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08.12.2000

Sir Bryan Carsberg
THE SECRETARY-GENERAL
International Accounting Standards Committee
166 Fleet Street
LONDON EC4A 2DY
United Kingdom

Dear Sir Bryan:

RE: Position Paper of the G4+1, *Accounting for Share-Based Payment*

Dear Sir Bryan:

Deloitte Touche Tohmatsu and its Member Firms are pleased to comment on the Position Paper, *Accounting for Share-Based Payment* (the "Position Paper"). While we recognize that currently there is no international standard that addresses share-based payment, we also recognize that there are long-embedded practices around employee share plans that will result in considerable debate and controversy about the accounting recommendations in the Position Paper for share-based payment, particularly for employee share plans.

The issue of accounting for share-based payments to employees has been extremely controversial in the United States. In 1993, the Financial Accounting Standards Board (FASB) proposed that employee stock options be recognized in the financial statements at their fair value. In the response to that proposal, the United States firm of Deloitte & Touche urged the FASB to change its direction and adopt a disclosure-based approach instead of a recognition-based approach and to retain the then current standard. Deloitte & Touche also recommended that, nonetheless, if the FASB proceeds with a recognition-based approach instead of disclosure, it should use the minimum value method to estimate the fair value of the compensation to employees.

If the IASC undertakes the development of an accounting standard for share-based payment, we encourage the board to strive to achieve a solution that can be accepted globally. If the IASC decides to implement a recognition-based model, we recommend the use of the minimum value method for employee stock options because of their unique attributes. While we believe that, conceptually, share-based payments should be recognized at fair value, we also believe that it is generally not possible to obtain reliable estimates of fair value for employee stock options that are not transferable.

While we believe a recognition model can be supported conceptually, we do not agree with some of the key recommendations concerning recognition in the Position Paper. We do not understand the recommendation to use vesting date as the measurement date. It seems to us that, when an option is granted, the option holder is given the freedom to decide whether to exercise it. Exercising an option typically means paying the exercise price. However, for an employee stock option it also means continuing employment through the vesting date. While we agree with the recommendation in the Position Paper to accrue an estimate of the transaction amount over the performance period, we observe that this recommendation is inconsistent with the use of the vesting date as the measurement date.

We also are unconvinced that fair values can be determined reliably for equity instruments that are not quoted on an active market. We believe that subjective nature of the estimate of fair value will yield diversity and confusion in the marketplace, and still not address the real key issue: can reliable estimates of fair value be obtained for such instruments? We observe that the difficulty of determining fair value reliably is recognized in IAS 39. While IAS 39 contains a presumption that fair values of financial instrument can be determined reliably, it acknowledges the difficulty of making a reliable estimate of fair value for equity instruments that are not traded. It specifies that the presumption can in fact be overcome for equity instruments that are not traded. While an estimate of fair value can be made with greater precision when the underlying equity share is traded in an active market, there exists considerable subjectivity in estimating fair value when an equity option itself or a comparable option is not traded in an active market,

Issues surrounding the ability to obtain reliable estimates of fair value generally are even more complex for employee stock option plans. Under many employee stock option plans, the stock option vests over time, is not exercisable until a specified date and, more importantly, is not transferable. In addition, comparable stock options usually are not traded in the market place because options that are traded on an exchange have short-term lives relative to employee stock options. These factors make the fair value estimate highly subjective because the volatility factor, which may have the greatest influence on fair value of the option, must be determined somewhat arbitrarily, since no market-based volatility factor generally exists. Also, since the option is not traded and cannot be sold, there is a liquidity adjustment to the fair value estimate that should be considered, but there is no objective means of computing it.

Perhaps the most unique attribute of an employee stock option that very often distinguishes it from other types of options is the usual restriction imposed by the employer/issuer that prohibits the employee from selling it in the market place. This restriction precludes the employee from realizing the volatility value of the option.

