UK SHARE SCHEME LAWYERS GROUP

RESPONSE TO INTERNATIONAL ACCOUNTING STANDARDS BOARD

ED2 SHARE-BASED PAYMENT

FEBRUARY 2003

UK Share Scheme Lawyers Group

Response to IASB Proposals - ED2 Share-Based Payment

This paper contains the response of the UK Share Scheme Lawyers Group to the Exposure Draft ED2 Share-Based Payment issued by the IASB on 7 November 2002.

The UK Share Scheme Lawyers Group was formed more than 10 years ago by lawyers in London law firms specialising in employee share schemes. The Group now has 158 members, representing 47 law firms and other specialist practitioners. Our members now include senior lawyers from all of the major London law firms and most of the major regional law firms in the UK. The main purpose of the Group is to consult with, and make representations to, the Government and other institutions involved in the regulation of employee share schemes.

EXECUTIVE SUMMARY

We set out below the areas on which we wish to comment in relation to the IASB proposals. In some cases, our comments reflect fundamental objections to the concept of expensing employee share awards. In other cases, without prejudice to our general objection to the proposals, we suggest improvements to them. The areas on which we wish to comment are:

- Share Schemes Are Not Remuneration;
- Exemption For All-Employee Share Schemes;
- New and Existing Shares;
- No "Truing Up";
- Double Hit To Earnings Per Share;
- Allow A Company To Choose Whether To Expense Options Or Employees' Services;
- Unreliable Option Pricing Models;
- Exemption For Unlisted Companies;
- Small and Newly-Formed Companies;
- Restrict Cost To Consolidated Accounts Only;
- Stock Appreciation Rights;
- Excessive Disclosure;
- Alternative Accounting Treatment;
- Corporate Transactions;
- Implementation Date.

Each of these areas is dealt with in detail below.

1. SHARE SCHEMES ARE NOT REMUNERATION

Remuneration is provided by a company to its employees. By contrast, employee share schemes can in practice only be provided by a company with the consent of shareholders. In the UK, for example, this can be easily demonstrated by the fact that any issue of new shares requires the approval of shareholders and, under the UK Listing Authority rules applying to companies quoted on the London Stock Exchange, specific shareholder approval is needed for an employee share scheme. It is thus recognised in corporate law and in stock exchange rules that any issue of shares (and, in particular, the issue of shares to employees) is a matter to be decided by shareholders. It is not a matter that the directors alone can determine. They require due authority from shareholders.

It follows from the above that the provision of shares to an employee represents a dilution cost to shareholders which, within certain limits (which, in the UK, are set out in published shareholder guidelines), shareholders will accept in the belief that spreading share ownership through employee share schemes will in the long run be beneficial to shareholders to the extent that, overall, corporate performance is improved. The cost/benefit equation is that, where a benefit is enjoyed by an employee, the cost is incurred by shareholders (through dilution) and not by the company itself.

The role of the company is to decide how the shares provided by shareholders should be allocated among its employees. There is no cost to the company as such.

Note also that employee shares schemes are virtually always discretionary, in the sense that the company can choose to discontinue them at any time. Again, this confirms that they are not remuneration (remuneration cannot be given or taken away on a discretionary basis).

2. EXEMPTION FOR ALL-EMPLOYEE SHARE SCHEMES

It is not true to say that, in the UK, employee share schemes represent part of the consideration paid for employees' services. Many UK companies (particularly quoted companies) offer a savings-related share option scheme to employees on an all-employee basis (this type of scheme has to be operated on an all-employee basis under the applicable UK legislation). Employees are offered an investment opportunity. To the extent that they are prepared to make regular savings (maximum £250 per month) out of their post-tax remuneration in a specially-designated savings account, they can buy shares at the end of a certain period (three, five or seven years) pursuant to an option granted to them at the outset. It is not realistic to view options granted under this type of scheme as a reward for employees' service. Instead, it is much more realistic to describe it as an arrangement under which shareholders encourage the acquisition of shares by employees as part of a process by which, in the long run, both shareholders and employees can benefit as owners of the business. This is the case even where options might be offered at a discount to market value. A discount does not mean that the options represent remuneration. It is almost always the case that (say) a rights issue will be made at a discount to market value in order to encourage shareholders to take up the investment opportunity. The same is true if options are granted at a discount:

shareholders are willing to agree to this in order to create a more attractive investment opportunity for employees.

