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Letter of comment from David Creed

Response to the concepts in FRED 31 and answers to the questions posed

This is a personal response that builds on the comments made by the Association of Corporate Treasurers. It does not however represent any person's or institution's views other than my own.

I strongly supports the view of the FRED that the making of share-based payments by an entity to suppliers of goods and services should be accounted in the same way as a cash payment, with the instrument used for payment being valued at fair market price at the date the agreement is entered into, even if the agreement is conditional on factors other than the supplier's performance. However, if the fair market value of the instrument is greater than its grant value when the instrument is settled, a loss of value has occurred from the perspective of the entity's shareholders, and this loss must appear in a performance statement, since it reflects on the performance and judgement of the managers of the entity deciding to make the payment in shares rather than cash.

I believe that if two entities start from economically indistinguishable positions and after the passage of time finish in economically indistinguishable positions, their total performance, but not necessarily its component parts, must the accounted as being identical. If this is not so, the concept of accounting as a rigorous methodology to measure the absolute and comparative performance of entities breaks down.

This hypothesis and my support for the FRED can only be reconciled if the FRED is taken further to embrace accounting from the shareholder's position as well as the entity's position, a step that will require a new performance statement covering management's stewardship of the entity's equity base.

The questions posed by the FRED are answered below and it is shown how the concept of an equity management performance statement will resolve the incompleteness of the FRED's proposals.

ASB questions

Q1 – Q2 (adoption 1/1/04 and all entities application): Yes

Q3 (applies to all types of payment): Yes, provided the same methodology is applied to the embedded share based payment of interest in debt instruments that are convertible by an investor into equity.

Q4 (applies to each member of a group): Yes

Q5 (withdrawal of UITFs sufficient to avoid breach of existing requirements): No comment

Q6 (application to granted but unvested instruments): Yes

IASB questions

Q1 – Q4 (scope, recognition, measurement at fair value at date of receipt of goods or services): Yes

Q5 (grant date valuation): Yes, but see the comments in Q19

Q6 (service value easier to find than instrument value): Yes, but on occasion it may be more readily determinable as the fair value of the instrument if, for instance, the instrument is traded on an exchange.

Q7 – Q8 (for employee transactions use fair value of instrument and expense over the vesting period): Yes

Q9 (unit of service costed by individual, not group): No. It is difficult to accept an expense to the income statement that can be materially greater (or less) than the grant date fair value of the payment instrument. For example, this will occur if the reduction in the instrument's value for the service based vesting conditions is over- (or under-) estimated and fewer (or more) employees than expected leave the entity during the vesting period. The proposal has the result that an employee, staying with his company and working hard to achieve the vesting conditions, is deemed to have cost more to employ than his colleague who doesn't. But this approach is not applied to salary or pension payments. Two preferable approaches are suggested:

Either adopt the approach in FRED 31, but re-price the instrument on vesting date once the outcome of the vesting conditions is known. This could be done by using the outcome values for the vesting condition variables and the values that applied on grant date for all non-vesting condition variables. Then, on vesting date, expense the change in the instrument's value through the income statement and credit equity. The result is that the entity expenses only the grant date value of those instruments issued, valued without vesting conditions. If no instruments are issued there is no expense, which seems sensible since if they are cash based no cash passes and if equity settled no equity instrument is issued. In the case of employee share options, the service to be given by the employee is that he shall have achieved the vesting conditions. If these are not achieved, no service has been given and no payment should be deemed to have been made and so no expense charged. The fact that employees may have been incentivised by the promise of an option that was never vested, and consequentially may have produced greater output as a result, will be reflected in the change in profit in the income statement. Reversing the charge to P&L if an option lapses would however not be my preferred approach if an equity management statement approach is adopted (see the reply to Q10 and Q19).

Or value the instrument at the grant date as though no vesting conditions applied (other than any known initial lock-out period) and expense the resulting higher value through the income statement during the vesting period, with a credit to the income statement, and a debit to equity, for the grant date value of any instruments not vested with employees at the end of the vesting period. This alternative has the advantage of not requiring the potentially difficult approach of adjusting grant date values for vesting conditions whose effects may be unknown or uncertain.

This second approach is preferred because it replicates better what would happen if an entity uses a third party's equity instruments to pay for goods or services. Vesting conditions are determined by, and their outcome is often under the partial control of, the entity purchasing the instruments. As a result any third party seller is likely not to wish to sell or price any instruments with vesting conditions attached. On the other hand the third party entity might be willing to take back, at cost, any unused instruments not vested, and credit the entity accordingly. It would seem appropriate that, wherever it is consistent with accounting principles, the Standard is structured to deal with equity instruments in an identical way, whether or not they are issued by the entity itself, or a third party. Such an approach also better handles the potential dichotomy that arises through the different accounting treatments for entities that either issue new instruments for payment of goods or services or buy those same instruments in the market through, for example, the operations of an Employee Share Option Plan Trust arrangement. (see Q19 for an extension of this approach).