An option typically will not be exercised before maturity because the holder, upon exercise, realizes only the intrinsic value and would forfeit any time value. For that reason, instead of exercising the option, the holder will sell it in the market place to realize both the intrinsic value and the time value. The time value of an option includes the value for risk, which is the volatility value, and the time value of money, which is a financing cost equivalent to the financing component in any forward contract, sometimes referred to as the cost of carry. It is clear that the financing cost of the option is realized over time, simply by holding the option. However, it is not clear that the volatility value can be realized. The only way the volatility value can be converted to cash is by selling the option, but the employee is not permitted to sell it. Clearly, the employee holding the option has the upside potential. However, the volatility value is not based on upward movements in price. It is the value of price changes, more technically the potential change in yield, both upward and downward. An employee who is restricted from selling the option can realize only an actual increase in value at maturity but not the value of the potential for change both up and down during the life of the option.

We believe that traditional option-pricing models will result in highly subjective and potentially unreliable estimates of fair value for options that are not transferable. Given the subjectivity of the estimate and the inability of the employee to convert the volatility value of the option into cash, we believe the IASC should consider recognizing only the financing cost component of the time value of options granted to employees. While it is not fair value, we believe a traditional options-pricing model also is not fair value in circumstances in which the option is prohibited from being sold.

We believe that the Position Paper is an important first step toward the development of a comprehensive standard for share-based payment. We fully expect that it will generate considerable debate and controversy and it clearly will involve the new IASC. While there are many areas of accounting that will compete for priority, we believe the accounting for share-based compensation is a very important area and should be given considerable attention by the new board. However, we believe that continued study is needed to understand fully the impact of any recognition provisions, particularly as related to valuations attributed to options granted to employees, and to determine the extent to which adjustment of the traditional valuation models should be made to comprehend the uniqueness of restricted employee grants.

We believe that the IASC is in the unique position to develop a model that can serve as a basis for harmonization of accounting in this area throughout the world and we would strongly support an approach that would contribute to a standard that could be accepted by the major standard setters throughout the world so as to reduce situations in which accounting requirements provide a competitive advantage to one entity over another.

The attached Appendix to this letter contains our responses to the specific questions raised in the Position Paper, including a detailed discussion of the matters referred to above.

If you have any questions concerning our comments, please contact Mr. Stig Enevoldsen at 45 33 76 36 90.

Very truly yours,

Appendix

RECOGNITION IN THE FINANCIAL STATEMENTS

Q1 Do you agree with the proposal that transactions whereby an entity purchases goods and services by issuing shares or share options should be recognized in the financial statements, thus resulting in a charge to the income statement when those goods and services are consumed (Chapter 3)?

We agree with the proposal that transactions whereby an entity purchases goods and services by issuing shares or share options should be recognized in the financial statements. We believe shares or share options are valuable financial instruments that are issued for valuable consideration (e.g., goods and services). That value should be reflected in the financial statements of the entity through a charge to the income statement.

Measurement basis

Q2 Do you agree with the conclusion that the appropriate measurement basis for such transactions is the fair value of the shares or options issued (paragraphs 4.13 and 4.14)? Please note that the related question of the date at which fair value should be measured is considered later.

Conceptually, we agree that such transactions should be measured at the fair value of the shares or options issued. The fair value of the shares or options issued represents a form of consideration provided by an entity for goods or services to be rendered by third parties. Recognition is appropriate, however, only if the value of the exchange can be measured with the requisite degree of reliability, and in a manner that promotes comparability among enterprises.

Measuring the fair value of share options

Q3 Do you agree that, where an observable market price for an option does not exist, an option-pricing model should be used to estimate the fair value of a share option (paragraphs 4.16-4.27)?

We agree that conceptually, fair value is the appropriate measurement attribute for stock options and stock awards issued for goods or services. We also agree that quoted market prices in active markets are the best evidence of fair value and should be used as the basis for measurements. If quoted market prices are not available, the estimate of fair value should be based on the best information available in the circumstances. The estimate of fair value could consider prices for similar assets and the results of valuation models to the extent available. However, we have significant reservations about whether option-pricing models or any other valuation models can reliably and objectively estimate the fair value of stock options. For reasons described below, we support recognition of the financing cost component of the time value of an option as the best estimate of fair value for all companies where quoted market prices in active markets are not available and the holder is prohibited from transferring the option.

