The European Employee Stock Options Coalition – EESOC

Ms Kimberley Crook
Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Brussels, 7 March 2003

Dear Ms Crook,

Re: Invitation to Comment on Exposure Draft *ED2 - Share-based Payment*

I am writing to you on behalf of the European Employee Stock Options Coalition (EESOC) in response to the IASB proposal on expensing stock options[1].

The EESOC is a group of companies and organisations, which are concerned about the recent IASB proposal to require companies to treat employee stock options as expenses. The Coalition's mission is to contribute to creating a favourable regulatory environment for Employee Stock Option Programs (ESOs) in the EU. The EESOC also promotes timely disclosure of accurate, reliable and meaningful financial information in relation to stock options as good accounting and as good corporate governance.

In summary, the EESOC believes that the IASB proposal on share-based payments is inconsistent, technically flawed, leaves some important implementation questions unanswered and would, if adopted, impair the credibility of reported numbers by reducing comparability and introducing an opacity to the accounts. EESOC's concerns arise at three levels and each of these will be dealt with separately and in some detail below.

- Firstly, the characterisation of ESOs as an expense based on the value of resources consumed is not exhaustively motivated. Indeed EESOC questions whether ESOs are a corporate level expense at all.

- Secondly, the measurement of the alleged expense using the class of models represented by the Black-Scholes model gives rise to estimation error of such a magnitude as to remove the intended information content of expensing.

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[1] IASB Exposure Draft – *ED 2 Share-Based Payment* of 7 November 2002.

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- Thirdly, the implementation of Exposure Draft 2 (ED 2) as a standard will impose a significant real cost on Employee participation which EESOC believes to be highly undesirable.

There is increasing evidence that the mandating of expensing options on the grant date basis, as envisaged by the IASB, will have a significant impact on European companies. Furthermore the impact would appear to be asymmetrical across firms. Technology and Pharmaceutical firms, young firms and small firms are likely to be disproportionately affected. This is the case because technology and pharmaceuticals firms rely largely on ESOs and would therefore be badly damaged and obliged to abandon the use of an essential instrument for employee participation in the ownership of business.

It is not by chance that ESOs are so common in enterprises facing high uncertainty, where ESOs operate as risk-sharing devices rather than as simple compensation awards. The IASB characterisation of these instruments is thus rather superficial. There is considerable international evidence to demonstrate a strong association between ESOs and corporate performance. If the aim of the EU is to improve economic performance in the future, adopting rules that lead to the abolition of ESOs would seem to be counter-productive.

The EESOC members are firmly convinced of the importance of presenting accurate, reliable and meaningful information on stock options. Such disclosure is an essential part of the European strategies to move towards greater transparency in company accounts. For this reason, the EESOC is convinced that it is crucial that the EU develops a common set of accounting rules for stock options which ensure that investors, employees and other stakeholders receive accurate and consistent information on a regular basis and which allow for a wider use of ESOs.

1. Employee Stock Option Schemes do not constitute a corporate level expense

1.1 <u>ED 2 invents a new expense associated with ESOs</u>

The proposed creation of an expense out of ESOs does not pass the most basic tests of expense recognition. The profession's own definition of an expense is an outflow or consumption of assets or creation of liabilities representing actual or expected cash outflows that have occurred or will eventuate. Nothing of the kind happens when companies offer their employees the opportunity to become partners in the enterprise through ESOs. There is no outflow of any sort, no asset is impaired and no liability is created. Indeed, if an employee ultimately exercises an ESO, the firm's assets

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are increased. The granting of an ESO simply provides for a potential redistribution of the firm's future earnings between existing shareholders and the new shareholder base, which would include those employees who have exercised employee stock options.

These fundamental conceptual issues were identified by the European Commission in 2000. In July 2000, the G4+1 issued a Special Report, Discussion Paper – *Accounting For Share-Based Payment*. Once the new IASB was formed, it, in effect, reissued this Discussion Paper and sought further comment. The Discussion Paper was roundly criticized. Importantly, the Commission in its submission focused on several fundamental flaws in the Discussion Paper, which have not yet been adequately addressed by the IASB. In its letter dated 7 February 2001[2], the Commission stated that:

> Our view is that this Paper has raised some serious and fundamental questions regarding the IASC's existing Framework – for example, the accounting for equity, the definition and recognition of expenses, opportunity cost accounting – <u>and these need to be thoroughly investigated and resolved before any agreement can be reached on the accounting for share-based payments</u>. . . . Consequently, our overall position is that the new IASC Board should, as a matter of priority, commence a new project that investigates the fundamental conceptual issues that this project encountered. Until such time as this occurs, it is premature to propose a system of recognition and measurement of share-based payments that will inevitably be flawed. [Emphasis added]

Rather than address the issues raised by the Commission, the IASB did no more than repeat its flawed conclusion in ED 2. We agree with the statement made in the Commission 's Discussion Paper comment letter that the real debate should be focused on whether:

- it is appropriate to recognize opportunity costs in the profit and loss account, and if so, whether it is appropriate to restrict this far-reaching notion to shares and options, and then only for certain transactions

[2] Letter from the European Commission to the IASC, 7 February 2001, "G4+1 Position Paper: Accounting for share-based payment".

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involving them; and

- the current extensive information about share transactions and future dilution can be demonstrated as being inadequate for accounts to show a true and fair view.

1.2 <u>ESOs are not the same as share-based payments to third parties</u>

ED 2 disingenuously treats all share-based payments as a group in order to develop its basis for expense recognition. The proposition that transactions for goods and services with third parties that are settled with the granting of options or shares should give rise to the same accounting entries as for ESOs is not justified. In order to illustrate this, transactions with third parties represent two separate transactions and consequently two separate accounting entries. Firstly, there is an agreed basis for the exchange of goods and services which gives rise to a liability and therefore an attendant expense. Secondly, the payment results in the conversion of the liability to equity. The net effect of these two entries is to create an expense and increase equity in a similar amount. Applying this shortcut to ESOs ignores the crucial fact that no liability or expense arises at any time with these instruments. Indeed, when, and if, an ESO is exercised, corporate assets increase.

Moreover, coupling ESOs with share-based payments to third parties is deeply flawed for additional reasons. Share based payments to third parties, which we agree should be expensed, are typically for goods and services already consumed. Employees typically receive cash compensation in the form of salary for the services already performed for the employer. These amounts, of course, are expensed. ESOs, however, are chiefly created to provide incentives for employees with respect to *future* performance. ED 2 fails to address this important difference when developing its position on recognition.

In the case of ESOs, the crucial link between the goods and services and incentives was not established. This point is explicitly acknowledged by the IASB in the measurement section of ED 2. Failure to establish this critical link is, in our view, a fatal flaw in the document.

1.3 <u>ED 2 is internally inconsistent</u>

Although ED 2 concludes that an expense is required for all types of share-based transactions without specific reference to ESOs, the measurement

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section draws a sharp distinction between transactions with employees and transactions with others. This section of ED 2 uncouples the two types of transactions. The stated basis for doing so is the inability to link the consumption of the goods and services with the incentives in the case of employee transactions. As a result, for purposes of measurement, employee transactions are treated differently than third-party transactions.

ED 2 is internally inconsistent, however, because the *raison d'être* for the creation of the expense in the first place was the crucial link between employee and third-party share based transactions. This lack of internal consistency is irreconcilable and calls into question the underlying premise of the entire document.