The fact that such schemes are not a reward for an employee's services is easily demonstrated. Suppose (for example) that a very junior employee decides to save £250 per month under this type of scheme and (say) a director chooses to save only £50 per month, the junior employee will receive 5 times the number of options granted to the director. According to the principles in ED2, this would seem to mean that the services of the junior employee are five times more valuable to the company in question than the services of the director. Clearly, that is a ludicrous conclusion. As mentioned above, the correct analysis is to say that this type of scheme is an investment opportunity given to employees by shareholders.

In view of the above, we firmly believe that there should be a specific exemption from the IASB proposals for employee share schemes which, under their terms, must be operated on an all-employee basis. Such an exemption currently exists in the US for employee share purchase plans (otherwise known as "Section 423 Plans") and we believe that it is right in principle that an all-employee scheme should be viewed as an investment opportunity (granted by shareholders) for employees rather than any form of remuneration. Further, we believe that such an exemption can apply internationally, since many countries (for example, the UK, US, France, Ireland) recognise such plans statutorily as a distinct class of employee share scheme.

3. **NEW AND EXISTING SHARES**

Under the proposals, no distinction is drawn between the issue of new shares under an employee share scheme and the provision of existing shares (e.g., purchased by a trust in the market) under the same employee share scheme. However, there clearly are major differences in terms of structure, cost and accounting implications. Under current accounting rules in the UK, a company will recognise an accounting cost where shares are purchased in the market. For example, if the purchase of shares is funded by way of a loan, then an interest cost will be recognised. If, over time, the shares fall in value so that the loan is unlikely to be repaid, then there will be a further accounting charge by reference to the amount of the loan that is written off. In the case of a bonus arrangement under which all-employee bonuses are paid in the form of shares (the Revenue-approved Share Incentive Plan in the UK falls into this category), a company may simply make a gift of money into a trust which will then purchase shares in the market and allocate those shares, free of charge, to employees under the scheme. The funds expended in this way will be recognised in the P/L account in the same way as if the company had paid a cash bonus of the same amount.

We cannot understand why the actual costs incurred in any of the above arrangements should be replaced by the theoretical costs suggested under the proposals. Presumably, the only reason for this is to make the proposals consistent (i.e. so that they apply equally to newly-issued and existing shares). However, it seems fundamentally wrong to replace an actual cost with a theoretical cost simply to make the proposals consistent.

Moreover, how is the actual cost under any of the above arrangements supposed to be recognised under the proposals? Presumably, there cannot be a double cost (i.e. the real cost mentioned above and the theoretical cost under the proposals)? We believe that, where existing shares are used and an actual cost is already recognised in the accounts, the proposals should not apply.

4. **NO "TRUING UP"**

There are constant references to the "increase in equity" which arises under employee share schemes (or other share-based payments). The increase in equity seems to be a very significant factor in the IASB's proposals as set out in ED2. However, in the context of employee share schemes, there is often no increase in equity because, for example, an option lapses without being exercised (e.g. on termination of employment) or an option relates to existing shares held by a trust or other third party. Whilst it may be arguable that an increase in equity through the issue of new shares should be reflected in a company's income statement since, ultimately, it can lead to additional costs for the company (e.g. paying dividends on a higher number of shares, increased cost of a buy-back of shares etc.), how can that principle apply in circumstances where there is no increase in equity (because an option lapses or because it relates to existing shares in the first place)? Alternatively, is the option itself viewed by the IASB as an increase in equity? If that is the case, then it is a very strange form of equity in that it can be extinguished so easily (e.g. if performance conditions are not met). In any event, the basic point here is that there should be a write-back if the option lapses.

Although it is true to say that the "units of service" approach taken in ED2 does lead to a reduction in the recognised expense where employees cease employment, that is not the same as a write-back of any expense previously recognised. Moreover, there is no reduction or write-back at all if an option fails to be exercised for a different reason (e.g. because performance conditions governing the exercise of an option are not met). Although we are not trained accountants, we presume that any future expense for which a provision is made in a company's accounts is written back if the event giving rise to the expense does not in fact occur - i.e. generally there is a "truing-up" in the accounts at a later stage to reflect what actually happens as compared with what was assumed in the accounts as being likely to happen. The lack of any truing-up under these proposals effectively means that the accounts are never corrected. This cannot be right if the accounts are intended to give a "true and fair" view of a company's financial position.

5. **DOUBLE HIT TO EARNINGS PER SHARE**

Given the dilution cost to shareholders, the method of expensing options under ED2 leads to a "double hit" as regards the earnings per share ("EPS") calculation: the numerator (i.e. earnings) is reduced by the expense in the accounts and the denominator (i.e. the shares) is increased by the dilution factor. This double hit seems incorrect as a matter of principle.

