ICT
IRELAND

Leadership in Information and Communications Technology

17 April 2003

CL 239

Ms Kimberly Cooke
Project Manager
International Accounting Standards Board
30 Cannon St.
London

Re: ICT Ireland Submission on proposed new accounting rules for share-based payments

Dear Ms Cooke,

I am pleased to enclose a copy of the ICT Ireland position paper on proposed new accounting rules for share-based payments. ICT Ireland is the IBEC body representing the Information and Communications Technology (ICT) sector.

We support the principle of international accounting standards, but the proposals and the consequences of its adoption is of major concern to ICT Ireland. Among these concerns are:

- The International Accounting Standards Boards proposal, if adopted, would discourage use of broad-based employee stock option programme.
- The increased accounting cost, compliance costs, regulation and the need to put in place procedures and systems to track employees.

ICT Ireland is of the view that any concerns surrounding employee shares schemes should be addressed through greater disclosure and better corporate governance rather than new accounting rules.

ICT Ireland do not support the proposed new standard because we believe it will act as a disincentive for the take up of Employee Share Ownership Schemes, which allows companies **to** attract, retain and reward employees.

We hope that you will put forward ICT Ireland's position in any dialogue with your international counterparts on this issue.

Yours Sincerely

Jim OHara
Chairman

Enc:ICT Ireland position paper on proposed new accounting rules for share-based payments

Director: Brendan Butler

ICT Information and Communications Technology Ireland Limited. A Sector of The Irish Business and Employers Confederation

IBEC

April 2003

ICT IRELAND POSITION ON PROPOSED NEW ACCOUNTING RULES FOR SHARE-BASED PAYMENTS

ICT IRELAND

ICT Ireland is the body in Ireland representing the Information and Communications Technology (ICT) Sector.

Proposed New Accounting Standards

On 7 November 2002 the International Accounting Standards Board (IASB) published a draft of a new accounting standard on share-based payments. On the same day the Accounting Standards Board (ASB) published Financial Reporting Exposure Draft (FRED) 31 'Sharebased Payment'. The FRED presents proposals for an accounting standard based on the International Accounting Standards Board's (IASB's) exposure draft, ED 2. In the FRED the ASB proposes that the IASB's standard should be adopted in the UK and Ireland.

FRED 3 proposes that the standard should apply to all Irish/UK entities—both listed and unlisted—and to all share-based payment transactions, including all employee share option schemes, all Save-As-You-Earn (SAYE) plans and similar arrangements, and all share-based payment transactions involving the receipt of goods and non-employee services.

According to the ASB, the draft standard is based on the following principles:

- When an entity receives goods or other services in exchange for a share-based payment, it should recognise an expense.
- That expense should be recognised over the period in which the services involved are rendered or as the goods involved are received.
- The expense should be measured by reference to fair value.

Impact of Proposed New Standards

If adopted, the proposed new standard will require companies to expense in their accounts a cost of awarding shares and granting share options to their executives and employees. This standard will apply to all companies irrespective of size or type of employee share scheme in place. If the European Commission endorses this new standard, every company listed on a regulated market in the EU will be required to follow it from 2005 onwards. ICT Ireland acknowledges that it is important that a standard for accounting employee stock options is recognised which contributes to increased use of broad-based employee stock options programme while providing all stakeholders with meaningful, accurate and reliable financial information however are concerned at a number of proposals put forward by the IASB.

ICT Ireland's Concern

While ICT Ireland supports the principle of international accounting standards, this proposal and the consequences of its adoption is of major concern to the association. There are also concerns regarding increased accounting cost, compliance costs, regulation and the need to put in place procedures and systems to track employees.

Employee Share Schemes have been very significant across the EU in encouraging regular saving and investing by employees. This, in turn, has resulted in substantial transfers of wealth to employees. Indeed, for many employees, these plans have made a significant difference in their quality of life.

While the potential rewards of Employee Share Schemes are clearly appealing to employees, the link to performance and their ability to promote a common interest between employees and management make such arrangements increasingly attractive to employers. Employers often view share schemes as tools to incentivise and motivate employees and indeed, they are generally credited for aiding employee commitment and loyalty.