1.4 Use of an option valuation model is mandatory for ESOs even where the cash value is known

ED 2 acknowledges that the amount to be treated as an expense is the fair value of the goods and services, *i.e.,* the cost to the company, and not the fair value of the instruments being exchanged, *i.e.,* the benefit to the recipient. It follows through with this logic in the case of share-based payments made to third parties – it applies a rebuttable presumption that the cost of arm's-length transactions is to be estimated directly. That is, the fair value of those instruments is the value of the goods and services provided to the company.

However, the significance of the decoupling of share-based payments with third parties and ESOs for purposes of measuring the "cost" of ESOs is that the cost of the ESOs is required to be estimated indirectly. That is, the fair value of an ESO is the value of the option itself and this amount serves as a surrogate for the fair value of the services. The reason offered, as referred to above, is the difficulty in establishing the link between the services and the incentive. This would suggest that where there is a choice between a cash package and an options package, *i.e.,* where the cash equivalent value is known, it is still prohibited to depart from the use of an option valuation model. This prohibition is made explicit elsewhere in the document. This lack of evenhandedness between ESOs and other transactions further illustrates that the conclusion of ED 2 is not fundamentally sound. It appears to be a rather clumsy attempt to pre-empt abuse which introduces an unnecessary degree of inflexibility.

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1.5 Accounting for ESOs as if they gave rise to an expense has significant implications for the credibility and accuracy of reported earnings, their comparability between companies and their consistency over time

1.5.1 Creating an expense for options places reserves beyond current shareholders

ED 2 perversely creates a disadvantage for current and future shareholders *vis-à-vis* option holders. The creation of an option expense cumulatively places, over the vesting period, retained earnings attributable exclusively to shareholders beyond their reach as dividends, just at a time when there is much demand among investors for the distribution of cash by many businesses. In effect, this provides a subsidy from existing shareholders to option holders by essentially diluting their claims to cash flows before the option holders are even potentially eligible for dividends.[3] This feature of the standard almost certainly has legal ramifications and should be addressed by the IASB. Wealth redistribution effects should really be beyond the remit of accounting standard setters, particularly when they work against the interest of those in whose name the standards are developed.

1.5.2 Inverse effect on performance will detract from the credibility of reported numbers

Applying ED 2 will have some counterintuitive and confusing effects. The imposition of an option valuation model will inevitably introduce the effect of the firm's future stock price performance into current reported earnings. Therefore, two firms with similar ESOs will not have similar reported earnings: the firm for which the market has a higher expectation of future performance, or higher stock price volatility, will have a higher value attributed to their options leading to a higher charge against reported income with the attendant lower reported income. Thus, the firm with the better prospects has lower earnings. Such a metric of performance is unlikely to attract much credibility. And this is the result only if the company makes the correct guesses when it is attempting to establish the "cost" of the ESOs. Most attempts at income determination usually result in a positive relationship between performance and reported income – the exact opposite of what would occur under ED 2. This illustrates the weakness in equating the value of the service received with

[3] Of course, many options are never exercised. Yet ED 2 would not permit the reversal of any expense that was recognized in a prior period to the extent those options are never exercised. ED 2 provides that firms should try to estimate this effect when they are establishing the expense number. Because this requires a true prediction of the future, the absurdity of this position is beyond doubt.

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the value of the benefit obtained by the recipient as the current proposal does. In addition, ED 2 creates a further divergence between reported earnings and cash flow generated, the driver of corporate performance.

1.5.3 Creating an expense for options double counts the cost

One of the first order effects of the ED 2 would be to double count the cost of the options. This is because earnings per share (EPS) would be reduced twice. Once by a reduction in reported earnings (numerator) and again by the increase in the future number of shares (denominator). The magnitude of these effects is illustrated below.

The dilution effect is, of course, the only true cost of issuing options and it makes little sense to double the effect as proposed by the IASB.

1.5.4 Expensing ESOs introduces stock market volatility into reported earnings

The phenomenon identified above is, of course, due to the insidious effect the standard would have on the objectives of financial reporting. Financial reporting exists to provide investors with useful information. The financial numbers generated by firms are intended to inform the expectations of investors. This purpose is ill served if the reported earnings are significantly affected by the expectations regarding the reporting entities own future performance – and even worse where the effect is inverted. The valuation of ESOs along the lines proposed in ED 2 is based largely on the market's expectations of future performance as reflected in the behaviour of share prices. The equating of the value of the service with the value to the recipient is again the culprit.

2. The ED2 prescriptions on measurement models are seriously flawed

The draft standard allows little leeway for the valuation of ESOs which will be required to be valued using a particular class of option pricing models. ED 2 explicitly identifies the Black-Scholes and Binomial models as standard and it further specifies the six key input variables that should be applied.[4]

[4] The six factors that must be taken into account are the exercise price, the expected life of the option, the current price of the underlying stock, the expected volatility of the underlying stock, expected dividends on the underlying stock, and the risk free interest rate.

Furthermore, no downward adjustment is permitted to recognize the fact that most ESOs cannot be exercised during the vesting period. The stated reason being that the Black-Scholes model assumes no exercise during the life of an option.[5]

The major problem with the mandatory use of existing option pricing models to value ESOs is that they were developed to value something entirely different. The Black-Scholes and Binomial models were developed to estimate the price of short-term, freely tradable options.

The three most significant differences between ESOs and the type of options that Black-Scholes and binomial models were developed for are that:

- ESOs are not transferable. They cannot be bought, sold, or pledged. Existing models do not and cannot account for this significant difference.
- ESOs typically have long lives (of 3, 4 or even 10 years) and vest over time. The freely tradable options Black-Scholes and binomial models were developed for generally are very short lived. Again, existing models do not and cannot account for this significant difference.
- ESOs generally have no intrinsic value when they are granted. ESOs are usually issued at or over the market price of the underlying stock. As a result, they do not have any intrinsic value at that time. The intrinsic value is the difference between the market price of the stock at the time the option is granted and the option exercise price. Freely tradable options generally do have an intrinsic value at the time they are issued.

ESOs also are subject to forfeiture and, if the option exercise price is below the price of the underlying stock when the option is exercisable, those options will never be exercised. Prior to meeting vesting conditions, ESOs are not really an option in the sense of the model.

It should be understood that these models also are subject to considerable estimation error, which is significantly amplified given the long expected life of the option. For example, companies must estimate the volatility of their stock. Volatility is a relative measure of the expected difference between the stock price at the end of the stock option's life and the stock price when the

[5] The Black-Scholes model estimates the value of a so-called European option, which cannot be exercised until the end of its life. In contrast the Binomial model estimates the value of a so-called American option, which can be exercised at any time during the life of the option. The American option is always more valuable than the European counterpart, ceteris paribus.

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option is granted. The volatility chosen can have a significant difference on the valuation. Virtually any volatility figure can be justified.

The apparent precision of the models is overwhelmed with error when applied to long-term options, which brings into question their use, especially as a surrogate measure of the cost to the company of granting an ESO.

