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FRED 31: SHARE-BASED PAYMENT

COMMENTS FROM NEW BRIDGE STREET CONSULTANTS

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1. **INTRODUCTION**

1.1 The views expressed in this paper are those of New Bridge Street Consultants, a specialist management consultancy that advises predominantly UK listed companies on remuneration and incentive arrangements.

1.2 We are happy for our views to be placed on the public record and would welcome the opportunity to meet representatives from the ASB if that was felt to be constructive.

1.3 In the interests of brevity we have chosen not to reproduce in this paper the proposed accounting treatment set out in the FRED. This paper is therefore confined to an expression of our views on the overall philosophy and answering questions raised on pages 27-42 of the FRED. This paper is also being sent to the IASB in response to their consultation exercise.

1.4 The context in which we make our comments relates to our field of expertise, namely share and cash incentive plans for employees. We do not therefore specifically express views on the application of the proposals to other transactions in shares. However, it may be that our views could logically be extended beyond employee share incentive plans.

2. **OVERALL PHILOSOPHY**

2.1 We reiterate our previously expressed views that the benefits provided to employees by the issuance of share options (in particular) are not a "cost" of the issuing company, but a cost to be borne directly by the shareholders of that company. We do not agree therefore that this "cost" should be charged against the issuing company's profit and loss account. However, we acknowledge that the views of both the ASB and IASB are probably decided on this point so, in the interests of being constructive, we make comment in this paper on the assumption that this does not alter.

2.2 We were pleased to see that the **date of grant** of the option/award has been chosen as the date at which the valuation is to be performed.

2.3 We are in favour of the disclosure of relevant information in annual reports and accounts if it allows the users of the accounts to make a more informed decision on the value of a company and its shares. However, the level of disclosure proposed is excessive and out of context to the impact on most companies' profits. We feel that as those figures are audited the level of disclosure should not be disproportionately more than for other accounting items (e.g. pension costs).

2.4 We remain concerned that the revision of UK accounting standards could result in companies reporting under UK GAAP being seen in an unfavourable light compared to companies reporting under other countries' accounting standards. Not only would UK reported profits be lower (without any impact on cashflows) but the ability to pay dividends would be reduced and in some cases extinguished altogether. The timing of the adoption of FRED 31 should therefore be considered in the light of adoption in the European Union and US.

2.5 We remain unconvinced that companies should find that they have reduced their ability to pay dividends as a result of issuing shares and making a creditor's position safer. This seems an incorrect approach and we feel that the correct approach is for distributable reserves to be unaffected by these accounting changes.

2.6 We have conducted research into what the impact might be for the UK's largest 100 listed companies (FTSE 100) operating both employee and executive style share option schemes. We have ignored schemes which deliver shares resulting in a charge under UITF17 as FRED 31 calculates the charge on a different, and probably not materially higher or lower, basis on average.

2.7 The results of our research are that, of those companies with positive earnings per share (as opposed to a loss per share) EPS would reduce by approximately 2.2% from the 2001 reported level assuming a full year's charge under FRED 31 on an ongoing basis. This is the median level of EPS reduction whilst the range is between 0.7% and 6% between the lower quartile and upper quartile positions.

2.8 Further details are set out in the Appendix.

3. RESPONSE TO SPECIFIC QUESTIONS RAISED IN FRED 31

Date of adoption

3.1 We feel that adoption from 1 January 2004 is too early given the likely delayed adoption by some of the other European Union countries and uncertainty over the US position. A deferral until 1 January 2005 would therefore be preferable.

Application of Standard

3.2 We do not agree that the proposed standard should apply to "all UK companies, other than those that are applying the FRSSE". We are concerned that the level of disclosure within subsidiary companies' accounts in large groups would be a further administrative burden that would serve little or no purpose to the ultimate shareholders. Disclosure of accounting charges within a subsidiary's accounts serves little purpose except where there are minority shareholders from outside of the Group. Accordingly, we feel that an exemption should be provided for subsidiary accounts of unlisted or "limited" companies where they are 100% held by another company. This would be in addition to the exemption for those companies applying the FRSSE.

Types of Share Based Payment

3.3 As stated above, we do not agree that employee and executive share incentive arrangements should be caught by the standard. We are particularly concerned that "broad based" employee share plans should not be caught since the argument that they provide a level of remuneration which would otherwise have to be paid in another form is very weak. All the evidence is that where companies have ceased to operate broad based employee plans there is no increase in the level of cash (or other) remuneration paid to these employees.

Application of Standard Within Groups of Companies

3.4 As stated above we do not agree that the standard should apply to wholly owned subsidiaries of a group that prepares consolidated financial statements. Similarly, there is little case for applying the standard to the parent company's accounts, since whether group employees have contracts of employment with the parent company or subsidiaries is often an accident of history rather than specific planning by the group. Presumably, shareholders are concerned with the consolidated financial statements rather than those of the parent company (except in respect of such matters as the ability to pay dividends).

Withdrawal of Existing UITF Abstracts

3.5 We feel that the proposed amendments would allow the withdrawal of UITF Abstracts, 13 and 17. However, please note our comment in respect of Social Security costs that we feel should be treated in the same way as liabilities under cash settled share based payments made to employees.

Retrospective Application

3.6 We feel that companies should be able to choose and state clearly why they have made their choice in respect of retrospective application for the proposed Standard. In some cases, changes from the current accounting treatment will show disproportionately large or small transitional impacts on the accounts.

