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FAO
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Here is the formal response of the Employee Share Ownership Centre to the FRED 31 share-based payment proposal. We have answered the specific questions as requested in the consultation document and have sent you several appendices (see Word attachments below) which give our overview on likely impacts.

We say that it is a failing on the part of the IASB to have (in our view) over-concentrated on the technical consistency of share-based payment accounting treatment routes at the expense of looking more closely at likely impacts, which in certain sectors are likely to be serious.

We say that the 'problem' (if there is one) could have been dealt with by demanding transparent exposure in every company report (in a prominent position, though NOT in the P & L account) of all outstanding share-based payment awards to employees, including (where relevant) info on the exercise price of options, maturity dates, total numbers of outstanding options, with estimates as to potential gain scenarios, and in the case of directors, named individual share-based payment awards by number, date, exercise price, performance conditions and value by current market price. Similar treatment should also apply to company board intentions to provide these kinds of awards to either some or all employees, in order that, in every case, shareholders would be afforded a clear opportunity to assess the scale of the proposed awards in terms of justification and likely dilutive effects, and vote on them according to their conclusions

Best wishes
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ESO Centre's Response to the IASB Invitation to Comment on ED2/FRED 31

27 February 2003

Question 1

Paragraphs 1- 3 of the draft IFRS set out the proposed scope of the IFRS. There are no proposed exemptions, apart from for transactions within the scope of another IFRS. Is the proposed scope appropriate? If not, which transactions should be excluded and why?

A. The ESO Centre is opposed to accounting for shareholder's dilution costs as a cost to the company. The proposal sits uncomfortably with the IASB conceptual framework defining a liability.

Most executive style share plans are run with the intent of obtaining the executive services. However, most broad-based employee share plans do not form part of pay. First they are non-contractual and second the purpose of the plan is more often to engender loyalty, engagement and financial awareness among employees as a generality, rather than aimed to acquire services from particular individuals. This is evidenced by the nature of the plans which tend to treat all employees on a broadly similar basis irrespective of their skills being deployed in their job.

Question 2

Paragraphs 4-6 of the draft IFRS propose requirements for the recognition of share-based payment transactions, including the recognition of an expense when the goods or services received or acquired are consumed. Are these recognition requirements appropriate? If not, why not, or in which circumstances are the recognition requirements inappropriate?

A. The recognition requirements are appropriate.

Question 3

For an equity- settled share- based payment transaction, the draft IFRS proposes that, in principle, the entity should measure the goods or services received, and the corresponding increase in equity, either directly, at the fair value of the goods or services received, or indirectly, by reference to the fair value of the equity instruments granted, whichever fair value is more readily determinable. (paragraph 7). There are no exemptions to the requirement to measure share- based payment transactions at fair value. For example, there are no exemptions for unlisted entities. Is this measurement principle appropriate? If not, why not, or in which circumstances is it not appropriate?

A. The measurement principle is appropriate.

Question 4

If the fair value of the goods or services received in an equity- settled share- based payment transaction is measured directly, the draft IFRS proposes that fair value should be measured at the date when the entity obtains the goods or receives the services (paragraph 8). Do you agree that this

is the appropriate date at which to measure the fair value of the goods or services received? If not, at which date should the fair value of the goods or services received be measured? Why?

A. The dates are appropriate.

Question 5

If the fair value of the goods or services received in an equity- settled share- based payment transaction is measured by reference to the fair value of the equity instruments granted, the draft IFRS proposes that the fair value of the equity instruments granted should be measured at grant date (paragraph 8). Do you agree that this is the appropriate date at which to measure the fair value of the equity instruments granted? If not, at which date should the fair value of the equity instruments granted be measured? Why?

A. We agree the grant date is the most appropriate date.

Question 6

For equity- settled transactions with parties other than employees, the draft IFRS proposes a rebuttable presumption that the fair value of the goods or services received is more readily determinable than the fair value of the equity instruments granted (paragraphs 9 and 10). Do you agree that the fair value of the goods or services received is usually more readily determinable than the fair value of the equity instruments granted? In what circumstances is this not so?

A. We do not see why a different basis is appropriate for non-employees than employees. If the employee basis is sufficiently strong, there is no reason in our mind why it should not be applied to all transactions.

Question 7

For equity- settled transactions with employees, the draft IFRS proposes that the entity should measure the fair value of the employee services received by reference to the fair value of the equity instruments granted, because the latter fair value is more readily determinable (paragraphs 11 and 12).

Do you agree that the fair value of the equity instruments granted is more readily determinable than the fair value of the employee services received? Are there any circumstances in which this is not so?

A. If an employee is delivering services, we are not aware of a better way of assessing the fair value of the services and the fair value of the instruments in point. We reiterate,

however, that broad-based plans are not run with a view to obtaining services but rather to engender other beneficial corporate effects.