2.1 Empirical evidence establishes the problems with using Black-Scholes (B-S) to value ESOs

A considerable body of evidence has now been assembled which demonstrates the extreme distortions that result from applying B-S style models to valuing ESOs. A number of key aspects of the data available are presented for the three hundred and seventy five European (146) & US (229) companies in the world's largest companies by market capitalisation. All of these firms had significant ESO programmes. Until recently, only two large companies, Boeing and Winn-Dixie, opted for the creation of an expense, the rest chose the pro forma alternative. All but a few of the 375 companies applied the Black-Scholes model for purposes of computing the required footnote disclosures.

2.1.1. The prescribed models excessively overvalue options

In order to demonstrate the extent to which the models prescribed by ED2 exaggerate the value of ESOs, the options the options granted by all 375 companies were calculated using the actual data reported by the companies and their stock prices at balance sheet date for the last three years. The value of the options based on the B-S model are reported graphically as a percentage of stock price in the figure below for the latest year. Exchange traded options trade at between 1% and 5% of the stock price. Here it is demonstrated that a significant proportion of these options are valued at 50% or more of the stock price. Bearing in mind that over two thirds of these options were "underwater", i.e. the share price was below the exercise price[6].

[6] The reference to an appendix in all figures refers to an Oxford Metrica database.

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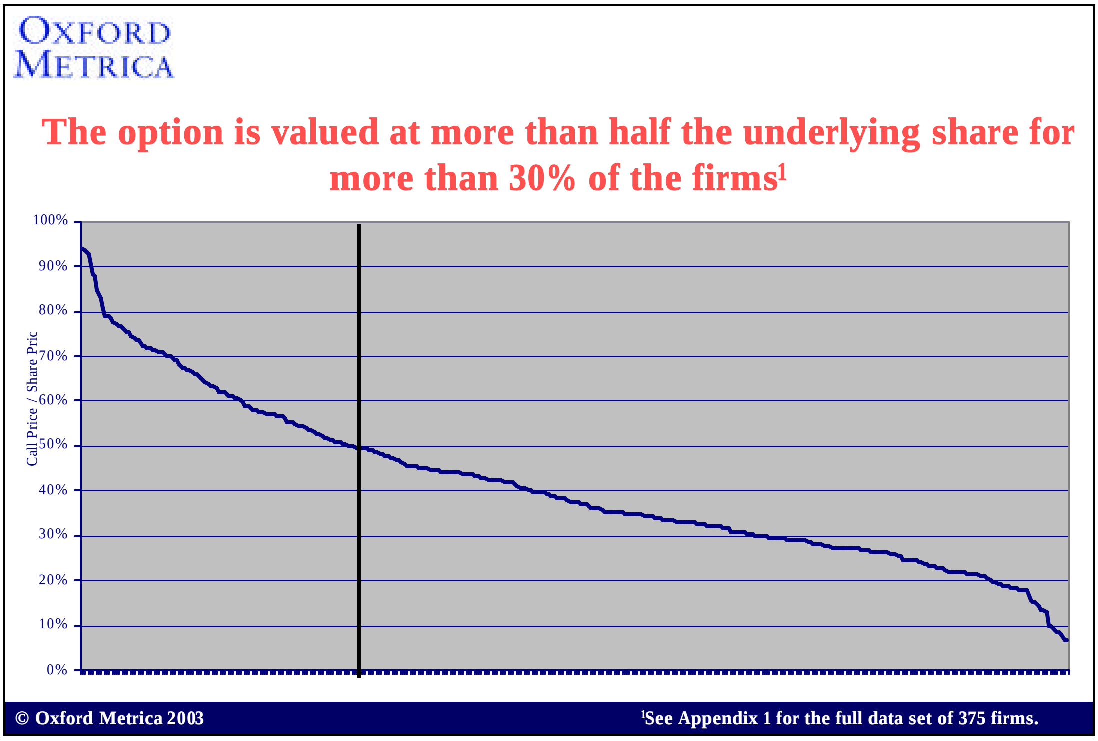

The following figure illustrates this point further with a number of specific company examples. Even options deeply out of the money such as Alcatel are attributed a very high value under the B-S model. If volatility is high enough and the expected life long enough all options will converge on the share price. In the case of ESOs the model is literally overwhelmed by the effect of volatility and a boundary result emerges, the option values generated by the model converge on the share price. This is a mathematical result rather than an economic reality. Since ESOs are not tradable the value attributable to volatility is illusory. The results show that on average across this set of companies approximately 80% of the option value for each company was attributable to volatility.

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OXFORD METRICA

B-S values a long term option as the share[1]

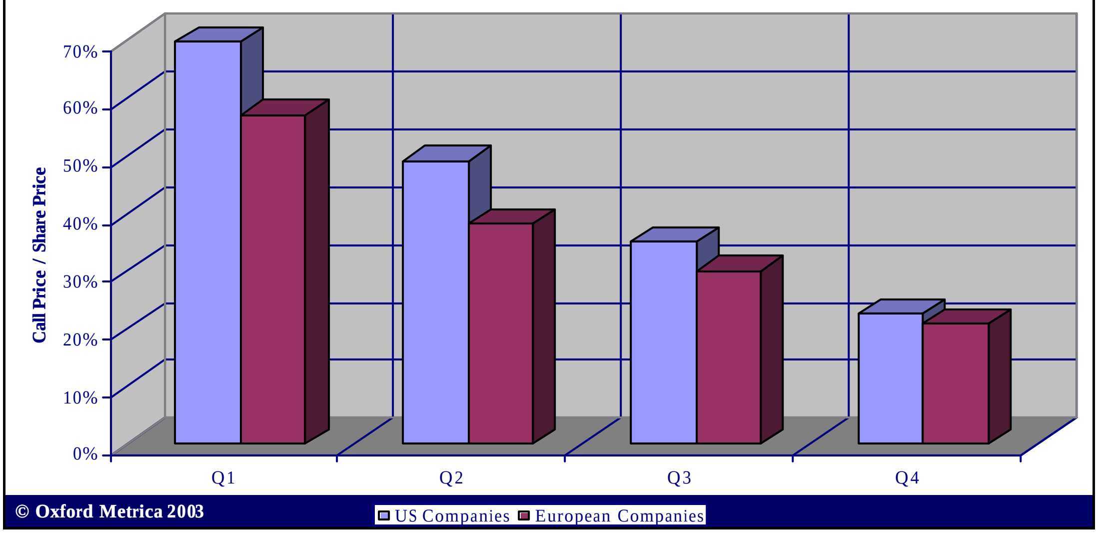
Company	Country	Share	Exercise	2001 Black-Scholes Assumptions				2001	
		Price	Price	Life	Volatility	D Y	Risk-free	Call Price / Share Price	delta
Concord Communications	US	32.78	32.78	7	89.00%	0.00%	6.00%	80.7%	0.91
Wanadoo	FR	5.63	6.00	10	58.30%	0.00%	4.65%	71.0%	0.87
Lundbeck	DK	210.66	66.60	5	30.00%	1.00%	4.00%	69.9%	0.99
Luxottica	IT	18.43	9.67	5	53.58%	0.53%	5.74%	66.9%	0.91
eBay	US	66.90	46.24	3	81.00%	0.00%	3.60%	62.8%	0.85
STMicroelectronics	FR	36.05	32.22	5	57.40%	0.10%	4.50%	56.1%	0.82
LVMH	FR	45.70	47.00	8	51.93%	3.19%	4.65%	44.3%	0.79
Seat-Pagine Gialle	IT	0.91	1.20	3.5	62.13%	0.00%	5.74%	41.5%	0.70
Alcatel	FR	19.20	35.00	5	71.69%	4.06%	4.65%	37.4%	0.67

[1]See Appendix 1 for the full data set of 375 firms.