IASB Questions

Question 1

3.7 As stated above, we feel that the scope of the proposed Standard is too wide. As a minimum, broad based employee share awards with a modest discount (e.g. up to 15% from the market price at the date of award) should be exempt.

Question 2

3.8 The recognition requirements are in our view, more complicated that they need to be to provide meaningful information to users of accounts. We would prefer to see the charge spread equally over the vesting period rather than apportioned by reference to the actual units of service during the vesting period. Alternatively, the discount factor applied in the fair value calculation for forfeiture could be removed and any awards that subsequently lapse due to forfeiture in these circumstances could be added back.

Question 3, 4, 5 and 6

3.9 We agree with the proposed Standard's approach.

Question 7

3.10 Where an employee waives salary in return for share based payment awards these awards might more appropriately be valued on the basis of the level of cash remuneration given up.

Question 8

3.11 In most circumstances we agree that the vesting period is the period during which it is assumed the counter party renders services. However, in respect of awards made because of performance in the past (e.g. deferral of annual bonuses) we feel that the vesting period should not be used. This approach is consistent with the current treatment under UITF 17 and assumes that no changes in principle are proposed here. Clarification on this point in the Standard would be helpful.

Question 9

3.12 We refer to our comments above in respect of simplifying the calculation of attributing the fair value to the "units of service received".

Question 10

3.13 We would prefer to see companies given the choice between discounting the fair value for risk of forfeiture/risk of failing to meet performance criteria and making no discount for these and adding back fair values when awards lapse. We are particularly concerned that companies may be driven to making "profit forecasts" and "dividend forecasts" in respect of very long periods of time when calculating fair values for employee incentive plans. The views of the FSA on this point would be relevant and we intend to write to them for clarification of their views.

Question 11

3.14 We agree that option pricing methodology should be applied to estimate fair value of options granted. However, we are concerned with some of the details of the assumptions which we feel will require further market testing to ensure that they create appropriate values. On a specific point, we feel that if the option exercise price is, say, within 5% of the market value on the date of grant then this should be taken as a proxy for market value rather than it be assumed that a "discounted" option is granted for fair value purposes. Such minor discounts result from an exercise price formula used in share plans being based on the average of several days' share prices prior to the date of grant.

Question 12

3.15 Agreed.

Question 13

3.16 This is an area which poses us the biggest problem in calculating fair values for share awards or option grants. As stated above, it can involve a profit forecast by a company or an assumption that a company's shares are over or under valued relative to the market both of which are neither capable of external audit nor verification. We are aware that some option valuation experts look to past earnings performance as a guide to future earnings growth. Clearly this also has its flaws.

3.17 Further guidance on this or the ability to disapply the discount factor for forfeiture and or performance conditions as stated above would be beneficial.

Question 14

3.18 Agreed.

Question 15

3.19 See answer to question 11.

Question 16

3.20 The appropriate estimate of fair value of share options is essential to the debate on the adoption of the proposed Standard. We feel that too little assistance has been provided in the implementation guidance notes so far and, in particular, there is no indication of what value may result from application of these models and whether these values are appropriate. Significantly more research and market testing needs to be done in this area before adoption of the Standard is to be proposed.

Question 17

3.21 We agree with the incremental value approach.

Question 18

3.22 We believe that companies should be allowed the choice of taking the remainder of the charge for an option that is cancelled at the time of cancellation.

Question 19

3.23 Agreed. However, we feel that if a company hedges the liability then the cost of that hedge should be spread over the vesting period instead of the proposed charge for cash settled share based payment transactions.

3.24 By way of example, in the UK, Social Security charges are levied on the employer based on the gain realised by an employee on non-tax approved share based payments. As an alternative, the employer can pass this liability to the employee and in doing so often grants an additional level of option by way of "compensation". We feel that it would be wrong for the prescribed accounting treatment to encourage or discourage companies from passing the liability to employees.

Question 20

3.25 Agreed.

Question 21

3.26 As stated above, we feel that there is far too much disclosure proposed for share based payments. After all, these charges will be audited and, if the key assumptions are stated by companies then shareholders will be adequately informed. If the proposed treatment was instead not to record a charge in the accounts for share based payments but instead to fully disclose in the notes to the accounts the potential charges then we agree that high levels of disclosure would be warranted.

Question 22

3.27 We refer to our response to the ASB's question on transitional provisions.

Question 23

3.28 Agreed.

Question 24

3.29 We believe that our views on this question are fully expressed above.

Question 25

3.30 No further comments.

4. CONCLUSIONS

4.1 We disagree with the application of the standard to <u>all</u> share based payments. In particular, we feel that broad based employee plans should be exempt. We further feel that the level of disclosure is excessive in Report & Accounts as proposed and question the need for the proposed Standard to be applied to wholly owned subsidiary companies or parent companies in consolidated group accounts. Our final concerns rest with the date of adoption and apparent lack of research and testing into how accurate the option valuation calculations will be.

APPENDIX 1

Impact of proposed FRED 31 costs on FTSE 100 companies' 2001/2 accounts

Based on levels of option grant, profits and EPS in the companies' accounts published in the 12 months up to 31 October 2002 the impact of a full year of charge as calculated under FRED 31 would be as follows: (Companies with a Loss Per Share were excluded from the analysis. On average 1% of issued share capital was optioned by these companies' in their last financial year)

	FRED 31 costs as % PBT	Movement in EPS
Lower quartile	0.77%	-6.03%
Median	2.20%	-2.24%
Upper quartile	5.45%	-0.73%

FRED 31 Impact on EPS