Question 8

Paragraphs 13 and 14 of the draft IFRS propose requirements for determining when the counterparty renders service for the equity instruments granted, based on whether the counterparty is required to complete a specified period of service before the equity instruments vest. Do you agree that it is reasonable to presume that the services rendered by the counterparty as consideration for the equity instruments are received during the vesting period? If not, when are the services received, in your view?

A. We agree that it seems reasonable to assume the equity instruments are provided for services during the vesting period – if services are delivered in respect of the plan at all.

Question 9

If the services received are measured by using the fair value of the equity instruments granted as a surrogate measure, the draft IFRS proposes that the entity should determine the amount to attribute to each unit of service received, by dividing the fair value of the equity instruments granted by the number of units of service expected to be received during the vesting period (paragraph 15).

Do you agree that if the fair value of the equity instruments granted is used as a surrogate measure of the fair value of the services received, it is necessary to determine the amount to attribute to each unit of service received? If not, what alternative approach do you propose? If an entity is required to determine the amount to attribute to each unit of service received, do you agree that this should be calculated by dividing the fair value of the equity instruments granted by the number of units of services expected to be received during the vesting period? If not, what alternative method do you propose?

A. We agree you should estimate the expected units of service to calculate the value of each service unit.

Question 10

In an equity- settled share- based payment transaction, the draft IFRS proposes that having recognised the services received, and a corresponding increase in equity, the entity should make no subsequent adjustment to total equity, even if the equity instruments granted do not vest or, in the case of options, the options are not exercised (paragraph 16). However, this requirement does not preclude the entity from recognising a transfer within equity, i.e. a transfer from one component of equity to another.

Do you agree with this proposed requirement? If not, in what circumstances should an adjustment be made to total equity and why?

A. If an amount has been added to equity in consideration for the services received and consumed then we agree that amount should remain in equity.

Question 11

The draft IFRS proposes that the entity should measure the fair value of equity instruments granted, based on market prices if available, taking into account the terms and conditions of the grant (paragraph 17). In the absence of a market price, the draft IFRS proposes that the entity should estimate the fair value of options granted, by applying an option pricing model that takes into account various factors, namely the exercise price of the option, the life of the option, the current price of the underlying shares, the expected volatility of the share price, the dividends expected on the shares (where appropriate) and the risk- free interest rate for the life of the option (paragraph 20). Paragraph 23 of the proposed IFRS explains when it is appropriate to take into account expected dividends.

Do you agree that an option pricing model should be applied to estimate the fair value of options granted? If not, by what other means should the fair value of the options be estimated? Are there circumstances in which it would be inappropriate or impracticable to take into account any of the factors listed above in applying an option pricing model?

A. We agree an option pricing model should be applied to estimate a fair value of options granted. However, no disclosure of items which might be price sensitive should be required.

Question 12

If an option is non- transferable, the draft IFRS proposes that the expected life of an option rather than its contracted life should be used in applying an option pricing model (paragraph 21). The draft IFRS also proposes requirements for options that are subject to vesting conditions and therefore cannot be exercised during the vesting period (paragraph 22).

Do you agree that replacing an option's contracted life with its expected life when applying an option pricing model is an appropriate means of adjusting the option's fair value for the effects of non- transferability? If not, do you have an alternative suggestion? Is the proposed requirement for taking into account the inability to exercise an option during the vesting period appropriate?

A. ***We agree that using the options expected life rather than its contracted life reflects the time value lost when an employee exercises before the end of an options life – a result that comes from non-transferability.***

Question 13

If a grant of shares or options is conditional upon satisfying specified vesting conditions, the draft IFRS proposes that these conditions should be taken into account when an entity measures the fair value of the shares or options granted. In the case of options, vesting conditions should be taken into account either by incorporating them into the application of an option pricing model or by making an appropriate adjustment to the value produced by such a model (paragraph 24).

Do you agree that vesting conditions should be taken into account when estimating the fair value of options or shares granted? If not, why not? Do you have any suggestions for how vesting conditions should be taken into account when estimating the fair value of shares or options granted?

A. We agree vesting conditions should be taken into account when estimating a fair value of options or shares granted including:

- ***The inability to access the option gain during the vesting; and***
- ***The risk forfeiture for not meeting the vesting conditions including:***
- ***An assessment of the risk of forfeiture due to staff turnover (this should be measured over the period from grant to the later of either, the date of remaining in service specified, or the date on which any other performance conditions are met);***
- ***The probability that the option will lapse unexercised (or become unexerciseable) due to the operation of any exercise conditions.***

Question 14

For options with a reload feature, the draft IFRS proposes that the reload feature should be taken into account, where practicable, when an entity measures the fair value of the options granted. However, if the reload feature is not taken into account in the measurement of the fair value of the options granted, then the reload option granted should be accounted for as a new option grant (paragraph 25).

Is this proposed requirement appropriate? If not, why not? Do you have an alternative proposal for dealing with options with reload features?

A. We have no strong views on this aspect.

Question 15

The draft IFRS proposes requirements for taking into account various features common to employee share options, such as non- transferability, inability to exercise the option during the vesting period, and vesting conditions (paragraphs 21- 25).