The figure below illustrates that this overvaluation pattern across companies is similar in both Europe and the United States.

OXFORD METRICA

Similar pattern in Europe & the US



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2.1.2 The use of B-S will considerably reduce comparability

It may have been assumed that a model which prescribed very specific inputs would at least lead to conformity across companies that would not detract significantly from comparability. The exact opposite has been experienced and the adoption of the ED2 will considerably jeopardize comparability. The following figure illustrates the range of input values across the 375 firms for each variable.

OXFORD METRICA

A wide array of reporting choice[1]

2001	Black-Scholes Assumptions			
	Life	Volatility	DY	Risk-free
Minimum	0.33	6.00%	0.00%	1.70%
Mean	5.72	38.51%	1.82%	4.96%
Maximum	10	92.13%	8.00%	8.00%

[1]See Appendix 1 for full data set of 375 firms.

Typically the options are very long-term with more than 70% of the firms granting options with a life of 5 years or more.

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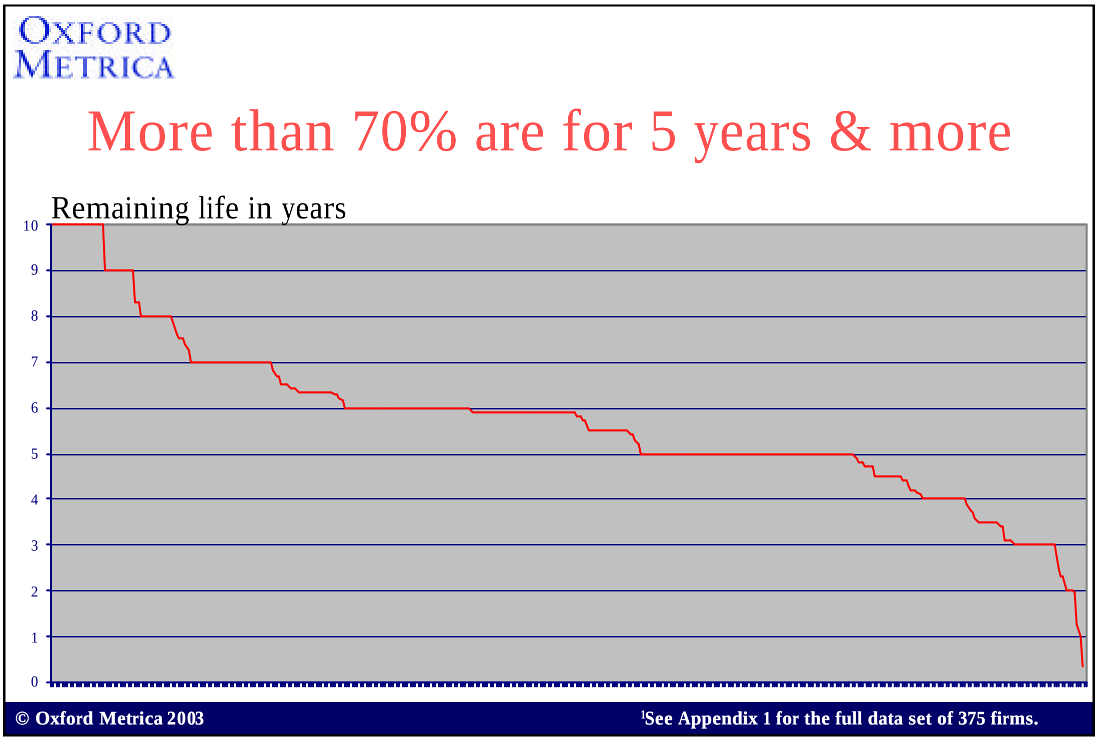

The wide array of volatility illustrated below demonstrates the very significant effect that volatility has across firms. A disturbing feature of the data is that firms are demonstrably applying a mechanical approach to volatility estimation. It would appear that the historic one-year standard deviation in share returns is used as an input. This results in wide fluctuations from year to year which when applied to expensing will be a source of considerable error and a further reduction of comparability across firms. It is unlikely that long-term volatility estimates will be any more reliable.

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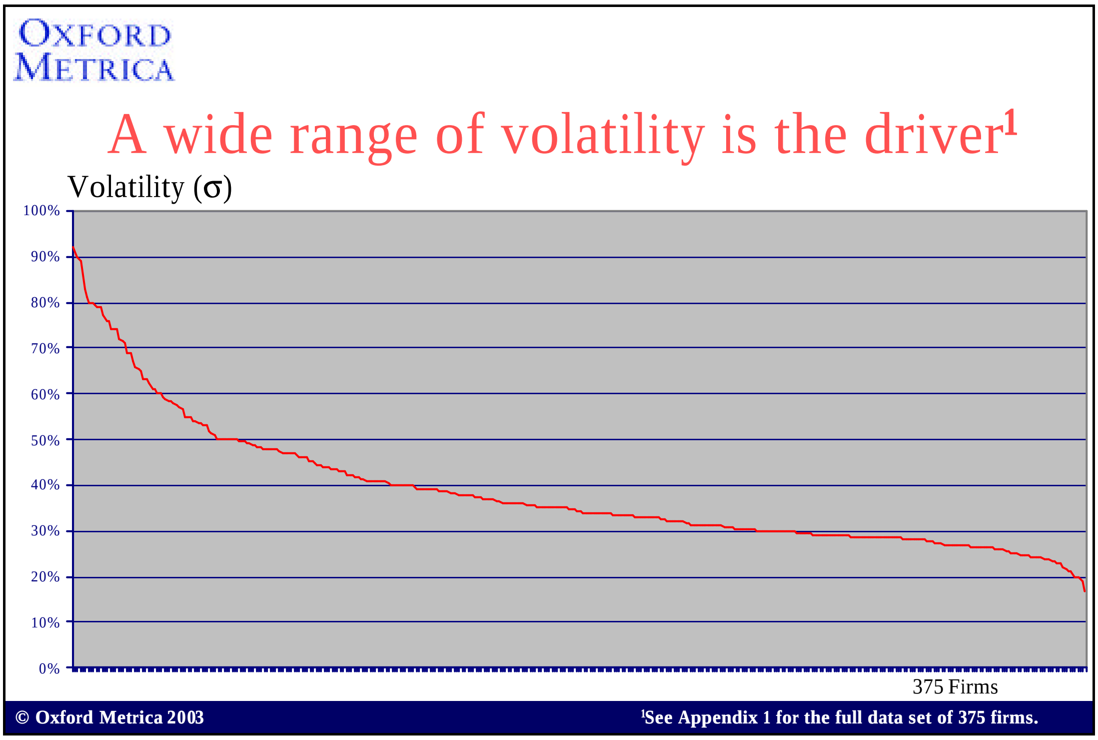
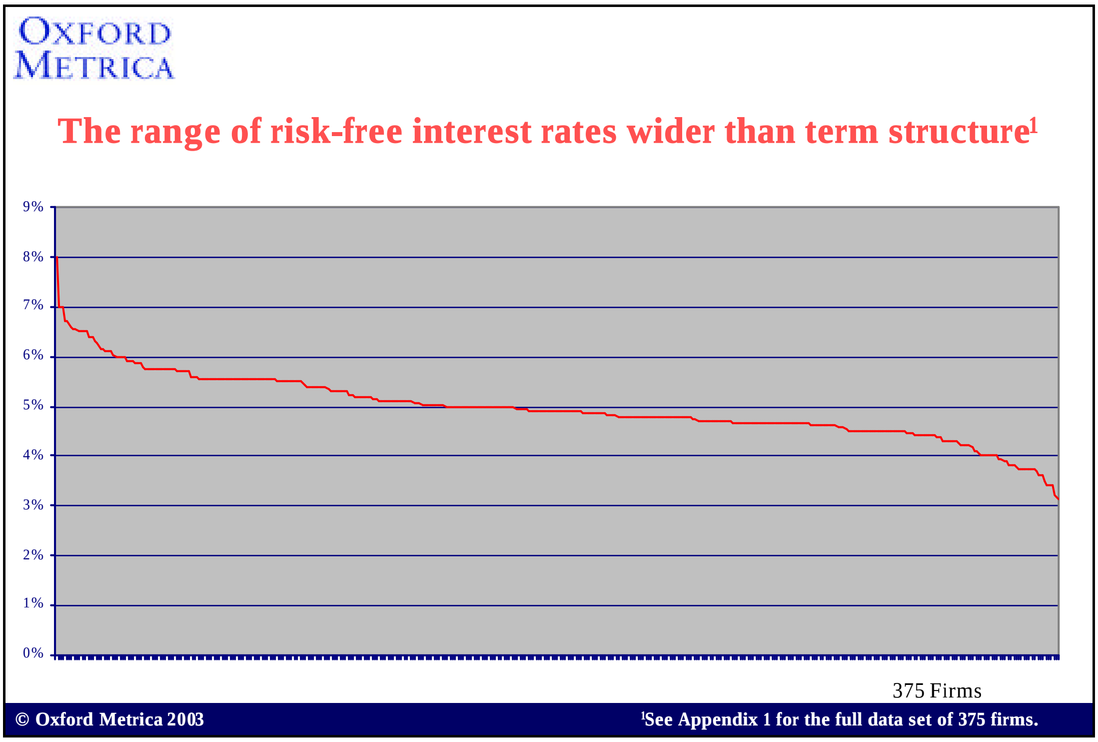


