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Dear Sir

FRED 31 Share Based Payments

I write to comment on FRED 31. I write in a private capacity, but with the background of having served as Group Finance Director of Logica plc (now LogicaCMG plc) from 1990 to 2002 and as a current chairman of the audit committee of two listed companies (Spectris plc and VT Group plc).

My comments address two parts of the FRED – firstly should there be a charge to the P&L and secondly, if there were to be a charge, I comment on the method proposed in the FRED. In addressing this matter my concentration is on employee related options, not because they are materially different from any other option (as erroneously implied in BC26) but because for listed companies this is by far and away the most common form of transaction

Should there be a charge to the P&L?

The FRED fails to make the case for this and fails to demolish the arguments of those who consider that there should be no charge. I therefore address the FRED's attempts to demolish the arguments against a charge by reference to paragraphs BC29-52.

The entity is not a party to the transaction (BC29-34)

The FRED is the most remarkable confusion of form and substance. It states in essence that since the entity sets up the plans, it is therefore the contracting party. This fails to address the substantive economic argument which is that the transaction is between the shareholders and the employees whereby the shareholders are prepared to give away a portion of their equity to the employees in the hope that their remaining smaller interest will be worth more than it would otherwise have been. The entity acts as the agent of the shareholders. This is evidenced by the fact that at no time is the cash position of the entity affected by the option transaction whereas if the option is exercised, the shareholders can see that they have incurred a cost. Standard

setters have consistently (and rightly) insisted that substance is more important than form but here have chosen to accept form over substance.

The rest of the FRED's arguments are secondary to this central concept. Once this first argument in favour of expensing fails, then the others are of no consequence, although it is worth noting the following:-

The employees do not provide services

It would be wrong to argue that the employees do not provide services but the Board has drawn the wrong conclusion from this point. The Board's argument is that the employees must be providing services because otherwise the entity would be issuing valuable share options and getting nothing in return. In this context it is the shareholders who are causing the entity to issue share options and it is they who bear the financial burden of the options. As above, this is a transaction whose economic substance is between the shareholders and the employees. Whether or not the employees provide service is of no relevance to who bears the economic burden

There is no cost to the entity, therefore there is no expense

The FRED fails to recognise that the cost is to the shareholders and the entity itself gets a 'free ride' – a cash free use of resources. To require the entity to account for these as an expense because it has consumed resources is simply to argue backwards – there was consumption, therefore there was an expense. The fact that there will never be a cash cost to the entity of the options means that there is no cost

Expense recognition is inconsistent with the definition of an expense

The FRED sets out the correct definition of an expense and then proceeds to ignore it. The depletion of assets is the assets of the shareholders not of the entity!

I therefore submit that the arguments in favour of treating share options as an expense are fallacious, the FRED should be withdrawn and a more appropriate way of portraying the impact of share options should be developed which properly shows that the impact is one of dilution of shareholders' interests not cost to the entity.

If the Accounting Standards Board and the International Board decide to remain in error and introduce this FRED as a standard then there are three points that I would like to make in regard to the practical implementation of any standard:-

1. The FRED proposes the computation of a cost per individual share option which allows the effect of actual employee attrition to be incorporated in the cost. Achieving this absolute precision will be time consuming and burdensome, particularly on large international groups and adds little value as compared to computing the estimated impact of attrition once at the time of the original estimate. If attrition is materially different then in future years the expected attrition could be changed for future option grants.

2. The FRED proposes that if options are cancelled, the cost should continue to be reflected in the P&L of the entity. This is absurd. If the argument was that the employees must be providing services because otherwise the entity would be giving away valuable share options for nothing (BC32), then if the options are cancelled the employees can't be providing services for nothing and hence there can be no cost.
3. The FRED fails to address what entities should do with regard to share options which are deeply underwater and where it is inconceivable for practical purposes that they will ever be exercised. Clearly no value is passing to the employees but the cost will still be reflected in the P&L. As with the proposed treatment of cancellation this makes no sense.

Yours faithfully

Andrew F Given