The point can be demonstrated very easily by way of the following (extremely simple) example:

Cash bonus

- Company has 100 shares in issue

- Company's profits for EPS purposes are £100
- Company's EPS is therefore $^{£100}/_{100 \text{ shares}}$ equals £1
- Company pays cash bonus of £10
- Company's profits fall to £90
- Company's new EPS is $^{£90}/_{100}$ equals £0.90

Option

- Company grants options over 10 shares
- Options deemed to have a value of £10
- Company's profits fall to £90
- Company's new EPS figure is $^{£90}/_{110}$ equals £0.83

Clearly, therefore, the provision of options (as opposed to cash) has led to a greater reduction in the company's EPS figure. This does not seem correct as a matter of principle.

The IASB tries to justify this double hit at paragraph BC50 of the "Basis for Conclusions" by arguing that there are in effect two separate events that should be recognised (the issue of shares and the "consumption of the asset"). A very peculiar analogy is drawn with an issue of shares for plant and machinery and reference is made to paragraphs BC37 and BC38 of the Basis for Conclusions (the depreciation in the plant and machinery is taken to be similar to the "using up" of employee services over a certain period).

The analogy with plant and machinery seems absurd. First, an employee's services do not depreciate over time. Secondly, if the analogy were correct, then an employee's services would (like plant and machinery) be treated as an asset in the company's balance sheet. The fact that this is not done (and would be somewhat ridiculous if it were done) illustrates how inappropriate the analogy is.

We suspect that the IASB may have deliberately chosen a depreciating asset in order to justify the similar treatment of employees' services. Indeed, reference is made in paragraph BC37 to the issue of shares for cash, where it is stated (which is unarguable) that "an entry is required to recognise the cash received". Our point here is that this would presumably be a single capital (not income) entry which would not lead to any "second hit" in the EPS calculation. Indeed, if the cash was used wisely by the company and generated a good return, there might be a positive enhancement of the EPS figure.

Other anomalies arise in relation to the EPS calculations. For example, there would be no double hit to EPS if an option related to existing shares. In that case, the denominator (i.e. the number of shares) would stay the same, but with the numerator (the earnings figure) being reduced (whether under existing accounting treatment or under the IASB proposals). Again, it appears that the differences between the use of newly-issued and existing shares have not been appreciated. In addition, if an option lapses, then (as mentioned earlier) both the numerator and the denominator should be corrected in order to "true-up" the accounts and not mislead the users of accounts. Under the IASB proposals, the denominator (the number of shares) would automatically be corrected if an option lapsed, but that would not be true of the numerator. There would therefore be a hit to EPS even where an option lapses. Again, that simply seems incorrect as a matter of principle if the purpose of the accounts is to give a "true and fair" view.

In short, we consider that the proposals have a number of unfair impacts on the EPS calculation and, in particular, create a double hit to EPS which cannot be justified.

6. **ALLOW A COMPANY TO CHOOSE WHETHER TO EXPENSE OPTIONS OR EMPLOYEES' SERVICES**

We suggest that a company should have the right (i.e. the choice) to value an option in terms of the employees' services instead of using an option-pricing model. We cannot see any reason why this type of flexibility should not be permitted. The whole basis for valuing an option is that it is believed by the IASB that the value of the option is more readily determinable than the value of the employees' services. However, we doubt whether that will always be true. As mentioned below, there clearly are huge uncertainties as to the correct method of valuing an option in the first place. By contrast, it might be relatively straightforward, for example, to place an economic value on the number of options granted to a CEO. This might be done, for example, by comparing his total "package" with the equivalent "packages" of CEOs in comparable companies. To the extent that his options seemed to replace a comparable element in another CEO's package, that would equate to their value.

7. **UNRELIABLE OPTION PRICING MODELS**

We are concerned that the use of a conventional option-pricing model, when modified in various ways to take account of the particular features of employee options, will simply make the model unreliable as a valuation tool. Bearing in mind that the authors of the Black Scholes method won the Nobel Prize for their efforts (thus, at the very least, indicating the complexity of the method), it seems clear to us that any "tweaking" of the method (which, after all was not intended to be used for employee options in the first place) is very likely to produce results which are simply unreliable. Further, the option pricing models themselves and, to an even greater extent, the "tweaking" of those models required under the proposals call for a detailed understanding of how each share scheme works and for a large number of assumptions about the future behaviour of the market for the company's shares, interest rates, the performance of the business and the behaviour of employees.