Perhaps the most significant indictment of the way in which the models have been applied and therefore could be expected to be implemented under ED2 relates to the input variable, the risk free rate of interest. This variable is outside the influence of management and should be consistent for all firms. Obviously the term structure of interest rates would be expected to cause some variation across firms since the option lives are not equal for all. Nevertheless, the range of values illustrated below is simply indefensible. The range is 630 basis points. This variation has a significant impact on the values generated by the model even for reasonably short term ESOs. If this amount of variation arises with an input factor for which there is no estimation error the potential for consistency on the other variables seems remote. This raises in turn the difficulties in the auditability of some of these numbers generated on the basis of these models which masquerade as the paragons of precision.



2.1.3 Volatility-based models are incompatible with the accounting

The Black-Scholes class of models that are based on volatility estimates are incompatible with the accounting model espoused in ED2. The volatility models are designed to estimate the instantaneous value to the recipient of the option to buy a share. These models are predicated on two central assumptions *viz.* (1) the value of the option is realizable instantaneously and (2) the payoff to the option is replicable continuously. Neither of these is applicable to ESOs and therefore the attribution of value to volatility is spurious. The inability to trade ESOs impedes the ability to trade their inherent volatility which in turns renders the models inadmissible. It is emphasized that this point is quite independent of the lack of exercisability.
The focus on fair market value in the hands of the recipient creates an intractable problem due to lack of tradability. This is so because ED2 naturally appeals to extant models of traded options. If ED2 took a broader view which focused on the value of services received with reference to the cost to the enterprise a very different measurement problem arises. The cost could be characterized quite differently and measured without resort to the models. It is strongly recommended that the IASB allows greater latitude in this area.

2.1.4 The application of the B-S model at grant date exacerbates the measurement problem

The valuation of options at their grant date using the B-S family of models as espoused by ED2 exacerbates the measurement problem significantly. This arises because at the grant date the option valuation is based on the longest period possible which results in the maximum effect of compounding the estimation error inherent in the volatility estimates referred to above. In addition, since a feature of the B-S model is that the option's value is most sensitive to volatility where the option is at the money, which is exactly the case for most ESOs at grant date.
In short, notwithstanding the arguments against using the models heretofore presented, the prescribed models are applied in a setting where they are least robust.

2.2 ED2 proposes arbitrary adjustments

In an attempt to address the measurement problems inherent in the approach presented by ED2 a number of arbitrary adjustments are permitted. These include:

1. Bayesian adjustments for the probability of vesting
2. Adjustment to inputs for the likelihood of vesting
3. Reduction of expected life to account for the lack of transferability
4. Estimation of early exercise

Being arbitrary these adjustments are not easy to justify and detract considerably from the document. The result we fear will be a considerable reduction in the usefulness of the information due to an increased opacity and a diminished degree of comparability. All of this augurs poorly for investor confidence in reported earnings.

3. The consequences of expensing

It is considered important to consider the consequences of an accounting standard such as that proposed under ED2 particularly because, as identified above it is developed outside the IASB's own conceptual framework and is

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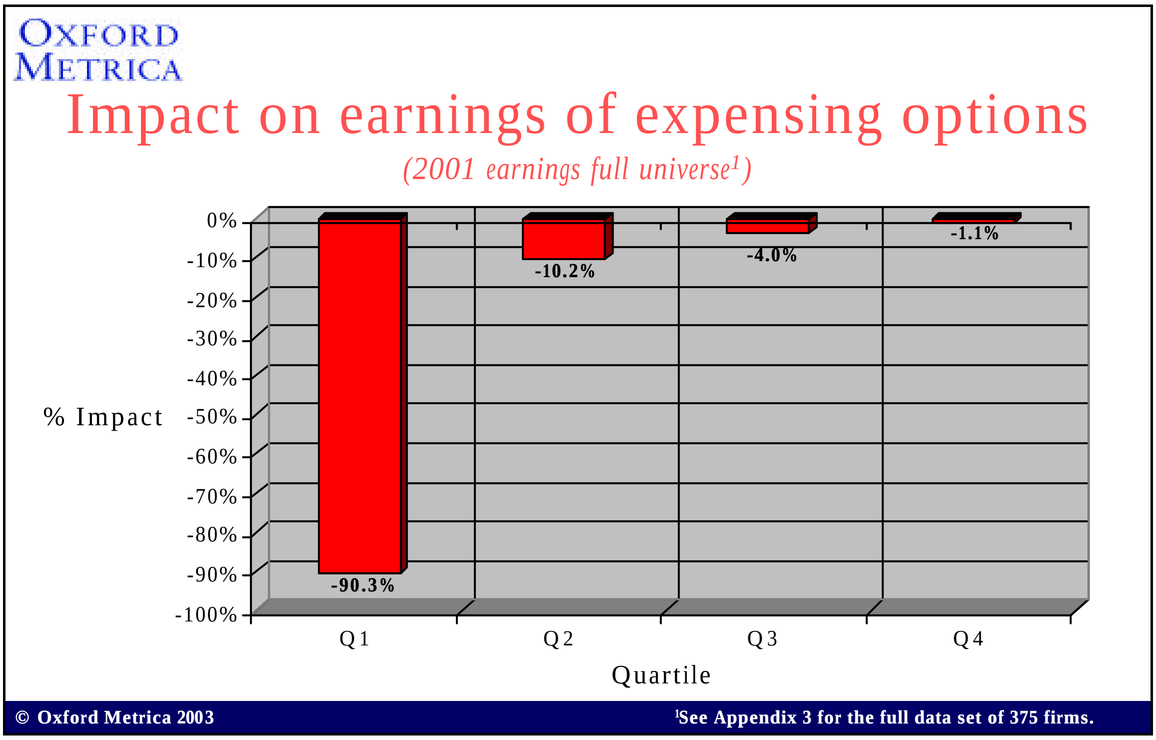
fraught with so many measurement problems. The 375 companies used in the analysis in section two were subjected to extensive analysis on the impact that ED2 would have on reported earnings if adopted. These numbers are based on real company data and were revalidated by a recalculation of every option. The result is an extensive database on the earnings the major findings from which are set out in the following sections. The remarkable feature of the proposed standard is that it has the largest impact on reported earnings of any standard in recent memory and its effects are quite different across sectors.

