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# Comments 'ED 2 Share-based Payments'

## Synopsis

These comments pertain to the IASB's Exposure Draft 2 Share-Based Payments. They do not relate specifically to any of the question proposed by the ED but rather to the fundamental concepts embodied by the exposure draft in terms of share-based payments settled by the issue of new equity.

This is clearly a controversial issue as a large portion of the basis for conclusion is devoted to tackling problems arising from the proposals in the ED regarding transactions settled with new share or option issues. The ED's point of departure is that the act of issuing new shares for services rendered is effectively the entity paying for services by issuing its own equity. Thus an expense is necessary in the income statement to correctly account for the consumption of the resource consumed.

The arguments proposed by these comments are based around the belief that the issue of new shares is the transfer of a portion of the existing shareholders rights, to the company's assets and future earnings, from the existing shareholder to the new shareholder.

The arguments put forward are thus structured around this premise. These comments begin with a justification of the Fundamental Argument being considered. The ED's justification of its proposal, as outlined in the basis for conclusions, is then examined. The comments then move onto changes that would be required to the exposure draft.

## Scope of comments

These comments are limited to transactions where the share payment is fulfilled by the company issuing new shares or issuing share options with the intent to issue shares if the option is exercised.

Transactions settled by the company buying back its own shares or purchasing options through a 3rd party are excluded.

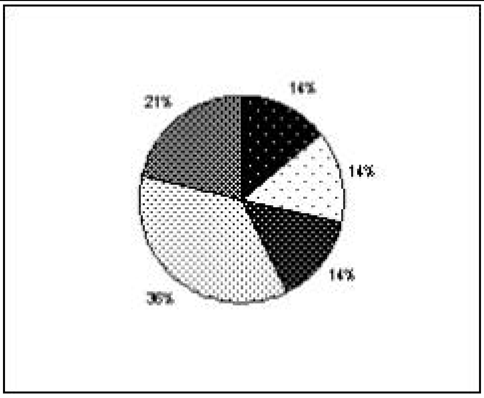
These comments have been written bearing in mind that IAS does not only apply to listed companies but unlisted private and public companies as well.

## Fundamental argument

Owning shares represents owning a percentage of that company, in substance if not in law. Including all its assets and liabilities. Therefore issuing shares takes a fraction of each person's current share holding and gives it to the new shareholder. This argument directly contradicts the boards view that *'Entity, not Shareholders set-up employee share plans and entities, not shareholders, issue options to their employees.'(BC 30)* Although the legal form of the transaction is for entities to issue shares, the economic substance of the transaction is that the existing shareholders reduce their claim on the company's assets and future earnings in favour of the new shareholders, as demonstrated by the graphs below. As payment for this the new shareholders contribute cash to the entity, compensating the existing shareholders with an increase in the net asset value of the entity.

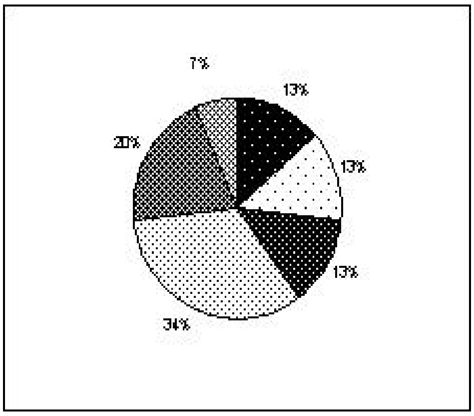
**Share holding *Before* share issue**

| | No of shares | % holding |
|---|---|---|
| 1 | 2000 | 14% |
| 2 | 2000 | 14% |
| 3 | 2000 | 14% |
| 4 | 5000 | 36% |
| 5 | 3000 | 21% |
| **Total** | **14000** | **100.0%** |




**Share holdings *after* Share issue**

| | No of shares | % holding |
|---|---|---|
| 1 | 2000 | 13% |
| 2 | 2000 | 13% |
| 3 | 2000 | 13% |
| 4 | 5000 | 33% |
| 5 | 3000 | 20% |
| New s/h | 1000 | 7% |
| **Total** | **15000** | **100.0%** |




AC 100 states that the overriding requirement of fair presentation is '***Substance over form,*** *Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely their legal form.'(AC 101 Para .11)* These comments will attempt to demonstrate that the 'ED 2 Share-Based Payments' does not fairly represent the substance or presentation of the transaction with the proposed treatment of companies issuing new shares or share options to employees or other providers of service.