These will, inevitably, be done in different ways by different companies. The results will be wildly inconsistent across companies and even across different years of the same company and so, we suspect, of limited value to investors. The lengthy disclosures required by the proposals will not assist as investors will be unable to assess whether or not the assumptions are sensible. The figures will be useful, however, in alerting investors to the danger of relying on the figures.

Clearly, in the context of trying ensure that the accounts give a "true and fair" view of a company's financial circumstances (and further taking into account the lack of any "truing-up" under the IASB proposals), it seems very unsatisfactory that a potentially unreliable method can be used in this way.

8. **EXEMPTION FOR UNLISTED COMPANIES**

Additionally, we strongly believe that there should be an exemption from the proposals for unlisted companies. The fundamental differences between listed and unlisted shares (no market, uncertain share valuation etc.) simply make it impossible to apply the IASB proposals meaningfully to unlisted companies. In addition, there must be an even stronger argument that shares delivered to employees in an unlisted company are not provided as a form of remuneration (since, among other things, the shares cannot easily be sold to realise cash). Instead, they are much more likely to be provided as part of a programme of widening the shareholder base within an unlisted company to include employees as well as the existing owners of the business.

9. **SMALL AND NEWLY-FORMED COMPANIES**

Particular problems are likely to arise for smaller and/or newly-formed companies. In the first place, as compared to the size of the company, the compliance cost associated with the use of an option pricing model (and the need to pay an adviser to "tweak" the model in various ways etc.) may be completely unreasonable, given the financial resources of the company concerned. There must also be a danger that, in the case of a small company, the factors on which any option pricing model relies (in particular, share price volatility) may have a hugely disproportionate effect upon the company's accounts. In simple terms, the accounts of a large company can probably absorb the cost of options quite easily, whereas that may be much more difficult (and therefore, much less reasonable) in the case of a small company.

A separate (but related) problem arises for newly-formed companies. In the first place, a newly-formed company is likely to be relatively small, in which case the problems mentioned above for small companies generally will arise. Moreover, it seems obvious that a newly-formed company will not have the necessary data (historic share price performance, historic volatility etc.) which will enable it to make meaningful "tweaks" to the chosen option pricing model. Therefore, in the case of a newly-formed company, the expense to be recognised in the accounts will be based on pure guesswork and will therefore be misleading and unreliable.

For the above reasons, we believe that the proposals should not apply to small and/or newly-formed companies. There would be no difficultly in creating exemptions for such companies - the exemptions could, for example, be based on the market value of the company or the number of years of trading since its inception. These exemptions would not significantly undermine the proposals. Instead, they would simply recognise the fact that, in the case of certain types of company, the proposals can produce unfair results.

10. **RESTRICT COST TO CONSOLIDATED ACCOUNTS ONLY**

It seems incorrect as a matter of principle to impose a charge on a subsidiary where options have been granted to its employees by its parent company. In the first place, the subsidiary has borne and will bear no cost in relation to the option (it is not a party to the contract between the parent company and the employee). Why, therefore, should its profits be reduced by the proposed accounting expense? From a practical point of view, why not simply limit any accounting cost to the group accounts? In reality, the typical user of accounts is likely to be concerned only with the group accounts and it seems to us an unnecessary compliance cost to force subsidiaries to have to adopt the IASB proposals as if they were providing the equity instruments to employees.

11. **STOCK APPRECIATION RIGHTS ("SARs")**

The proposals in relation to SARs seem to add complexity to the way in which a SAR would currently be accounted for by a company, without affecting the overall accounting charge. Under current accounting rules, a company will typically make an annual provision against the likely cost of making a payment to an employee when a SAR is exercised in the future. As and when a payment is actually made, there is then a "truing-up" so that, for example, there will be a further charge in the accounts if the value of the payment exceeds the previous provisions or, by contrast, there will be a write-back in the accounts if the actual payment is less than the provisions previously made.

Under the IASB proposals, the net result is ultimately the same (i.e. there is again a truing-up when a payment is made). The only difference is the way in which the payment is provided for at an earlier stage (i.e. the proposals envisage that a SAR will be subject to the same option-pricing model as a share option, but with a truing-up at the point of payment).

It does not seem sensible (and obviously may represent a major compliance cost for a company) to oblige companies to make provisions at different times and in different amounts where, ultimately, the actual cost in the accounts will be the same as under the current accounting treatment. We therefore consider that, in the case of SARs or any other cash-based awards, the current accounting treatment should continue.