Are there other common features of employee share options for which the IFRS should specify requirements?

A. Many plans vest early for the compassionate leavers or on take-over. However, it would be difficult to include this for an accounting purpose.

Question 16

The draft IFRS does not contain prescriptive guidance on the estimation of the fair value of options, consistently with the Board's objective of setting principles- based standards and to allow for future developments in valuation methodologies.

Do you agree with this approach? Are there specific aspects of valuing options for which such guidance should be given?

A. We agree.

Question 17

If an entity re-prices a share option, or otherwise modifies the terms or conditions on which equity instruments were granted, the draft IFRS proposes that the entity should measure the incremental value granted upon repricing, and include that incremental value when measuring the services received. This means that the entity is required to recognise additional amounts for services received during the remainder of the vesting period, ie additional to the amounts recognised in respect of the original option grant. Example 3 in Appendix B illustrates this requirement. As shown in that example, the incremental value granted on repricing is treated as a new option grant, in addition to the original option grant. An alternative approach is also illustrated, whereby the two grants are averaged and spread over the remainder of the vesting period.

Do you agree that the incremental value granted should be taken into account when measuring the services received, resulting in the recognition of additional amounts in the remainder of the vesting period? If not, how do you suggest repricing should be dealt with? Of the two methods illustrated in Example 3, which is more appropriate? Why?

A. We have no strong views on this aspect.

Question 18

If an entity cancels a share or option grant during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied), the draft IFRS proposes that the entity should continue to recognise the services rendered by the counterparty in the remainder of the vesting period, as if that grant had not been cancelled. The draft IFRS also proposes requirements for dealing with any payment made on cancellation and/ or a grant of replacement options, and for the repurchase of vested equity instruments. Are the proposed requirements appropriate? If not, please explain why not and provide details of your suggested alternative approach.

A. We do not agree with this treatment. Cash paid to an employee should pass through the profit and loss account and not the remaining value of a equity instrument that no longer exists.

Question 19

For cash- settled share- based payment transactions, the draft IFRS proposes that the entity should measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity should remeasure the fair value of the liability at each reporting date, with any changes in value recognised in the income statement.

Are the proposed requirements appropriate? If not, please provide details of your suggested alternative approach.

A. Again we disagree. If an entity has a liability to pay cash, that liability is its intrinsic value, not its theoretical value.

Question 20

For share- based payment transactions in which either the entity or the supplier of goods or services may choose whether the entity settles the transaction in cash or by issuing equity instruments, the draft IFRS proposes that the entity should account for the transaction, or the components of that transaction, as a cash- settled share- based payment transaction if the entity has incurred a liability to settle in cash, or as an equity- settled share- based payment transaction if no such liability has been incurred. The draft IFRS proposes various requirements to apply this principle.

Are the proposed requirements appropriate? If not, please provide details of your suggested alternative approach.

A. We agree with this treatment – subject to our concerns on cash based settlement mentioned in our answers to questions 18 and 19.

Question 21

The draft IFRS proposes that an entity should disclose information to enable users of financial statements to understand:

(a) the nature and extent of share- based payment arrangements that existed during the period,

(b) how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined, and

(c) the effect of expenses arising from share- based payment transactions on the entity's profit or loss.

Are these disclosure requirements appropriate? If not, which disclosure requirements do you suggest should be added, deleted or amended (and how)?

A. The disclosure requirements in paragraph 45 to 53 inclusive is excessive and should be simplified.

Question 22

The draft IFRS proposes that an entity should apply the requirements of the IFRS to grants of equity instruments that were granted after the publication date of this Exposure Draft and had not vested at the effective date of the IFRS. It also proposes that an entity should apply retrospectively the requirements of the IFRS to liabilities existing at the effective date of the IFRS, except that the entity is not required to measure vested share appreciation rights (and similar liabilities) at fair value, but instead should measure such liabilities at their settlement amount (ie the amount that would have been paid on settlement of the liability had the counterparty demanded settlement at the date the liability is measured).

Are the proposed requirements appropriate? If not, please provide details of your suggestions for the IFRS's transitional provisions.

A. We believe that the transition arrangements are appropriate but that the start date should be 1 January 2005 in line with the rest of the European Union.

Question 23

The draft IFRS proposes a consequential amendment to IAS 12 (revised 2000) Income Taxes to add an example to that standard illustrating how to account for the tax effects of share- based payment transactions. As shown in that example, it is proposed that all tax effects of share- based payment transactions should be recognised in the income statement.

Are the proposed requirements appropriate?

A. We agree.

Question 24

In developing the Exposure Draft, the Board considered how various issues are dealt with under the US standard SFAS 123 Accounting for Stock- Based Compensation , as explained further in the Basis for Conclusions. Although the draft IFRS is similar to SFAS 123 in many respects, there are some differences. The main differences include the following.

