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COMMENT ON ASB FRED31 / IASB ED2 ON SHARE-BASED PAYMENT (November 2002)

The ASB's and IASB's exposure drafts on *Share-Based Payment* propose (paras. 4-5) that 'an entity shall recognise the goods or services received or acquired in a share based payment transaction when it obtains the goods or as the services are received' (with a corresponding increase in equity if the transaction is 'equity-settled'). 'When the goods or services…do not qualify for recognition as assets, they shall be recognised as expenses.'

This principle seems wholly correct. However, it is the failure of other accounting standards adequately to recognise assets that, in my view, is one of the main reasons why the FASB's related standard, Statement of Financial Accounting Standards No.123: *Accounting for Stock-based Compensation*, was extremely controversial.

Professor Steve Zeff of Rice University (in Cooke and Nobes, 1997) has given a lively account—and commented on the fearful dangers—of how successful economic consequences lobbying by US corporations, reaching a new height in gaining support in the US Congress and in particular from the Senate, forced the FASB to abandon its originally proposed standard on the treatment of stock option compensation in the income statement, even though the Board remained convinced that this was the proper accounting treatment and had the support, *inter alia*, of seventy US accounting academics who wrote to Senator Levin, and of one of the leading US institutional investors (Warren Buffet), who wrote similarly:

'If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?' (quoted by Zeff at p.185).

But considering now whether the ASB's/IASB's proposals are acceptable brings out the need to consider whether the *overall* accounting content of the proposed standard is reasonable. While it may be indeed be argued that:

> 'Stock options have value; they impose a cost on companies that issue them; and the cost of stock option compensation ought to be charged to corporate earnings' (quoted by Zeff at p.185)

the issue of *when* they should be charged remains unresolved. Here the paradox is that the most valid motive for utilising stock options to incentivise top managers (rather than say performance based remuneration linked to accounting earnings) is that the benefits of the kinds of decisions and efforts they are being encouraged to make will not show up in accounting earnings until long after they have shown up in the price of the company's shares—for example where those managers are developing the intangible factors, or undertaking research and development, crucial to a company's long-term success. This is one reason why such forms of remuneration have been so popular in high tech start-up companies and 'dot.coms'. So, while a proper 'matching' would accrue the cost, but not charge the expense against accounting earnings until the expected benefits are also reflected in accounting earnings, it is in relation to areas such as research and development and other 'internal' intangibles that conventional accounting standards—in requiring immediate write-off—currently fail most conspicuously through their inability properly to 'match' the expense and the revenues.

Expensing over vesting period—to parallel expensing of 'conventional' cash salaries /bonuses—may therefore charge expense before benefits are recognised in the accounts (even though already reflected in share price).

Recent empirical research in the US suggests that stock prices reflect both the dilutive and the incentive effects of employee stock options, i.e. both the 'expense' and the 'benefits'.

One beneficial role of issuing executive stock options (provided there is full disclosure) may be to overcome this deficiency of accounting's content. The political lobbying over the unacceptable 'economic consequences' for corporations in the US and elsewhere of the FASB's original proposals (also especially relevant to countries like the UK where stock markets and the growth of high-tech companies and other knowledge-based enterprises are sufficiently developed to make this form of remuneration increasingly attractive), may indeed reflect a legitimate concern that proposals—such as the ASB and IASB are now adopting—to measure and *charge this cost against earnings* merely exacerbate what is already an inadequate feature of conventional accounting. Standard setters need to undertake a much more radical rethink about accounting for intangibles before attempting to 'fix' this particular issue.

Reference:
The Development of Accounting in an International Context: a Festschrift in honour of R.H. Parker edited by T.E. Cooke and C.W.Nobes, Routledge International Studies in Business History, London, 1997, xii + 261pp. (ISBN: 0-415-15528-2).

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