Q10 (no change to equity for non vesting or lapsing): Yes, but subject to the comments in Q19

Q11 (apply option pricing model if market price unavailable): Yes

Q12 (valuations use expected life not contracted life): Yes, but subject to comments made in Q9 concerning vesting conditions.

Q13 (vesting conditions to be taken into account in valuations): Vesting conditions must be incorporated into the assessment of the expense in some way, but a preferred approach is described in Q9 which gives the effect that no value need be ascribed to instruments that are never issued because vesting conditions are not met. It seems perverse to value and expense the value of an instrument that is never issued. If, for example, an employee is offered a £100 bonus for completing work by a given date and he fails, his company will not recognise an expense of £100. If, instead of cash, bonus shares are offered why should the accounting differ? Only when the contract is delivered, and payment settled, should there be any irreversible financial impact. A provision can be made over the vesting period in the expectation that the outcome contracted will be achieved, but the provision should be reversed when the contract is not met. The value of the instrument should however be set by reference to the grant date at which the bargain was struck.

Q14 (options to be valued including any reload feature): Yes

Q15 (other features not specified): No comment

Q16 (no prescriptive valuation guidance): Yes

Q17 and Q18 (option repricing during vesting period and cancellation): Yes. The accounting treatment should follow the assumption that the instrument is cancelled and reissued, even if the legal form is a repricing. The incremental value of the new options could be spread as an expense over the new vesting period, leaving the original expense to be charged over the old vesting period, but a preferred approach is to recognise any uncharged element of the original expense and spread it over the vesting period of the repriced option, together with the incremental value of that option. The question of the accounting for a cancelled grant is commented on further in Q19.

Q19 (cash-settled shared based payments are continually revalued and charged to the income statement): No. There seems to be a fundamental flaw in an accounting standard that will result in two entities having materially different accounted outcomes when they could have started and finished with exactly the same assets, liabilities, performance and expectations. Making such a material difference as that proposed between cash-settled and equity-settled share-based payment transactions will potentially result in a major distortion in behaviour. No entity is likely to make a cash-settled share-based payment if its competitor can achieve an identical position by making an equity-settled share-based payment with a materially lower expense appearing in the income statement.

Take two entities A and B that are identical.

At the beginning of its accounting year A makes a cash-settled share-based payment to its supplier (of say 100 shares) with an unconditional vesting period of say one year. At the end of the year the payment is settled and at the same time A issues to the market 100 shares, the payment for which funds the cash-based payment to the supplier.

B issues 100 shares to its supplier, which vest after a year. Under the FRED31 proposals, the accounts for the year for the two entities will be very different. Although the total equity in the balance sheets will be the same, the performance statement of A will show a much inferior result compared with B's. Only if the shares are valued at their vesting date will accounting equivalence be obtained between them, and yet the outcomes of the two sets of transactions are economically indistinguishable.

If it is agreed under Q5 that the grant date value is to be used for the accounting for entity B, grant date value should be used for cash-settled share-based payments on vesting date, with the difference between the settlement cash paid and the grant date valuation being a debit to equity.

However, for an option, the cash-settled share-based settlement date may be later than the option's vesting date, i.e. on the exercise date. Under this circumstance the cash based settlement will reflect the option's value at the 'exercise' of the option. This date may be much later, and the consequent settlement amount much higher, than at the vesting date. It seems curious that an accounting standard should recognise value being paid, and therefore a payment being expensed, when it is made in cash but not in kind. The fact that it is an entity's own shares in which payment is made should not detract from this. Thus if the preferred treatment suggested above, that of treating part of the cash settlement as a debit to equity, is not accepted (and there are good reasons why it should not be) there seems no alternative to recognising as an expense in a performance statement the whole change in value from an option's grant to its exercise.

This line of argument, that of requiring accounting equivalence for economic outcome equivalence, irrespective of legal form, needs to be developed for equity instruments through the concept of an equity management performance statement that lies alongside the income (business performance) statement. Such an arrangement would show, from the perspective of the shareholders that, in the example given but assuming the instrument was an option, entity A's use of cash rather than issuing an option was an expense in the business performance statement, but with no debit to the equity management performance statement. However entity B's accounts would have a much smaller expense in its business performance statement and a loss in its equity management statement, such that the combination of the two statements for each entity would show an equal performance outcome for both of them.