### Additional considerations

- One should ignore the role of the entity in the physical process of issuing shares.
- Any new share issue must be authorised by the shareholders.

## Transfer of equity instruments to employees

The basis for conclusion addresses the fundamental issues that have been raised in opposition to the proposed accounting for share-based payments including the arguments presented earlier. This section will follow the format of the basis for conclusion and justify the current treatment of share-based payments as outlined by the existing International Accounting Standard. The relevant sections of the basis for conclusion have been included in appendix 2.

BC 16 and 17 proposes '*In some situations, an entity might not issue shares or options to the employees (or other parties) direct. Instead, a shareholder (or shareholders) might transfer equity instruments to the employees (or other parties).*

*Under this arrangement, the entity has received services (or goods) that were paid for by its shareholders. The arrangement could be viewed as being, in substance, two transactions—one transaction in which the entity has reacquired equity instruments for nil consideration, and a second transaction in which the entity has received services (or goods) as consideration for equity instruments issued to the employees (or other parties).*

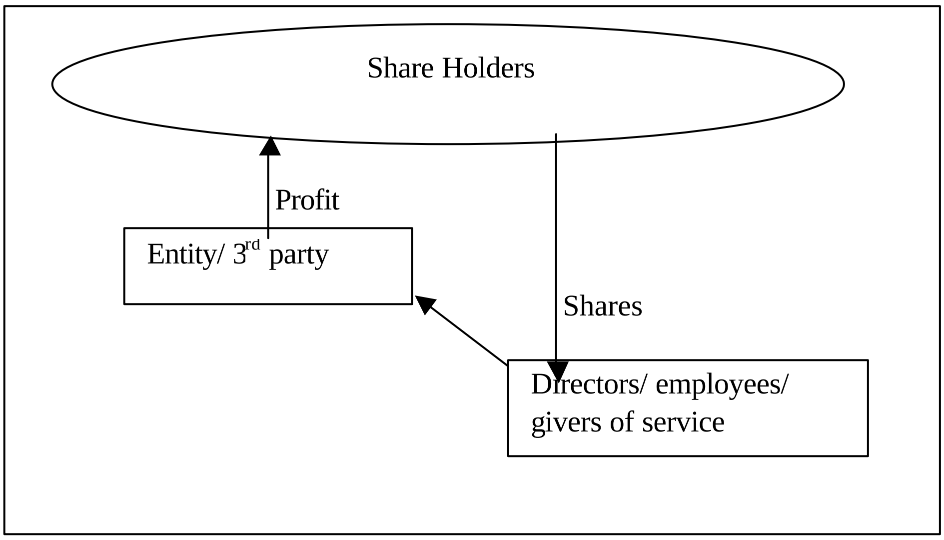
Following the argument that the issue of new shares is effectively a transfer of equity the substance of this transaction is economically the same as issuing new equity. Except that the shareholders receives payment by the employee rendering services to the entity, which the shareholder owns a percentage off.

BC 17 views these transactions in 2 parts. The receipt of equity for nil value and then pays for services by re-issuing the equity. This transaction could also be viewed as the employee or other party receiving the equity form the share holders and paying for the equity by performing service to the shareholders asset, the entity. This argument is discussed further under 'The entity is not party to the transaction'

## Equity settled share-based payment transactions

### 'The entity is not party to the transaction'

Arguments for and against the recognition of share and option issues as an expense hinge on the **assumption** that the entity is a party to the transaction. The basis for conclusion takes the view that the entity is party to the transaction




**Graphical**

**depiction of the effect on the entity of a share issue**

The substance of this transaction is that share holders give a percentage of their ownership to the Director, or providers of professional services, the directors in return for this will provide service to the entity with the intention of increasing the profit, net asset value or share price of the entity. The shareholders then effectively receive the service as an increase in the value of their shareholding, represented by an increase in EPS, an increase in their % of net assets or share price. For the share issue to be profitable to the shareholder the value of their holding must increase more than it will be reduced by the dilutive effects of the share issue. Thus the entity is affected by the transaction but is not a party to the transaction. Therefore the transaction should be accounted for in the shareholders books

