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Private & Confidential
Accounting Standards Board
Holborn Hall
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Our Ref: EB/GEVM/L/03.1 5 March 2003

Dear Sir

FRED 31 CONSULTATION

I am writing in response to your invitation for comments on the proposed accounting standard for share-based 'payments'.

INTRODUCTION

NW Brown Employee Benefits advises employers on a range of remuneration planning and employee benefits issues. We have significant expertise in employee share schemes, particularly for private and smaller quoted companies (including AIM and OFEX companies). Therefore, my comments are made partly as an adviser, reflecting this area of expertise.

NW Brown Employee Benefits is part of NW Brown Group, a diverse financial and business services organisation. NW Brown Group is a private company, based in Cambridge. The Group's operations include venture capital, investment management, and corporate finance. (It is not for me to present the views of NW Brown Investment Management, but my colleagues in that department do not subscribe to the view, advanced by the IASB, that there is investor pressure for the proposed accounting standard.) The Group has its own share schemes and currently about 75 of the 90 staff either own shares or have share incentives of some kind. The Group aspires to remain privately owned. Therefore, my comments are made partly as an employer using share schemes (and as an employee participating in share schemes – of which I have also had experience in a quoted company).

GENERAL REMARKS

I have no enthusiasm for the FRED 31 proposals. With the exception of the ASB's indication that FRRSE companies will be exempted from the requirements, I can find nothing about which to be complimentary.

The whole proposition, certainly as far as unquoted companies are concerned, is based on a fallacy: that employee share transactions are a form of remuneration. I believe that it was people like Warren Buffet who coined the specious argument “if these transactions are not wages, then what are they?” The IASB seems to have fallen into the same trap, as is evident from their titling “ED 2: Share Based Payment” (my underlining). The proper title for the discussion should be “Share Based Transaction”.

It is an old barrister’s and politicians trick, to limit the debate by careful wording of the question, which is what I think Warren Buffet and others have thus far succeeded in doing. A horse has four legs. I fear that the Warren Buffet/IASB line of thinking would lead people to conclude that a dining-room table is therefore a horse.

I will return to the IASB’s muddled and inaccurate thinking, when I make some specific comments in response to their ED material. For now, I hope that the ASB is not falling into the same syllogistic trap.

In private companies, employee share transactions are not about pay; they are about something more fundamental and less tangible. They are about culture, participation, purpose and ownership. None of these is an item to be expensed on a P&L. You only have to look at companies like, for example, TTP Group or Burral Limited or indeed NW Brown Group to see this.

Creating fictional accounting entries is surely not the way forward, particularly at present. Enron was constructed on fictional accounting entries and look at the outcome there.

Not only does FRED 31 create a fictional expense, it is also fiction of the worst kind. Even the IASB concedes that the methodology required to establish a fair value is not simple and is highly subjective. Private companies in particular are going to have to go to great lengths and considerable cost to quantify the fair value of the employee share transactions – in some cases merely to come up with an answer that is nil or immaterially small. The only outcome of that is extra fees for the auditors (and for advisers like NW Brown Employee Benefits), in which case FRED 31 smacks of “jobs for the boys”.

The point has been well made that fair value calculations and option pricing models are very complex animals. It is also worth reflecting on their viability. The Black Scholes model has been much cited in the context of ED2 and FRED 31. Yet any investor who consistently used the Black Scholes model would in fact have lost money, I am told. To introduce an accounting measure that is both fictional and unreliable is lunacy.

For where does one draw the line, if one accepts the premise of the FRED 31 fictional expense? The IASB posits its proposal by reference to a "depletion of assets" - or a "diminution of resources", as I think Bob Garnett put it at a recent seminar. In that case, it seems that the accounts should measure the economic effect of every bad decision which a Director makes. It seems that the accounts should, using the IASB's arguments, create an expense every time an employee takes holiday.

What happens if the FRED 31 fictional accounting entry turns a company's profit into a loss in a dividend-paying company? Employee-owned companies certainly would not be happy with such an outcome.

The IASB suggests that it is investor pressure which has led to the need for FRED 31, because accounts do not give the investor a clear picture. Accounts are clear in their information about employee share transactions. There is not some serious invisibility. There is invisibility, for example, about huge pay-offs for failed executives. Such items suddenly appear in the accounts at the end of the relevant year, often months after the event. There are no clues in the previous accounts, unlike with share options and similar share awards, where shareholders are forewarned of the transaction before it matures.