This concept also handles the accounting of a grant of an option that is subsequently cancelled. The value to be taken into account by the supplier of the goods and services that are being bought by the option will be its fair value. This will not be the value the supplier assessed when the grant was made, but its value at the date of cancellation. It is this value that will have to be restored to the supplier. Any new equity instrument grant or cash payment will reflect this. The fair value of the option at the date of cancellation should be taken as a credit, and the fair value of the new grant expensed, both in the income statement over the new vesting period. The original value of the first option at its grant date, the value on its cancellation and the value of the new option at replacement grant date are all then posted as credits/debits in the equity management performance statement. When the option is exercised, a debit equal to the difference between the option strike value and the fair value of the equity issued is made to the equity performance statement to show the effect of issuing equity at other than market price. If the option lapses unexercised, the equity management performance statement will show a gain equal to the cumulative value of the amounts credited and debited to the income statement, thus mirroring those entries so as to give a value of zero to the combined statements of performance. This reflects the fact that an option granted to, vested in, but never exercised by an employee is not a loss or gain overall to an entity from the perspective of an equity shareholder. (It is however a risky exercise and as such needs reporting and disclosing; and it may produce a better performance from the employee that will be reflected in an improved labour cost per unit of output).

A small minority of entity managers have been in the habit of freely dispensing share options to third parties and employees at values that are not necessarily representative of market values, and that often do not in their outcomes cover the value lost to shareholders from their exercise. Their behaviour would be constrained by the knowledge that a sound measurement of their management of the entity's equity base will be reported. That performance could then be added to their performance in managing the business' assets and liabilities to allow shareholders to draw appropriate conclusions on the state of the entity and its managers' competence.

The introduction of an equity performance statement lying alongside the present business performance statement would move accounting from the perspective of the entity to that of its ordinary shareholders. Such a move will make accounts far more relevant to shareholders, since it is the performance of the business in the accounted period, and the attribution of the period value generated to those who were shareholders at the start of that period, that is the most relevant reporting framework in assessing management.

This concept of how to account for value created or destroyed through the issue of share options also applies to the value created or destroyed in the buy-in and re-issue of treasury shares, in the issue of embedded share options in convertible debt as a means to reduce interest payments, and in other equity derivatives such as contracts for differences.

A good example of its application would be in the comparative accounting for ESOPs referred to in Q9. Entities issuing employee share options that are to be equity settled may either issue new shares on exercise or issue shares from an ESOP trust that has bought in shares at the ESOP's initiation, or at an intervening date. The Standard proposed will not recognise any difference between these approaches. All the ESOP activity will be debits or credits to equity as shares are bought or sold (if options are abandoned unexercised) in the market. This is because the ESOP assets are regarded as being part of the entity's balance sheet assets. Nevertheless cash will be consumed or generated during the life of the ESOP, which is not the case for options settled by issuing new shares, and so the income statement will be impacted because of the financing costs. The accounting proposals in the Standard will encourage entities not to set up ESOPs for this reason, that is the funding cost of the ESOP. However from the shareholders' view point an ESOP may be a highly effective hedge operation, protecting the shareholders from potentially substantial losses of value from shares issued at a large discount to their market value when the options are exercised. Any Standard must take into account the effect it will have on the activities of entity managers so as to ensure that no distortions occur. It is difficult to see how, without an equity performance statement showing the value created or destroyed in management's decisions on equity issuance and buyback, these distortions can be avoided.

Q20 *(option to settle in cash or shares)*: It seems inappropriate that the fact that an entity may have a potential obligation to settle a share-based payment in cash, but does not actually do so, results in it having one accounting treatment, but that a similar entity, whose actions are identical to the first but without the potential obligation, results in it having a different treatment. This introduces the concept of accounting for what might have been, not what actually happened. While I have no problem with this concept per se, if this type of approach is to be used it is better applied as in the proposal under Qs17/18 on the equivalence of accounting for instruments that are repriced with those that are cancelled and reissued, by deeming any repricing as having been effected for accounting purposes as a cancellation and reissue. Such an approach will achieve accounting equivalence for economic equivalence, which the proposal made for the Standard discussed in Q20 will not.

Whether an option is cash-settled or share-settled, essentially the same value is passing to employees and it is difficult to escape the view that the employees' gain in value is the shareholders' loss under both circumstances. From the shareholders' perspective, whether that loss is apparent in the income statement or in an equity management statement is not material – it is still a loss. When it appears, however, as a reduction in equity with no record of it passing through a performance statement, a misleading distortion is introduced. When that distortion occurs just because an entity may have had to, but in the event did not, issue shares, the accounting becomes even less transparent.

Q21 – Q23: Yes

Q24: No further comment, but see responses to earlier questions.

David Creed
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