**'There is no cost to the entity therefore there is no expense' (BC 36 – 39)**
*'BC35 Some argue that because share-based payments do not require the entity to sacrifice any cash or other assets, there is no cost to the entity, and therefore no expense should be recognised. The Board regards this argument as unsound, because it overlooks that:*
*(a) Every time an entity receives resources as consideration for the issue of equity instruments, there is no outflow of cash or other assets, and on every other occasion the resources received as consideration for the issue of equity instruments are recognised in the financial statements; and*
*(b) The expense arises from the consumption of those resources, not from an outflow of assets.'*

Under the 'ED' the cost of the service provided by the payment of shares is expensed in the income statement and equity is credited with a gain. At the end of the financial period this expense is transferred from profit and loss to equity effectively cancelling out the initial gain. This has the same net effect on equity as if no initial transaction had occurred. I.e. not expensing share options.

This raises the question does the expense on the income statement represent fair presentation of the companies financial performance for the period and change in financial position.

The service was provided and paid for by the shareholders presumably with the intention of increasing the organisations net assets and profits enough to counteract the dilutive effect of issuing shares. The share payment should have increased the assets of the enterprise

BC 37 and 38 argues that 'The Recognition of an expense arising out of such transaction represents the consumption of resources received, i.e. the using up of resources received for the share options.' If one follows the premise that the shareholders resources paid for the service fair presentation is achieved by not putting an expense through the income statement of the entity but rather through the income statement of the shareholder. The arguments presented in BC 37-38 focuses on the depreciation of machinery as equivalent to the organisation expensing service paid for by share options. This is not a correct comparison as the depreciation expense is the recognition of the reduction of the assets value in the balance sheet and is necessary to maintain fair presentation. If this expense were not put through assets would be overstated. The depreciation represents an adjustment to the company's financial position and not to the initial recognition of an item on the balance sheet.

One does not recognise internal brands and human capital on the balance sheet, as it is impossible to accurately account for assets of this nature. Why should one therefore recognise an expense, consumption of asset, in the income statement that cannot be valued or accounted for accurately. Please note that this example is only applicable to the disclosure and fair presentation issues and cannot be used in relation to the accounting issues around share-based payments.

### ‘Adverse economic consequences’ (BC 53- 55)

*‘BC53 Some argue that to require recognition (or greater recognition) of employee share-based payment would have adverse economic consequences, in that it might discourage entities from introducing or continuing employee share plans.*

*BC54 Others argue that if the introduction of accounting changes did lead to a reduction in the use of employee share plans, it might be because the requirement for entities to account properly for employee share plans had revealed the economic consequences of such plans. They argue that this would correct the present economic distortion, whereby entities obtain and consume resources by issuing valuable shares or options without accounting for those transactions.’*

The greatest benefit of the statement is that it makes the shareholders aware of the true cost of the options. This kind of disclosure should be required of all organisations. However the accounting is fundamentally flawed and accounts for the transactions adversely. The transactions should be accounted for in the shareholders books, as they are the ones whose resources are being consumed.

*‘… it is not the role of financial reporting to give favourable accounting treatment to particular transactions to encourage entities to enter in to them.’* (BC 11) Conversely it is not the role of financial reporting to give unfavourable treatment to a particular type of transaction and discourage organisations from engaging in them. This effectively makes the arguments in BC 55 redundant if one does not believe that the current accounting treatment is favourable.

## Share Based Payments in relation to AC 000 & AC 100, 101

This section focuses on the key issues in the conceptual framework and AC100 & 101 in relation to the ED and the existing treatment of share payments by the IAS.

### Ac 000

*Para .12*
*‘The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions’*

Paragraph 15 then emphasis the need to provide information to users to enable them to ‘*Evaluate the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.*

The Proposed treatment of share based payments attempts to recognise the cost to the entity of resource consumed in the entities financial statements whereas this cost is actually born by the shareholders and as such should be reflected in the shareholders financial statements. The cost of share options will be reflected in shareholders financial statements through a fair-value or market value adjustment to their investment. It has been argued in studies that the share price, market value, does not adjust for the issue of options and new equity, however it should be noted that the aim of issuing share options is often to improve the performance of a business negating the dilutive effect of issuing new shares.