The logical conclusion of the IASB's reasoning is that bonus/scrip/rights issues would need to be reflected on the P&L, particularly if a company has more than one class of share. There could then be wholesale avoidance of FRED 31, by creating an employee class of share that enjoys bonus/scrip/rights issues.

The IASB has referred to the need to curb executive excess. Here I am sure that it will find support not just from me. However, the IASB has, in reference to or response to other aspects of ED 2, said that its remit does not include corporate governance. Therefore, there is inconsistency in the IASB's reasoning, when it cites executive excess as a reason for introducing a new accounting standard.

There is one area where there has been insufficient commentary. Quite rightly, much of the focus of the proposals and of the debate has been about the P&L hit. However, I would welcome more comment and advice about the other side of the double entry. If there is a debit to P&L, there must be a credit to somewhere else. Presumably, that credit could be to Creditors (the only comment I can find from the IASB refers to Cash, but that is not appropriate for most of the employee share transactions which are at the heart of the IASB proposal). Thereafter, presumably, taking a share option as an example, the double entry will be to debit Creditors and credit Share Capital/Share Premium? If my analysis is right, this creates a Balance Sheet fiction (to add to the P&L fiction). And what happens to that debit in Creditors if the employee share transaction does not subsequently mature (eg the share option is not exercised)?

It is this other side of the double entry that casts doubt on the ED 2 notion that there would be no write-back of the proposed expense if the employee share transaction were subsequently never to mature. If the IASB were to regard the employee units of service for these employee share transactions as more akin to unpaid overtime, this double entry complication could be removed.

SPECIFIC RESPONSES TO ASB QUESTIONS

The invitation to comment contains six questions to which the ASB particularly seeks answers. I answer those questions as follows.

Question 1

Essentially, I do not agree with the approach of adopting in the UK a standard based on the proposed IFRS. As you will understand from my previous comments, I do not support the proposed IFRS. I supply answers to the remaining questions, without prejudice to my answer to this question.

Any IFRS on the subject should not be introduced until such time as there is certainty that the rest of the world will adopt the same accounting convention.

Question 2

I fully support the FRSSE exemption, but this alone is not enough.

Some ‘small’ companies cannot take advantage of the FRSSE because of their line of work. For example, companies in the financial services sector are not able to avail themselves of FRSSE. All ‘small’ companies should be exempted from the obligations of FRED 31; they simply would not be able to cope with the administrative and financial burden of wrestling with the complexities of FRED 31.

All unquoted companies should also be exempted. The sheer complexity of the fair value calculations and the fact that the resulting numbers are completely unreliable make it obvious that unquoted companies should not have to observe FRED 31.

Question 3

I do not see that it is a question of whether there should be an exception for SAYE type share plans. To my mind, all share plans which are ‘all-employee’ plans should be excepted, because (as previously stated) they are about culture, participation, purpose and ownership. (This would include not only the Inland Revenue approved types of all-employee plan, such as SAYE and SIP, but also EMI and CSOP schemes where used on an all-employee basis.) The key, picking up again the IASB’s point about corporate excess, is that discretionary share schemes for executives should not be excepted.

Question 4

If I have understood the question correctly, any FRED 31 type proposal should apply to the entity whose shares are being used. Therefore, it should not apply to a subsidiary company (unless it is the subsidiary whose shares are being used).

Question 5

The idea of abolishing as many other regulations as possible and the creation of a single regulation like FRED 31 is a good thing. Others are more competent than me to give a detailed reply to this question. I would like to understand the presentation required by FRED 31 before absolutely approving the abolition of UITF Abstract 10.

Question 6

The proposed standard should not apply to transactions as from 7 November 2002. It should apply only to transactions from the standard's introduction date (ie 1 January 2004).

IASB's "BASIS FOR CONCLUSIONS ON EXPOSURE DRAFT"

It is hard to know where to start – and impossible to know when to end – in addressing the IASB's conclusions. The IASB's paper is littered with inconsistent reasoning and is predicated on the basis of some fundamental misunderstandings about employee share transactions, particularly in private companies.

The references used are the numberings used in the IASB paper.

BC8 et seq

The inference is that the Partnership Shares element of Inland Revenue approved Share Incentive Plans would not need recognising under the proposed standard.