(a) Apart from transactions within the scope of another IFRS, the draft IFRS does not propose any exemptions, either from the requirement to apply the IFRS or from the requirement to measure share- based payment transactions at fair value. SFAS 123 contains the following exemptions, none of which are included in the draft IFRS:

- employee share purchase plans are excluded from SFAS 123, provided specified criteria are met, such as the discount given to employees is relatively small;
- SFAS 123 encourages, but does not require, entities to apply its fair value measurement method to recognise transactions with employees; entities are permitted to apply instead the intrinsic value measurement method in Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees (paragraphs BC70- BC74 in the Basis for Conclusions give an explanation of intrinsic value); and
- unlisted (non- public) entities are permitted to apply the minimum value method when estimating the value of share options, which excludes from the valuation the effects of expected share price volatility (paragraphs BC75- BC78 in the Basis for Conclusions give an explanation of minimum value).

A. (a) We agree that with FSAS 123 exempting non compensatory plans from the accounting requirements – recognising the economic reality of broad-based plans. In addition, we agree that disclosure is a good alternative to accounting for the reasons given in our answer to question 1.

Like FAS 123 we think unlisted companies should be permitted to assume volatility of zero.

(b) For transactions in which equity instruments are granted to employees, both SFAS 123 and the draft IFRS have a measurement method that is based on the fair value of those equity instruments at grant date. However:

- under SFAS 123, the estimate of the fair value of an equity instrument at grant date is not reduced for the possibility of forfeiture due to failure to satisfy the vesting conditions, whereas the draft IFRS proposes that the possibility of forfeiture should be taken into account in making such an estimate.
- under SFAS 123, the transaction is measured at the fair value of the equity instruments issued. Because equity instruments are not regarded as issued until any specified vesting conditions have been satisfied, the transaction amount is ultimately measured at the number of vested equity instruments multiplied by the fair value of those equity instruments at grant date. Hence, any amounts recognised for employee services received during the vesting period will be subsequently reversed if the equity instruments granted are forfeited. Under the draft IFRS, the transaction is measured at the deemed fair value of the employee services received. The fair value of the equity instruments granted is used as a surrogate measure, to determine the deemed fair value of each unit of employee service received. The transaction amount is ultimately measured at the number of units of service received during the vesting period multiplied by the deemed fair value per unit of service. Hence, any amounts recognised for employee services received are not subsequently reversed, even if the equity instruments granted are forfeited.

A. (b)

- ***We agree that the fair value of the equity instrument should reduced to reflect the possibility for forfeiture due to the failing to meet vesting conditions.***
- ***If the company is to recognise the shareholders dilution cost as a profit and loss charge, then we think it logical that only the actual dilution charge should be recognised – not the original potential dilution charge. Accordingly, we do think that FAS 123 is correct in allowing "truing up".***

(c) If, during the vesting period, an entity settles in cash a grant of equity instruments, under SFAS 123 those equity instruments are regarded as having immediately vested, and therefore the amount of compensation expense measured at grant date but not yet recognised is recognised immediately at the date of settlement. The draft IFRS does not require immediate recognition of an expense but instead proposes that the entity should continue to recognise the services received (and hence the resulting expense) over the remainder of the vesting period, as if that grant of equity instruments had not been cancelled.

A. (c) Where cash is paid to employees we believe that this is the legitimate charge against profits. As the instrument no longer exists, it is hard to see why the company is bearing a charge in respect of it.

(d) SFAS 123 does not specify a measurement date for transactions with parties other than employees that are measured at the fair value of the equity instruments issued. Emerging Issues Task Force Issue 96- 18 Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services requires the fair value of the equity instruments issued to be measured at the earlier of (i) the date a performance commitment is reached or (ii) the date performance is complete.

This date might be later than grant date, for example, if there is no performance commitment at grant date. Under the draft IFRS, the fair value of the equity instruments granted is measured at grant date in all cases.

A. (d) We agree with SFAS 123.

(e) SFAS 123 requires liabilities for cash-settled share appreciation rights (SARs) to be measured using an intrinsic value measurement method. The draft IFRS proposes that such liabilities should be measured using a fair value measurement method, which includes the time value of the SARs, in the same way that options have time value (refer to paragraphs BC70- BC81 of the Basis for Conclusions for a discussion of intrinsic value, time value and fair value).

A. (e) We agree with SFAS 123 and believe that liabilities which are cash settled should recognised at their intrinsic value not their full theoretical fair value (for the reasons given in answer to question 19).

(f) For a share-based payment transaction in which equity instruments are granted, SFAS 123 requires realised tax benefits to be credited direct to equity as additional paid- in capital, to the extent that those tax benefits exceed the tax benefits on the total amount of compensation expense recognised in respect of that grant of equity instruments. The draft IFRS, in a consequential amendment to IAS 12 (revised 2000) Income Taxes, proposes that all tax effects of share- based payment transactions should be recognised in profit or loss, as part of tax expense.

A. (f) We have no strong views on this proposal.

For each of the above differences, which treatment is the most appropriate? Why? If you regard neither treatment as appropriate, please provide details of your preferred treatment. (Respondents may wish to note that further details of the differences between the draft IFRS and SFAS 123 are given in the FASB's Invitation to Comment.)