Ac 000 defines financial position in terms of Equity, which is equal to Assets less Liabilities. The change in equity each year therefore represents the change in financial position. Matching between income and expenditure is used to ensure that the financial position of an entity is not distorted. Expenses are recognised in the income statement on the basis of a direct association between the cost incurred and the earnings of specific income. This raises the question of what income has been earned to justify the expense of share-based payments and why is the income recognised directly in equity and not in the income statement. All of these considerations are unrelated to the generation of cash and cash equivalents and do not provide decision useful information.

**Ac 100**

**Fair presentation and comparability AC 100**

The proposed treatment makes it difficult for prospective shareholders to discern the economic performance of companies that have issued share options, as income would appear understated, reducing the reliability of most valuation techniques. This would be further compounded if the prospective shareholder did the valuation using diluted EPS, as the dilutive effect of the option as well as the reduced income would be included in the valuation model. These effects are undesirable in terms of AC 100. Ac 100 aims to provide information that is comparable with previous periods and other companies in the sector. This will not be possible as the expense created from share based payments will vary massively from company to company depending on their share price and a myriad of other factors that could be used to distort the accounting value without changing the economic effects of the transaction.

**AC101**

Ac 101 highlights the importance of the matching concept. *"Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earnings of specific items of income.' (AC 101 Para. 95)* This is a mainstay of the proposed accounting for share-based payments. The Exposure Draft correctly argues that the entity received resource from a share-based payment, the service rendered. Thus in terms of AC 101 a corresponding expense should be recognised. This fails to recognise two points about the financial statements. Firstly they are meant to provide information decision useful information to users. The exposure draft does not provide useful information to either shareholders or creditors. Creditors are primarily concerned with cash flow, as debts are usually payable in cash and shareholders are concerned with the future earnings of a company and its return on equity. The exposure draft makes all these more difficult to determine. Secondly the income with which the expense of share-based payments is associated is not always possible to determine. Share based payments are often used to obtain benefits for a company that do not directly affect the bottom line. I.e. the long-term commitment of management to the company or the increase of share price.

AC 101 Para .88. The overall changes in equity represent the total gains and losses generated by the enterprise during the period. The exposure draft creates a gain in equity and then a loss in the income statement that cancels out the gain made in equity. These changes do not fairly reflect the performance of the company during the period.

## Conclusions on ED 2 Share-based Payments

The Exposure Draft has been written treating all share based payments the same and has neglected the economic reality and substance of these payments that are fundamentally different. The linking of ones salary to the share price, phantom share scheme, is a fundamentally different transaction from the issue of new shares. The key problem with the Exposure draft lies in Para 4 & 5. *'Recognition of services when acquired through a share issue or option issue (Para .4 & 5)'.* Para 4 & 5 require that services acquired by share issue or share option be recognised. This assumes that the option issue will either be exercised in which case the company will settle the transaction by issue of shares and receive some form of financial resource for its shares or if the option is allowed to lapse their will be no services rendered to the company.

## Conclusion

*"… it is not the role of financial reporting to give favourable accounting treatment to particular transactions to encourage entities to enter in to them." (BC 11)* Equally it is not the role of financial reporting to give unfavourable accounting treatment and thus discourage the practice.

The expensing of share-based payments with the corresponding gain in equity effectively distorts the company's financial results by recognising a gain in equity that does not exist, as there is no corresponding increase in resource over which the entity has control.

It should be recognised that most companies are complex entities that are comprised of several interlinked parts such as their physical assets, intellectual assets, human capital, public perception, brand recognition, market shares and environmental and social responsibilities. The running of these entities is a hard and complex task as such straightforward cash transactions have never been sufficient to maintain human capital. Perks and job satisfaction are key considerations to most employees as well as the working environment. These Non-financial factors are never costed and added to the financial statements unless they lead to a reduction of an asset, this expense being necessary to correctly reflect the asset value of the company.

Share-based payment made with the issue of new equity or share options do not have a financial effect on the entity but on the shareholder and should be excluded from the entities financial statements.

Please do not hesitate to contact Richard Tanner on (027833022829) if you wish to discuss any of the issues raised.

Yours faithfully,
Richard Tanner