The output of an option-pricing model is only a mathematically derived “theoretical” value, which may or may not be indicative of fair value. Since a market for employee stock options generally does not exist, there is no objective way to assess whether the theoretical value approximates the price at which the option could be sold in an active market. Indeed, empirical evidence suggests that many employees do not perceive options to have near the same value as option-pricing models would suggest.

In addition, option-pricing models have certain limitations. Certain variables used in option-pricing models can be very subjective. For example, the computation of volatility will vary significantly depending on a number of factors, the most significant being whether the company is a listed entity whose shares are traded on an open market (we expect a significant number of unlisted entities will fall within the scope of the proposed standard) and what periods and time intervals are used in the calculation. Additionally, many of the factors that influence fair value are based on expectations of the future date that cannot be fully comprehended in a model. Models generally do not incorporate expectations of supply and demand forces that affect fair value, nor do they consider possible government actions and potential changes in various facets of the economy. Even complex valuation models greatly simplify reality. Consequently, any requirement to use an option-pricing model must comprehend an awareness that the model produces a theoretical estimate, which is no more than a surrogate for an indeterminable fair value. And, given that fair value cannot be determined, the level of measurement precision required by the Position Paper is unwarranted. It not only increases the complexity and cost of complying with the proposal, but also increases the potential for incomparability among enterprises.

Because of concern about the subjectivity of the variables used in an option-pricing model, we support recognition of the financing cost component of the time value of an option as the best estimate of fair value for all companies where quoted market prices in active markets are not available and the holder is prohibited from transferring the option. The theory behind this methodology is that a person who wishes to buy a call option on a given stock would be willing to pay at least (and the option writer would demand at least) an amount that represents the benefit (sacrifice) of the right to defer payment of the exercise price until the end of the option’s term. A value is calculated without considering the expected volatility of the underlying stock. The value may be computed using a standard option-pricing model and a volatility of effectively zero. It also may be computed as (a) the current price of the stock reduced to exclude the present value of any expected dividends during the option’s life minus (b) the present value of the exercise price.

(4) Assuming that the use of an option-pricing model is required, do you agree that:

(a) for pragmatic reasons, it is acceptable to modify the assumptions used in the option-pricing model in the case of unlisted entities, when not all of the relevant information is readily available, as suggested in paragraph 4.28?

We support recognition of the financing cost component of the time value of an option as the best estimate of fair value for all companies where quoted market prices in active markets are not available and the holder is prohibited from transferring the option.

(b) in the case of employee share options, the assumptions used in the option-pricing model should be adjusted to take into account the non-transferability of such options by using expected life rather than contracted life in the calculation (paragraphs 4.30-4.35)?

If the financing cost component of the time value of an option were used as a measurement basis and the resulting charge was to be amortized over the vesting date, we do not believe it would be necessary to adjust the assumptions used in the option-pricing model to take into account the non-transferability of such options. Since this method represents only the financing cost component, adjusting the assumptions for non-transferability would understate that cost. If the option were to be forfeited prior to the end of the contracted life, the entity would simply discontinue recognizing the charge at that point in time.

Q5 Do you agree that, if an entity were to argue that it could not reliably measure the fair value of its options at the required measurement date (whatever that date is), it should instead be required to measure the transaction at the fair value of the goods or services received, or, if neither fair value can be reliably measured, at the fair value of the share options at exercise date (paragraphs 4.38-4.41)?

We believe that all transactions in which goods or services are the consideration received for the issuance of equity instruments should be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. We believe that if an entity is unable to determine the fair value of either the equity instruments issued or the goods and services received at the measurement date, the fair value should be determined at the first date at which the fair value can be reliably measured.