Question 25

Do you have any other comments on the Exposure Draft?

A. The administration required by the calculations and also the disclosure in the standard will be complex. We would welcome the disclosure being simplified and do not think that the calculations involving units of service would produce a significantly more accurate result than making an accounting estimate and sticking with that estimate in respect of each grant.

October 30 2000

Kimberley Crook
Project Director
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Re: ACCOUNTING STANDARDS BOARD: 'SHARE-BASED PAYMENT'

Dear Kimberley Crook,

Please find attached the response of the Employee Share Ownership Centre to your discussion paper, entitled 'Share-Based Payment,' which was published on July 20. Our response is the distillation of senior practitioner members' views on the assertions made in your paper.

The independent subscription based Centre, with its sister organization, the European Centre for Employee Ownership, is generally recognized to be at the leading edge of thinking and practice on the evolution and implementation of employee share plans, both in the UK and globally. Practitioners from the all over the world regularly attend the conferences it organizes.

The Centre's membership is divided equally between practitioners and plan user companies.

Yours sincerely

Malcolm Hurlston
Chairman

Re: ASB Discussion Paper: Share-Based Payment

Response of the Employee Share Ownership Centre 30.10.00

We contest the paper's central assertion that that the value of share options or share-based payments to employees is a true cost to the company. We accept that there is a cost, but that this cost falls not on the corporate entity but rather on shareholders directly and normally with their express consent. The cost to shareholders is dilution – specifically Earnings Per Share (EPS)

It is therefore for shareholders to decide whether they wish to approve or reject proposals to adopt such incentive payments. Shareholders should possess sufficient savvy to know whether their interests would be significantly damaged, or not, by share-based payment awards. They decide whether to bear the cost of these plans to the benefit of other stakeholders – particularly creditors. **Certainly companies should disclose the existence of share-based incentive payments in clear accounts footnotes so that shareholders, prospective shareholders and other users of accounts have an opportunity to form a judgement on the effects of such awards in the particular circumstances in which the company finds itself.**

Almost all quoted corporates have institutional investors whose job it is to monitor such developments and to understand their implications. The argument is that share-based payment, increasingly, should be performance-related and that the added value generated thereby should offset the financial effects of dilution.

Accounting for share-based payment is strictly a matter between the company (the board which represents the entity) and its shareholders, who are stakeholders in the company. Shareholders give their informed consent to particular share-based awards, so no outside body can have any genuine locus in this matter. Any such external intervention into this matrix can be seen as unwarranted interference into the running of the company and the relationship between the corporate entity and its owners – the shareholders. Informed shareholder consent is thus the key issue in this respect.

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Centre response 2

If the main ASB proposal were adopted, then a company could easily appear much less profitable than it really was. This could affect its credit-worthiness in the eyes of others – eg the price of new capital for expansion/development could become higher than it need be. Fast growing companies could run the risk of breaking their bank loan covenants because they are often reliant on share-based payment systems to recruit and retain the best staff. It is not enough to say that most analysts and bankers would automatically discount in their minds the specific impact of P & L accounting for share-based payment. The entry in the P & L accounts of share option costs would have to have objective meaning, otherwise changing the accounting treatment of share-based payment in the manner proposed would be pointless.

The proposal is particularly unsuitable for smaller companies - share based payments (particularly options) could be killed off in private companies. Some might even relocate to more options-friendly jurisdictions in order to maintain their competitive position regarding the recruitment and retention of highly-motivated key staff.

Those who study SME accounts do so either because they want to value the company (in which case they ask about share options) or because they are checking its creditworthiness, in which case the existence of share options has no impact. So for smaller companies the ASB proposal is largely irrelevant and unnecessary anyway.

'True cost' P& L accounting for share-based payment would be a blunt and crude instrument in some circumstances. For example, CSOPs (Company Share Option Plans) are used by supermarket multiples specifically to encourage employees to stay loyal in an industry where the staff haemorrhage rate can reach 16 per cent or more per annum. Relatively modest one-off share option awards, tax free after three years, to all qualifying employees are proving efficacious in reducing staff losses, particularly on the check-out tills and so forth, since staff have to stay around in order to realize their option gains.

But to record the 'true cost' of these options in the P & L account in isolation would be grossly misleading: such a book entry would fail to take account of the direct savings accruing to the company – such as lower recruitment and training costs - as a result of operating a CSOPs.

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Centre response 3

It does not wash to say that the savings would show up in the accounts anyway, albeit elsewhere – the linkage should be transparent. This illustrates a conceptual flaw in ASB thinking – the assumption that share-based payment is always all cost and of no benefit to the corporate entity.

In addition, the central proposal is inconsistent with current international practice, though the ASB's German counterpart has a similar discussion paper in play, and it is odd that the ASB should put forward such a proposal with no guarantees whatsoever that other major western economies will adopt it. In other words, the ASB implicitly expects UK companies to adopt this controversial measure unilaterally, if necessary. Current evidence suggests that the US corporate community will continue strongly to resist such a move. The 'agreed approach' adopted by the G4 + 1 group is all very well, but it is not binding on their parent organizations.