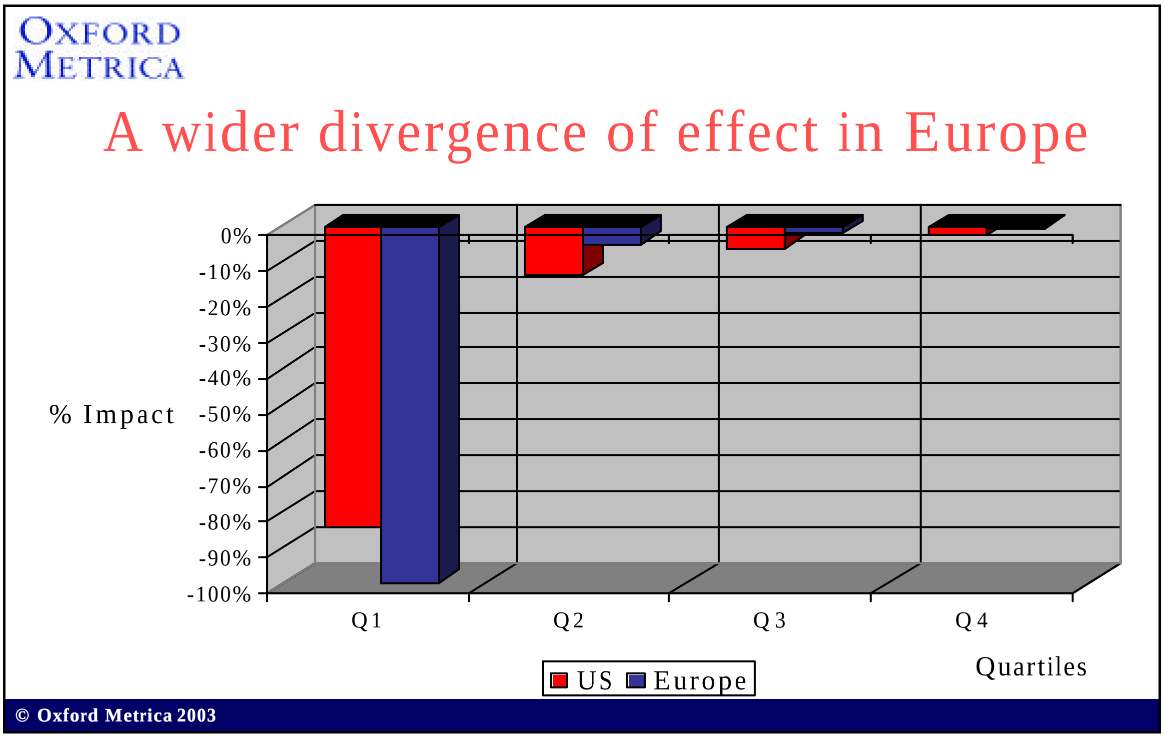
3.1 ED2 will have an impact in excess of -10% on half the companies

The figure below illustrates the distribution of the percentage impact on reported earnings based on 2001 numbers for the 375 largest US & European companies. The effect is not symmetrical in that the hardest impacted quartile have a median effect of over 90% and the lowest impacted quartile is only reduced by 1.1% on average. A significant number of these companies will report losses continuously if required to implement the standard. These consequences should be considered by the IASB and the various regulators around the world.



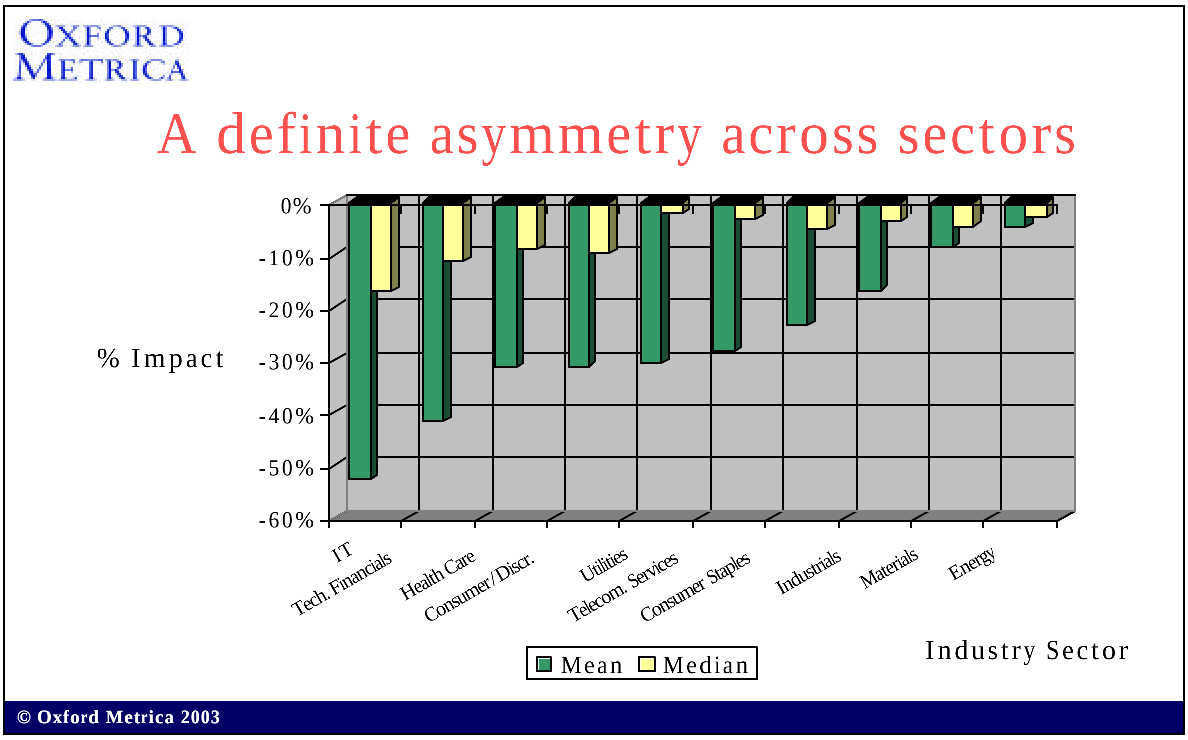
3.2 The impact in Europe is similar to the US except more extreme

The following figure compares the distribution of impact between the US and European companies. Surprisingly the impact in Europe may be larger for the hardest hit companies.