Measurement Date

Q6 Do you agree with the conclusion that vesting date is the appropriate measurement date, for the purposes of determining the fair value of the shares or options issued (Chapter 5)?

No, we do not believe that vesting date is the appropriate measurement date for the purposes of determining the fair value of the shares or options issued. We believe that <u>grant date</u> is the appropriate measurement date for the purposes of determining the fair value of the shares or options issues. Grant date measurement is consistent with the definition of an equity instrument in the conceptual framework that states "an equity instrument is any contract that evidences a residual interest in the assets of an enterprise after deducting all of its liabilities…" When an entity issues equity instruments to employees, it becomes obligated at that date. It has effectively issued a financial instrument that is an equity instrument.

Additionally, the entity and the employee come to a mutual understanding of the terms at the grant date and the employee begins to render services to earn the award at that date. In determining how many shares to award to an individual employee, both parties to the agreement presumably utilize the fair value at the grant date. Using a fair value at a later date would not be consistent with the substance of the transaction. Furthermore, we believe that the recommendation in the Position Paper to accrue an estimate of the transaction amount over the performance period is inconsistent with the use of a vesting date as the measurement date. We believe that in using grant date measurement, all restrictions inherent in vesting requirements should be reflected in estimating the value of the instrument.

Q7 If you do not agree that vesting date is the appropriate date, which of the other dates discussed – grant date, service date, and exercise date – do you regard as the appropriate measurement date(Chapter 5)?

See response to question 6.

Q8 If you consider that grant date is the appropriate measurement date:

(a) should the transaction amount be subsequently adjusted if the number of options that actually vest is greater or less than originally expected (paragraph 5.2) and, if so, how would you reconcile this view with the conceptual framework, whereby equity instruments are not remeasured after issue (paragraphs 3.6-3.8)?

We do not believe the transaction amount should be subsequently adjusted if the number of options that actually vest is greater or less than originally expected. See response to Question 4(b).

(b) should the transaction amount be recognized as a charge to the income statement in full on grant date or spread over the performance period?

We believe the transaction amount should be recognized as a charge to the income statement over the <u>vesting period</u>, which should coincide with the performance period. This is the simplest and most rational approach.

(c) if you consider that the transaction amount should be spread over the performance period, how would you resolve the problem that there appears to be no recognizable asset at grant date (paragraphs 5.21 and 5.22)?

There should be no asset recognized when the transaction amount is determined at the grant date. At the grant date, we believe awards are merely executory contracts. Once employees begin to render the services necessary to earn the compensation, execution of the contract has begun, and recognition of the services already received is appropriate. Therefore, we believe that compensation cost for an award of equity instruments to employees should be recognized over the period(s) in which the related employee services are rendered by a charge to compensation expense and a corresponding credit to equity.

Q9 If you consider that service date is the appropriate measurement date:

(a) is it your view that the credit to equity arising from recognition of the transaction over the performance period represents the issue of an equity instrument? If not, what is the nature of the credit?

N/A

(b) if it is you view that the credit to equity during the performance period represents the issue of an equity instrument, should be transaction amount be adjusted subsequently if the number of options that actually vest is greater or less than expected? If so, how would you reconcile this view with the conceptual framework, whereby equity instruments are not remeasured after issue (paragraphs 3.6-3.8)?

N/A

Q10 If you consider that exercise date is the appropriate measurement date:

(a) do you regard a share option as a liability or an equity instrument (paragraph 5.16)?

N/A

(b) if you regard a share option as a liability, not an equity instrument, how would you reconcile this with the conceptual framework (paragraph 5.16)?

N/A

(c) if you regard a share option as an equity instrument, how would you reconcile exercise date measurement with the conceptual framework, whereby equity instruments are not remeasured after issue (paragraphs 3.6-3.8)?

N/A

Vesting Date Measurement

Q11 Assuming that vesting date is accepted as the appropriate measurement date:

(a) do you agree that the transaction should be recognized as an accrual over the performance period? If so, is your conclusion based upon pragmatic reasons only, or do you consider that it is conceptually valid to do so under vesting date measurement (Chapter 6)?