Regarding the international situation, the wording on the US in the discussion paper*: "Companies are also encouraged to apply FAS 123 instead of Opinion 25 for transactions with employees*" (ref 2.7) is painful in the extreme for it acknowledges that the vast majority of corporate USA does NOT do this. Only when options go underwater, and companies then reprice the options lower, does the P & L treatment of options apply.

Unilateral action by the ASB on this issue could be deeply damaging to UK corporate health. Such action could put some UK companies at a competitive disadvantage vis-a-vis the *apparent* relative strengths of the P & L accounts, especially in an age dominated by image and global takeovers.

The ASB paper claims that share-based payment is currently seriously under-reported or unreported. It presents no evidence for this assertion. The Centre believes that the vast majority of UK corporations do report the existence of such payments, though not in the P & L accounts which, surely, should reflect ***underlying trading performance***, and not employee share-based payment transactions.

The Centre accepts that, as an alternative to P & L charging for such payments, there should be more disclosure requirements re the dilutive effect of share options.

Centre response 4

As for the logistical implications of the main proposal itself, the notion of the charge being set when the shares become exercisable is a difficult process to crystallize numerically and, if implemented, could cause expensive and time-consuming accounting problems in some companies. The difficulties many smaller companies would face in comprehending such a process, let alone coming to terms with its operation, can be well imagined.

Furthermore: -

- It runs against the concept of ‘share-based payment’ as the value received is unknown until after the services have been delivered and cannot be retrieved, which is hardly the basis of any normal contract.
- It is at odds with FAS123 and so helps create disharmony in international accounting.

End

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ESO Centre response to FRED 31 via ASB

Appendix 1

<u>Impact on SMEs</u>

The ESO Centre believes that the impact of 'expensing' employee share and share option awards in many small and medium size companies (SMEs) will be substantial:

- Kimberley Crook, IASB project director, told the European Centre for Employee Ownership's annual global equity pay conference in Davos (Feb 2003) that the ***IASB had considered and rejected the case for exemption of all unlisted and/or SME companies from the 'options expensing' proposal.***
- Cash raised from sales of shares to employees in SME buy-outs (with say venture capital help) is often essential to the success of the transaction. However, heavy P & L pre-tax profit hits will make many small businesses wary of choosing the ESOs route and could reduce the number of buy-outs.
- Logistical difficulties for SMEs over how to **measure** the proposed fair value of share options over the period of their life. How many SMEs have in-house resource sufficiently capable of assessing Black Scholes values to all outstanding share options and deferred share bonus schemes? How much will they be charged for this key info by outside consultancies? – remember this obscure but lengthy measuring exercise will have to be repeated **every year.**
- Even with bought-in advice, SMEs may find it difficult to cope with the administrative task of tracking early leavers, volatile share prices, cancelled options etc (in order to record accurately the P & L impact).
- Most high tech companies **cannot afford** to pay key employees incentives based solely on cash. Equity pay is the proven best way to keep high achievers on the payroll.
- Yet if SMEs perceive that they will suffer a P & L hit for adopting all-employee, or even key employee, share/share option schemes they may jack in ESO schemes entirely, or just retain them for a few top execs. Many will have to assess the likely pre-tax profit hit against the size of the new guaranteed Corporation Tax Deduction – paid to companies as soon as employees receive the shares or options.

For these reasons, the ESO Centre recommends that all small and unlisted companies should be exempt from the proposed new accounting standard on share-based payment.

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Employee Share Owenership Centre

Smaller companies, particularly in the high tech sector, will be hit hard by the soon to be enforced P & L accounting for employee share and share option incentives**,** the Employee Share Ownership Centre warned in a press release last November.

Hundreds of UK small high tech companies will risk breaking their banking covenants if they continue to award their staff performance-based substantial share option or share packages, once the accounting change comes in, said Centre chairman Malcolm Hurlston, who urged Chancellor Gordon Brown to probe…. "this accounting madness."

He said: "Many of these companies have no choice but to give highly mobile staff equity incentives, because they don't have the reserves which would allow them to substitute cash bonuses for their employee share option or share awards. The alternative for them, if you can call it that, will be to suspend or cutback their share option schemes, resulting in desertion by their star staff to more cash-rich employers.

"Those who think that this an exaggeration should read reports by investment houses on both sides of the Atlantic, pointing out that some high tech companies like ARM plc will see their pre-tax profits slashed by more than 50 per cent, when they have to record the alleged true cost of their share-based payments in the P & L account every year," said Mr Hurlston.

"Another problem which unlisted companies will face under this new accounting regime is how to get speedy and cost-effective valuations of their share capital, without which they will be unable to comply with the P & L accounting requirement.