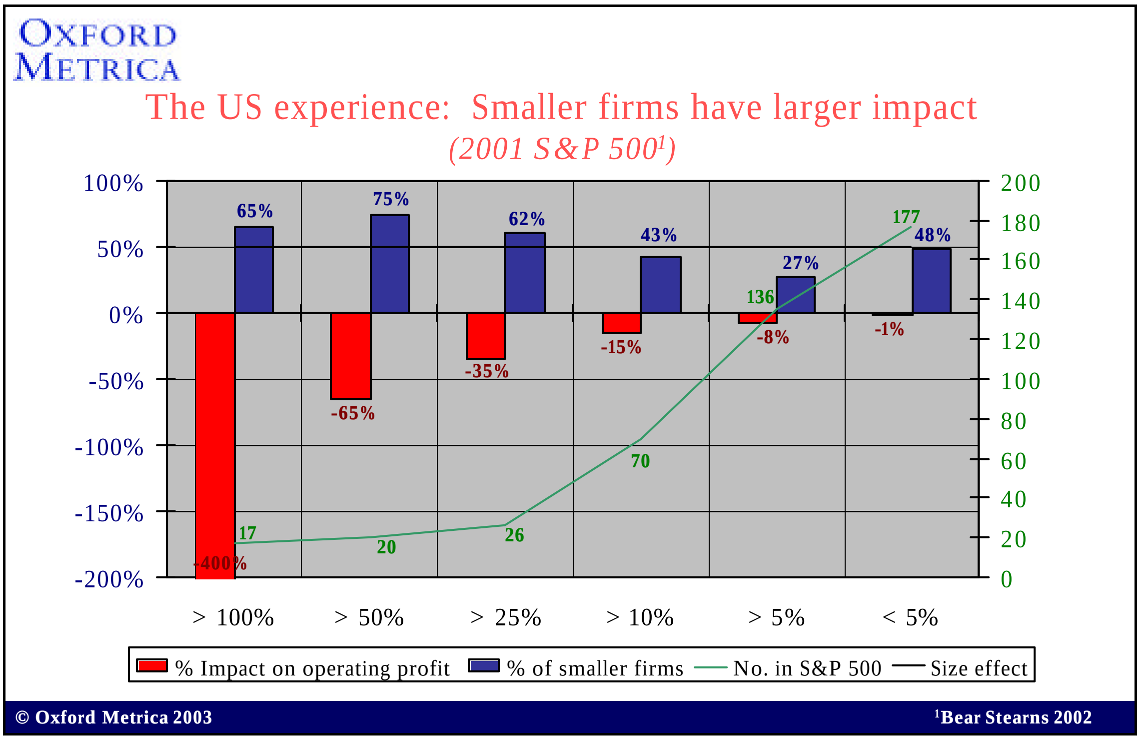
3.3 ED2 will have a divergent effect across sectors

The figure below identifies the effect across industries, Technology companies and health care companies are hardest hit with energy companies having the lowest impact. This study restricted itself to the world's largest industrial companies and thus financial institutions are not included.



3.4 Smaller firms will tend to be more severely impacted

The figure below analyses the impact of ED2 on the S&P 500 companies. It shows the distribution of the impact across six groups ordered by the size of the impact ranging from above 100% to below 1%. Overlaid is the proportion of the companies in each impact category that were in the bottom half of the S&P500 by size. It can be clearly demonstrated that smaller firms tend to be in the high impact groups and larger firms tend to be in the small impact groups. This raises serious issues on the encouragement of growth. It would be highly undesirable for smaller firms to be more adversely effected by the proposed standard.



3.5 ED2 will have a significant impact on technology companies

The results reported above on the cross-sectoral impacts were confirmed when the S&P500 were analysed. The Technology firms made up a significant part of the high impact groups.

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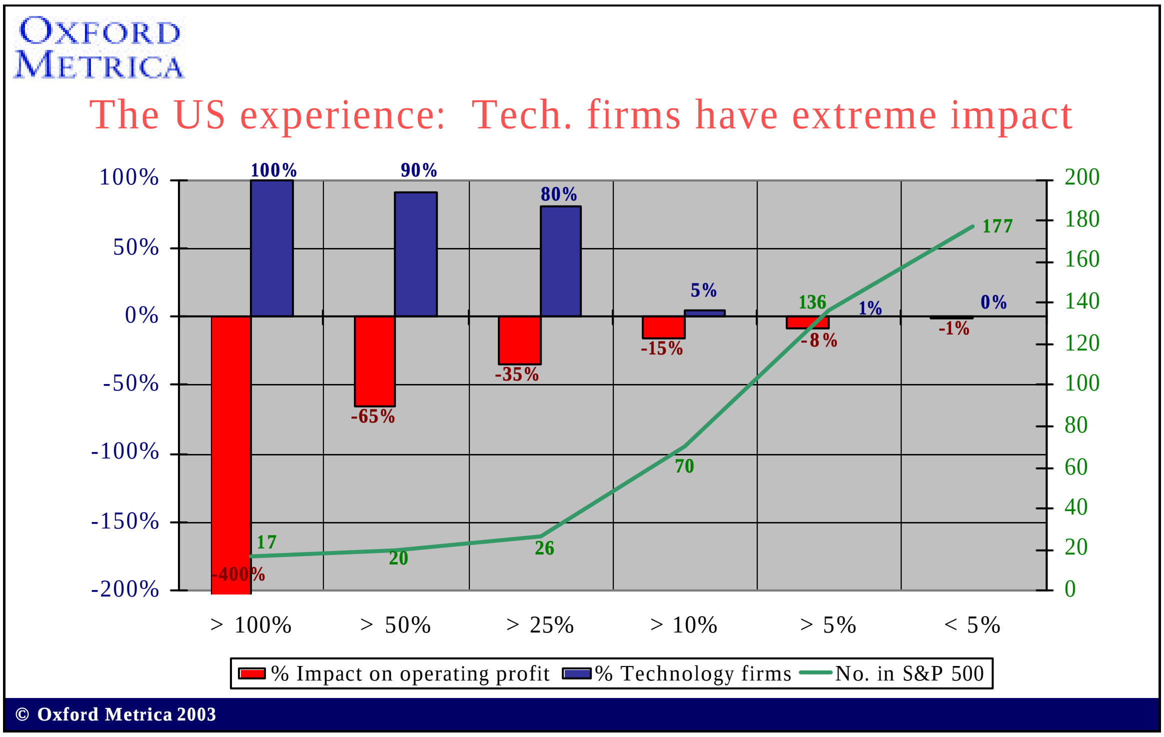

4. Recommendations

We propose the following steps to be taken as regards the procedure in relation to ED 2 and as regards finding a technical solution to the accounting issue itself.

4.1 The IASB should grant itself time to adopt appropriate accounting rules for ESOs

As discussed above, both the Commission and EFRAG have urged the IASB to take the necessary time to first investigate and resolve the fundamental questions with regard to the accounting of ESOs and the existing IAS framework. The Commission's expressed view is that until the fundamental conceptual issues have been properly investigated, it would be premature for the IASB to propose a system with recognition and measurement of share-based payment and that new IAS regarding ESOs adopted under such circumstances would inevitably be flawed. However, the IASB has chosen to essentially ignore these views and has, without explanation, decided to proceed with ED 2.

