods beginning on or after 1 January 2007, and would be required to be applied retrospectively. Earlier application would be encouraged.*

*Are the proposed effective date and transition appropriate? If not, what do you propose, and why?*

26. If the Board decides to implement the proposed changes, then we accept the effective date and transition.

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