"The ASB itself questions whether the new Exposure Draft Standard should apply to unlisted companies too, on the basis that that it is often more difficult for them to measure the value of share-based employee awards than it is for listed companies," he added

The Accounting Standards Board admitted in a background note that the compliance costs suffered by SMEs would go up, while "in many cases" the accuracy of the resulting information would be reduced. But having considered whether some or all unlisted companies should be exempted from the new accounting rule, the ASB said merely that it "agreed" with the International Accounting Standards Board that there was *nothing unique about UK small companies that meant the share-based payment analysis should not apply to them.*

However, the UK's smallest companies may yet win exemption from the accounting change, because the ASB will refer to an internal committee the exemption case for 'smaller entities' falling within the Companies Act definition – either turnover less than £2.8m per year; balance sheet less than £1.4m or fewer than 50 employees and to get under the net the company has to satisfy two of these three conditions.

Mr Hurlston warned: "This technically flawed and unnecessary accounting change will dent severely the all-employee share ownership movement, which Chancellor Gordon Brown, among others, has been trying to build up in the UK, as an essential tool in the campaign to improve the UK's lagging productivity record.

"The Chancellor for one will not be pleased that one of his new ESO schemes, the Enterprise Management Incentives, aimed at helping small companies, will be one of the first to suffer the P & L accounting pain. He should intervene now and investigate the likely effects of this accounting madness," he added.

The ESO Centre fears that ratification next autumn of the consultative Exposure Draft by the IASB may force many small companies to abandon key staff share option plans.

"But many large companies too will feel the pinch in having to record in their P & L accounts the cost of popular all-employee share plans, such as SAYE-Sharesave. The tragedy is that none of this need happen because the technical justification for share based payment expense accounting is badly flawed - it is the other shareholders who pay the cost of these equity pay plans - in the form of dilution, which is eventually reflected in earnings per share - and NOT the corporate entity itself in terms of normal cash flows, " added Mr Hurlston.

"The Centre will continue to fight share options expensing all the way - the war is not yet lost," he added.

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Notes for editors: The Employee Share Ownership Centre is an independent not-for-profit membership organization, established by Malcolm Hurlston in 1988 to inform, lobby and research in the interest of employee share ownership. Its subscription-based membership includes consultants, professional advisers, trustees, banks and companies who have either introduced employee share schemes or intend to do so shortly. Member firms include: Abbey National, Allan & Overy, Amvescap, Andersen, Bacon & Woodrow, BA, BG, BT, Cazenove, Citibank, Clifford Chance, Deloitte & Touche, Diageo, Ernst & Young, Eversheds and SMEs.

Appendix 2 of ESO Centre response to IASB/ASB FRED 31

Impact on all-employee share ownership plans

1. SAYE-Sharesave and other all-employee share plans

Up to a million employees may suffer if new accounting rules for share options unveiled by the International Accounting Standards Board (IASB) have to be adopted by UK companies, according to a survey of UK finance directors released last November (2002).

The survey obtained the views of nearly 100 public companies on the current proposals being discussed by the IASB.

The main casualty will be employees who benefit from the highly successful Sharesave (or SAYE) scheme that has been used for over 20 years. Generous payouts under Sharesave schemes have provided a valuable top-up to retirement pensions and savings as well helping people to meet everyday expenses and repay their debts.

Most companies have a Sharesave or one of the other all-employee schemes (the new Share Incentive Plan or the Company Share Option Plan = CSOP) because they want to increase employees' feelings of involvement and commitment in the business, not to reward actual services performed. The gain is not part of remuneration and is not seen as such by companies, employees or stakeholders. Moreover, as we are seeing with pensions, the result of these proposals looks like being that companies may downgrade or even cancel all-employee share option schemes for the workforce because of the hit on the profit and loss account.

Both the UK Government and the European Commission want to increase financial participation by all employees for a variety of reasons, not least in order to help close the yawning productivity gap between the US and Europe (**on any measure you care to use, US employees are on average between one third and 40 per cent more productive than their UK counterparts).**

The IASB proposals, if adopted without amendment, will deliver a damaging blow to this policy. The ESO Centre forecasts that many companies, rather than annually having to go through the tedious and expensive business of assessing the 'fair value' of their share-based payments to employees, will scrap or scale back such schemes, particularly those involving all employees**.**

This is borne out by responses to a recent major survey conducted by Mercer Consulting.

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More than one million employees participate in some 1,200 Sharesave schemes in the UK. 92% of FTSE 100 companies have an SAYE savings-related share option scheme, the most popular of all-employee share schemes. Furthermore, major companies such as BA have exported the Sharesave concept to their overseas employees, so that tens of thousands of employees from Malaysia to South Africa enjoy the benefits. Employee share schemes tend to be generally used for motivation and loyalty purposes and such schemes are not generally considered by employees as part of their pay packets. Since their inception, the initial value of shares and options, awarded under the UK's share schemes has exceeded £35 billion.