12. **EXCESSIVE DISCLOSURE**

The element of disclosure required under ED2 is clearly excessive and, in many cases, amounts to the provision of commercially-sensitive information. Specifically:

(a) If a company operates (say) four separate employee share schemes (which is common, particularly in larger companies) and (say) there are five option grants outstanding under each scheme, then paragraph 46(a) of ED2 seems to require 20 separate grants to be disclosed in the accounts. Taken together with the other information referred to in paragraph 46, the overall level of disclosure (as compared with the general content of the report and accounts) would be unwieldy and completely disproportionate;

(b) Any assumption as to the likely level of vesting of an option could be price-sensitive in that it could reveal (say) a future redundancy programme (where vesting is assumed not to occur due to future terminations of employment) or could be viewed as a form of profits warning (to the extent that it implied that future corporate performance targets would not be met) or, say, the likely duration of a new CEO's tenure;

(c) Any disclosure of the dividends expected to be paid is obviously highly sensitive in that (for example) an assumption that dividends might fall could again be viewed as a form of profits warning.

From a practical point of view, it might be better simply to disclose the value attributed to each option and to state that, of course, this value was arrived at in a proper way by reference to a specified option-pricing model, with adjustments that had been audited by the auditors.

13. **ALTERNATIVE ACCOUNTING TREATMENT**

A more acceptable way of dealing with the accounting treatment of options and other share awards for employees would be to improve the quality of disclosure in the company's accounts. For example, the position in the UK at the present time is that there is very significant disclosure of options and other share awards granted to directors (the disclosure includes, for example, grant date, exercise price, vesting period, applicable performance targets (if any), weighted average gains etc.), with such disclosure applying to each director by name. By contrast, in the case of options or other share awards granted to non-directors, there is generally a somewhat "broad" disclosure with very little detail as to the potential gains to be made by employees.

In the case of non-directors, greater disclosure of all outstanding awards (e.g. on the same per grant basis as is suggested under the proposals) would enable users of accounts to understand fully the commitments which the company has made under its employee share schemes (the individual disclosure of directors' awards would continue). Users of accounts would also be able to calculate the likely gains to be realised by employees and the dilution cost to shareholders. There would be no need for option pricing models or other similar mechanisms which may distort a company's accounts. Moreover, this fuller disclosure would distinguish the use of newly-issued shares as compared with existing shares, with an actual accounting cost being attributed to the use of existing shares.

In short, this alternative accounting treatment would give users of accounts all the information they require in order to assess the impact on the income, capital and prospects of the company arising from employee share schemes without any of the distortions and problems which arise under the IASB proposals.

14. **CORPORATE TRANSACTIONS**

There seems to be nothing in the IASB proposals to give guidance on how the proposed expense should be varied (accelerated, written-back or whatever) in relation to corporate events. We have not sought to describe in detail the great number of corporate events (takeover, re-organisation, demerger etc.) which might affect an employee's participation in an employee share scheme. In all cases, however, there is invariably some impact on the options held by the employee at the time of the corporate event. There is no guidance in the IASB proposals as to how the accounting charge should be dealt with if such an event should occur.

To illustrate the need for guidance, it might well be the case (for example) that, on a takeover, the vesting of some options would be accelerated, other options might lapse (e.g. where performance conditions relating to the exercise had not yet been met at that time) and other options might be exchanged for options of equivalent value over shares in the bidder. It is not remotely clear from the IASB proposals how each of these possible effects on outstanding options should be dealt with. The fact that we, as experts in the area of employee share schemes, cannot understand how the IASB proposals are meant to apply to corporate transactions suggests that the proposals need to be developed further in this respect.

15. **IMPLEMENTATION DATE**

We believe that, in the UK, the implementation date for the proposals should be delayed until 1 January 2005 or such later date as all major economies (including in particular the US) have adopted the proposals. The reasons for this are as follows. First, 1 January 2005 is the EU implementation date, i.e. the date on which all international standards adopted by the EU Commission will become compulsory for all EU listed companies. Since the purpose of international standards is to have common accounting standards worldwide, it makes sense to have a common start date. Moreover, 1 January 2005 is also the date on which EU company law will be changed to permit the new standards, as it will override any domestic laws which conflict with them (we believe that the IASB proposals currently conflict with UK company law). More generally, companies will simply need time to put in place systems to comply with the new proposals. Since the IFRS is not expected to be produced until late 2003, it is unreasonable to expect companies to have all their systems in place by 1 January 2004.

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