BC11

The analogy with pension schemes is flawed, because employer-sponsored pension schemes involve an outlay of cash. The issuing of new shares to satisfy employee share transactions does not.

BC42

UK company law would not recognise the IASB's definition of assets. A company's own shares are not assets of the company (the shares of a subsidiary would be).

BC140

The IASB itself makes the case for exempting unquoted companies for the proposed standard. "These approaches…..are subjective". Indeed they are. They are very subjective and hence unworkable.

BC193 and elsewhere

The notion of an employee unit of service is of course a fudged solution. Even by its own logic, it is flawed. The IASB believes that the employee's relevant service should be the vesting period. However, some employee share schemes require a prior period of service before the employee can participate in the award of a share/share option. If the IASB really does believe in its argument that such transactions are disguised remuneration (ie a reward in return for employee service), then surely the prior period of service needs to be included.

BC205

If one uses the IASB's own logic at the beginning of its paper, an employee's leaving does not result in "no change to the entity's net assets". Using the IASB's logic, there has been a change in the entity's net assets; there has been, to use an IASB phrase, "A depletion of assets", in the form of the human capital asset which the proposal has been measuring in the 'employee unit of service' calculation.

BC205

There is a second piece of inconsistent logic in this section. It is argued that a departing employee "has no effect on the entity's financial position". (I will leave aside the obvious counter-argument that an employee's leaving has a serious effect on the entity's financial position.) There is no effect, it is alleged, because "in effect one type of equity interest (the option holder's interest) becomes part of another type of equity interest (the shareholders' interest)". If the IASB is right on this point, it then destroys its own logic for ED 2, because the converse must also be true. When an employee enters a share transaction there is similarly no effect on the entity's financial position. In effect, one type of equity interest (the shareholders' interest) becomes part of another type of equity interest (the option holder's interest). Therefore there is nothing to account for and so ED 2/FRED 31 are unnecessary.

IASB QUESTIONS

It is difficult to provide answers to the IASB's specific questions, when the basis for the questions is fallacious. However, in answer to IASB Question 3, there should be an exemption for unlisted companies. The proposed standard is simply unworkable for unlisted companies. The proposed standard is based on a fundamental misunderstanding about employee share transactions in unlisted companies.

It would be interesting to know if anyone at the IASB has the relevant experience to gainsay this view.

OTHER COMMENTS

As I mentioned, it is impossible to know where to stop in analysing the IASB's conclusions. The above are just some of the comments that could be made.

There are other aspects of the whole matter that the NW Brown Employee Benefits team and its clients have not got to grips with yet. Clearly, the position depends on whether new shares or issued shares are being used to satisfy the employee share transaction. For private companies the realisation route may have an impact (eg MBO, flotation, Employee Benefit Trust). Speaking as a share schemes adviser, I can also foresee some interesting negotiations with the Shares Valuation department of the Inland Revenue. Presumably, the Corporation Tax side of the Inland Revenue will be concerned, if the effect of FRED 31 is to depress the taxable profits of UK companies. (I wonder if you have sought or received any comment from that department or from other departments of the Inland Revenue?).

SUMMARY

I have written at greater length that I had originally intended, but there are important concerns to air. By way of a summary, I would list the following key points:

- Firmly against the proposed accounting standard, because the fundamental reasoning for it is seriously flawed.

- It should not be applied to private companies, because the proposed standard completely misunderstands what employee share transactions are usually about.

- Firmly in favour of the FRSSE exemption.

- It should not be applied to any 'small' company, because of the administrative and cost burden of tackling the highly complex fair value/option pricing calculations.

- If executive excess is a legitimate target of accounting standards, put the FRED 31 proposal where UITF Abstract 10 currently stands, so that executive share transactions are recognised rather than disclosed – this only for quoted companies.

- Issue revised FRED 31 proposal, aimed only at quoted companies.

- Detailed comment about the other side of the double entry for the mooted P&L expense.

Strident and critical as some of the comments in this letter are, nonetheless I hope that they are also helpful to your deliberations.

In closing, I would like to acknowledge Mary Keegan’s efforts. Mary’s willingness to step into the lion’s den and present the ASB’s views, to audiences whom she knows are not keen to embrace those views, has ensured greater debate and a better quality of debate about the ED2/FRED 31 proposals.

Yours faithfully

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