We would strongly urge the IASB to reconsider its proposal and include an exemption for approved all-employee schemes such as Sharesave and the Share Incentive Plan

In addition, the ESO Centre maintains that:

The proposed share option measurement methodology is questionable: Taking the suggested Black-Scholes formula for determining 'fair value' of share options, we need to ask: ***What affects option values?***
Answer: exercise price of the option, current share price, expected volatility, expected dividends, risk-free interest rate and the term of the option.
However, the main drawbacks of the Black–Scholes formula are:

- No allowance for performance conditions
- No allowance for early exercise and vesting
- Will the dividend yield be constant?
- How volatile will the share price be?

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Response to FRED 31 Appendix 3

The case against stock options 'expensing'

- The damage to pre-tax profits of many FTSE100 companies would be severe if IASB chairman Sir David Tweedie gets his way, a New Bridge Street Consultants survey suggests. Of those that operate share plans, (94 out of top 100) 36 per cent would suffer a profits reduction of at least 50 per cent and a further four per cent would slip into pre-tax losses.
- Another survey, by Capital Strategies, 'equity at work', which reviewed share incentives in UK software and computing services companies, revealed that P & L account 'costing' of share option awards would reduce their pre-tax profits by an average of almost six per cent. Their aggregate market capitalisation would fall by up to £2.3billion if the market made a full valuation adjustment to reflect the fall in headline profits.
- Some smaller companies would find themselves at risk of breaking their banking covenants if they persisted with reissuing significant equity pay packages post Exposure Draft publication date (7 November 2002) because they would be stoking up high levels of P & L accounting liability. Estimating the 'true cost' of equity pay packages for employees would have additional cost implications for all but the very largest companies.
- All matching and free share awards by companies to participating employees in the government's Share Incentive Plan already have to be accounted for in the P & L as 100 per cent share price discounts. This threatens to destroy at a stroke the main prop protecting participating employees from a sudden fall in their company share price *after* they had purchased their partnership shares. There is evidence that many companies which operate the SIP are holding back from awarding matching shares to participating employees. Performance shares would be caught too, though their P & L treatment would be more complex.
- The fall guys of the IASB plan would be fast-growing high tech companies who, often lacking sufficient cash resources to incentivise key players, rely on substantial share/share option based payments in order to retain key and motivate staff. Many would face very heavy P & L hits indeed, especially in view of the volatility of their share prices. For example, ARM plc's pre tax profits would be more than halved. Thus Tweedie's plan is a covert attack on the springs of technological progress in the West. Ultimately, the level of investment by smaller businesses would be hit by this unwanted, deeply regressive measure.

'True cost' P& L accounting for share-based payment would be a blunt instrument in some circumstances. For example, CSOPs (Company Share Option Plans) are used by supermarket multiples specifically to encourage employees to stay loyal in an industry where the staff haemorrhage rate can reach 16 per cent or more per annum. Relatively modest one-off share option awards, tax free after three years, to all qualifying employees are proving efficacious in reducing staff losses, particularly on the check-out tills, since staff have to stay in order to realize their option gains. But to record the 'true cost' of these options in the P & L account in isolation would be grossly misleading: such a book entry would

fail to take account of the direct savings accruing to the company – such as lower recruitment and training costs - as a result of operating a CSOPs. It does not wash to say that the savings would show up in the accounts anyway, albeit elsewhere – the linkage should be transparent. This illustrates a conceptual flaw in ASB thinking – the assumption that share-based payment is always all cost and no benefit to the corporate entity.

- Although in the UK pensions and employee share schemes are strictly separated, ESO ('financial participation') plans are already a vital mechanism in some countries – eg France and the US - through which employees can 'save' for their retirement. There is no doubt that many stock plans throughout the West will be closed if stock option packages are forcibly expensed. This would damage the efforts of western governments to encourage employees to save more for their retirement, as average longevity increases sharply at a time when a worryingly large 'savings gap' has opened in western economies. Put bluntly, expensed stock options would constitute an attack on employee savings.
- Until an employee sells his or her shares (gained from exercising options) no-one knows what the 'true value' was. Employees might not sell their shares – what then? It is not necessarily accurate to apply the Black-Scholes measure of value. The risk is that we could end up with a new worldwide accounting standard less reflective of 'true value' than what we have now. We have no confidence in auditors recognising the 'true cost' of equity pay under the proposed new accounting standard because we are not measuring apples and apples - there are too many variables to consider. One would need specially trained people to do this. They would have to issue certificates and analysts would question the process.
- The IASB implies that employee services are purchased in exchange for benefits provided under an employee share plan, in the same way as goods and services may be purchased from another entity in exchange for shares or options. This analysis is incorrect because a company is **not** purchasing employee services when it provides share benefits. These are provided on a discretionary basis and are, typically, entirely separate from the employment contract. Companies give share benefits to employees as an incentive.
- In a survey by Mercer Human Resource Consulting, one-third of 200 large employer respondents stated that if they were required to expense stock options, they would reduce the number of options granted, while another third stated that they would reduce the number of people who were eligible to receive options. Some US corporations have already advised the American Benefits Council that they will terminate their stock plans entirely if stock options expensing comes to pass.

FRED HACKWORTH ESO Centre Nov 2002