We believe that the transaction should be recognized as an accrual over the vesting period, which should coincide with the performance period. This is the simplest and most rational approach.

(b) assuming that the transaction is recognized as an accrual over the performance period, do you consider that the credit entry should be classified as a liability or part of equity (Chapter 6)?

We believe credit entry should be classified as part of equity.

(c) do you agree that the transaction amount should be adjusted for options that lapse, or are expected to lapse, during the performance period, i.e., before vesting date (paragraphs 7.4-7.10)?

We do not agree the transaction amount should be adjusted for options that lapse, or are expected to lapse, during the performance period, i.e., before vesting date. See response to Question 4(b).

(d) do you agree that the transaction amount should *not* be adjusted for options that lapse, or are expected to lapse, after vesting date (paragraphs 7.11-7.17)?

We agree that the transaction amount should *not* be adjusted for options that lapse, or are expected to lapse, after vesting date. See response to Question 4(b)

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(d) do you agree that the transaction amount should be adjusted if the vested option is repriced or other modifications in terms are made (paragraphs 7.18-7.26)?

We agree that the transaction amount should be adjusted if the vested option is repriced or other modifications in terms are made.

(f) where the other party (e.g., the employee or supplier) is able to choose, *on or before* vesting date, to receive cash instead of share options:

(i) do you agree that the transaction amount should be adjusted to reflect the form of consideration given, i.e., cash or share options (paragraph 7.29)?

We agree that the transaction amount should be adjusted to reflect the form of consideration given where the other party is able to choose, on or before vesting date, to receive cash instead of share options.

(ii) with regard to the accrual during the performance period, do you agree with the approach outlined in paragraphs 7.32 and 7.33 or do you prefer the approach outlined in paragraphs 7.35 and 7.36?

We agree that where a share plan includes a cash alternative, the credit entry recognized during the performance period should be treated as a liability if the employee has the choice whether to receive the cash alternative, or included in equity if the entity has the choice whether to pay the cash alternative. We believe that assessing the probability of whether the holder of the option will choose cash or shares is too subjective to incorporate into this proposed standard.

(iii) do you have any other comments or suggestions regarding the amount and presentation of the accrual during the performance period?

We have no other comments or suggestions regarding the amount and presentation of the accrual during the performance period.

(g) where the other party (e.g., the employee or supplier) is able to choose *after* vesting date to return the vested share option in exchange for cash, do you agree with the proposed treatment outlined in paragraphs 7.37-.7.44?

We agree with the proposed treatment where the other party is able to choose *after* vesting date to return the vested share option in exchange for cash.

OTHER ISSUES

Q12 Do you agree with the proposed treatment of share appreciation rights as outlined in paragraphs 7.45-7.49?

We agree with the proposed treatment of share appreciation rights where the accrual is based on the entity's share price at the end of each reporting period. We believe the accrual should be over the <u>vesting period</u>, which should coincide with the performance period.

Q13 Do you have any comments on the discussion of the application of the proposals in this Paper to employee share purchase plans (paragraphs 7.50 and 7.51)?

We believe that the issue or transfer of shares to employees should be measured based upon the fair value of the shares on <u>grant date</u> as opposed to the vesting date. Any difference between the fair value of those shares and the price paid by the employees should be charged to the income statement. An accrual should be made over the vesting period, which should coincide with the performance period.

Q14 Do you have any comments on the discussion of the application of the proposals in this Paper to transactions with parties other than employees (paragraphs 7.52-7.54)?

We believe that transactions with parties other than employees should be measured based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. If the fair value of the equity instruments is considered more reliably measurable, the value of the shares or options issued should be measured on grant date. The resulting accrual should be made over the vesting period, which should coincide with the performance period.

Q15 What other issues would need to be addressed if the proposals in this Paper were to be developed into an accounting standard?

N/A