We believe that the IASB should grant itself time to ensure that any new standards on share-based payments are wholly appropriate for the task.

4.2 The economic consequences of mandatory expensing of ESOs need to be thoroughly analysed

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We believe that the economic consequences of ED 2, and the way it directly affects EU competitiveness, are more important than the accounting consequences. The IASB can conduct field studies, organise hearings and undertake the research it deems necessary to properly support its proposals. With regard to ED 2, however, the IASB has not yet indicated that it will conduct any research regarding the economic impact of ED 2

We believe that the IASB should ensure that the economic consequences of ED 2 for companies should be properly researched and analysed ahead of any introduction of new accounting rules in this area.

4.3 Develop and analyse alternative solutions to mandatory expensing of share-based payments

EFRAG in January 2002 proposed to the IASB that until the significant conceptual and practical difficulties relating to mandatory expensing of share-based payments have been resolved, an interim standard of disclosure is needed. EFRAG in a letter dated 14 January 2002[7] stated that

> "we recognise that it will take time td[o] resolve the conceptual and practical difficulties satisfactorily. It[f] a solution cannot be found in the short term, we believe an interim solution standard of disclosure is needed. If such a disclosure standard were to be introduced, it could be modelled on that used in the US and the level of information would be high. This would have the advantage of convergence of standards until such time as the final standard is introduced following resolution of the issues referred above. [Emphasis added]

The importance of disclosure of financial information has been recognised by the EU's High-Level Group of Company Law Experts, which outlines the benefits of disclosure in a clear manner in its report published in November 2002:

> "Disclosure requirements can sometimes provide a more efficient regulatory tool than substantive regulation through more or less detailed rules. Such disclosure creates a lighter regulatory environment and allows for greater flexibility and adaptability. Although the regulatory effect may in theory be more indirect and remote than with substantive rules, in practice enforcement of disclosure requirements as such is normally easier. The Group believes that the EU, in considering new – and amending existing –

[7] Letter from EFRAG to IASB, 14 January 2002, "Share-Based Payment".

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> regulation of company law, should carefully consider whether disclosure requirements are better suited to achieve the desired effects than substantive rules."[8]

We believe that disclosure of financial information enhances the accountability for and the transparency of companies' financial performance and governance as a whole and should, therefore, be used with regard to ESOs. Full public disclosure of stock options to shareholders and other stakeholders on a regular basis is preferable to recognition of estimated amounts in companies' income statements. We therefore propose that a disclosure standard that would require companies to provide extensive and accurate information on stock options, and other forms of equity participation by employees should be adopted by the IASB.

4.4 Internationally divergent accounting rules on ESOs should be avoided

If ED 2 is adopted and endorsed in its current form, internationally active European companies with ESOs will have to comply with multiple and diverging accounting requirements depending on jurisdiction. Users will be faced with confusing information. Such a development would be contrary to one of the objectives of accounting standards: International convergence.

We believe that it is important that the IASB does not foreclose international convergence by making expensing of share-based payments mandatory as proposed in ED 2.

I would be very pleased to respond to any questions you might have on the present submission.

Yours sincerely,

Rory Knight
Chairman

[8] The final report of the EU High-Level Group of Company Law Experts, published 4 November 2002, page 34.

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Appendix A

Responses to the questions in IASB's invitation to comment

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?

EESOC does not agree that options should be expensed. We believe that if the standard is accepted, employees are likely to bear the cost as companies begin to reduce these schemes due to the increased cost induced by mandatory expensing.

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?

No. We do not agree that these recognition requirements are appropriate. We believe that an expense is realised only when an asset is impaired or where a liability is created, along the lines of the IASB's own conceptual framework.

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

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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?

The draft IFRS does draw a distinction between the services on the one hand and the financial instrument on the other, however it does not clarify that there are two distinctive perspectives, that of the recipient and that of the enterprise. Quite evidently it is the value of services derived by the enterprise that should be the focus. Therefore the primary aim should be to discover what the cost of issuing the instrument is to the enterprise, rather than value to the recipient. This would avoid many of measurement problems inherent in ED2. Obviously in market based transactions the value and cost from both perspectives happily coincide.

The measurement principle would only be appropriate if there was a market-based transaction in a tradable commodity such as cash.

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?

The good or service should be measured on the date of exchange.

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?

Since we disagree with expensing we cannot agree to any date being appropriate.

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?

No. The IASB produces no evidence and scant argument for their position on this issue.

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?

No. In the case of Employee Stock Options (ESOs) it may turn out to be a more tractable problem to measure the cost of the instrument to the enterprise as the most direct way of estimating the value of the service received. The IASB produce no evidence and scant argument for their position on this issue.

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?

Options are typically awarded for a multiplicity of reasons, including to incentivise employees for future performance, to attract new staff to develop a sense of ownership etc. These elements are likely to be influential over the full working life of an employee. Therefore to distil out the pure compensation element and then to correctly identify this over a specific period of time will prove impossible in most cases.

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 methods do you propose?

This procedure is unlikely to be accurate for reasons given. A pure grant date model would take the charge as a lump at grant date.

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?

Since we disagree with expensing we cannot support this requirement.

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?

We believe that the suggested models are not appropriate. In fact, we are not aware of an approach that would reliably measure the value of stock options. Further, the use of option pricing models will have as consequence that inaccurate and unreliable estimates of the stock options value will impair the quality of financial statements.

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?

This is an entirely arbitrary proposal with which we are not in agreement. Non transferability undermines the premise of the option models, which would impair the quality of financial statements.

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?

The problem is obviated by seeking to measure the cost to the company. If that is not achievable it makes little sense to expense.

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?

As far as we are aware the models are not amenable to adjustment for a reload feature, which, again, underlines that they are not appropriate for the tasks set out in ED 2.

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?

Since the lack of transferability results in an inability to trade the volatility, this aspect should be ignored in the valuation. It would be more practicable to characterise the option as a financial costs and attempt to calibrate the effect issuing options has on the firm's financial capacity.

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?

The draft IFRS does not do what the preamble to this questions suggests. It simply does not allow sufficient flexibility in the measurement of options. It has proposed one single class of models with a set of arbitrary adjustments. We do not think the IASB is in a position to provide guidance on models that don't yet exist.

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, i.e. 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?

If expensing is adopted by the IASB we would accept this approach.

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.

As indicated above since we do not agree with expensing it is not possible to agree with this suggestion. We do acknowledge that the proposal is internally consistent in this regard.

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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.

We agree with this approach.

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.

We would agree with this in most circumstances if the transaction was with third parties.

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

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(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)?

We are in broad agreement with the disclosure requirements.

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 (i.e. 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.

If adopted we agree with the transition arrangements.

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?

Since these requirements introduce the volatility of the equity instruments issued the entity into its own income statement we consider these requirements to be inappropriate.

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).

(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

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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.

(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.

(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

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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.

(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).

(f) (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.

As stated we do not agree with either FAS123 or the exposure draft that ESOs should be valued at fair market value for footnote disclosure or for expensing via the income statement.

Question 25

Do you have any other comments on the Exposure Draft?

Detailed comments have been provided in the main body of our response.

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