Current Practice

UITF 17 requires stock compensation expense to be charged to the profit and loss account to the extent that there is a difference between the market value of the share at date of grant and option price.

The UITF states that the credit entry should go to reserves but does not say what reserve. Therefore while current practice affects operating profits. it may not affect the distributable reserves of the company, if the current entry is made to retained reserves.

FRED 31

When an entity receives good/services and payment is in the form of an equity settled share based transaction, the proposed standard is of the opinion that an equity instrument is issued on the grant date and the fair value of that instrument on that date will equal the fair value of the goods or services that are expected to be received at the grant date.

In the case of a share option scheme used to remunerate employees, the fair value of the services received would be charged as an expense to the profit and loss account, with a corresponding credit entry to the equity capital of the entity. As the stock compensation is a notional entry, the reserve into which it is credited should be realised such that the distributable reserves are maintained.

ICT Ireland's Position

Technology companies, unlike companies in other industries, count on the issuance of stock options as a major source of compensation for its employees.

A transparent reporting of a particular transaction is one that gives a faithful representation of the underlying economic effect of the transaction on the reporting entity. We are not aware of any valid evidence that the grant of an employee stock option constitutes an economic cost to the granting entity. When an employee stock option is granted, there is no outflow of assets or a decline in asset value as a result of the stock option grant. Imputing an expense into the income statement would imply that there is an economic cost (i.e. an incremental cash outflow required) when no such cost (i.e. no outflow) has or will occur. The true economic cost of a stock option transaction is already reflected in current financial reports via the earnings per share disclosure

As far as the issue of 'fair value' is concerned the requirement to use an option pricing model to measure the value of an employee stock option will result in highly subjective and potentially unreliable data being recognised in the income statement as the standard requires companies to estimate a non cash expense, when none has been borne or accrued using a valuation method (e.g Black Scholes) not created for that purpose. There is no subjective model to determine the fair value of unexercised employee stock options. The "fair value" method in the proposed standard requires that the non-cash expense once calculated remains unchanged, taking no account of unexercised options or a change in the underlying economic value realised on exercise. In the present environment with many stock options underwater significant "expense" would be recognised when no actual economic value has been realised. This effect would serve to increase the distortion in financial statements over time and the subjectivity of assumptions used in option pricing models will yield diversity in application from one company to the next, thereby, impairing comparability and confusing the users of financial statements.

Summary

Current accounting for stock compensation expense affects operating profit, but does not affect distributable reserves. The measurement of stock compensation under FRED 31 is based on fair value, calculated by reference to an option pricing model. Hence, stock compensation expense is likely to be higher when calculated on fair values. FRED 31 accounting will reduce operating profits, and should be interpreted in a manner so as not to affect distributable reserves.

Earnings per share (EPS) is currently calculated by reference to profit after tax. Any adverse effect on operating profit will therefore have an adverse effect on earnings per share. EPS is an important performance indicator, in the market place. The dilution in EPS due to stock options is already reported in a company's financial statements. To create a further adverse effect on EPS due to stock compensation expense, would impair the transparency, comparability and usefulness of the company's financial reports. It would inappropriately and imprecisely "double count" the effect of stock options and could potentially have a negative impact on the market price of a share, unless it is adjusted for by analysts when they are assessing companies' performance.

Conclusion

According to the IASB, the objective of the proposal is to ensure that entities recognise share-based payment transactions in their financial statements, so as to provide high quality, transparent and comparable information to users of financial statements. The body also states that the proposal has been developed in the context of increasing take up by companies of Employee Share Schemes. However, ICT Ireland is concerned that the IASB proposal, if adopted, would impact the proliferation of new broad-based employee stock option programmes and lead to the cancellation of or narrowing of the employee base in existing schemes.

ICT Ireland's view is that the concerns that surround employee share schemes relate to executive schemes only and should be addressed through greater disclosure and better corporate governance rather than new accounting rules. ICT recognises the need for high quality, transparent financial reporting including the needs of investors for a true and accurate picture of the true cost of employee share schemes. Current accounting and disclosure rules provide this, while the current proposal will make them less meaningful and reliable

ICT does not support the proposed new standard because, ultimately, it will have a detrimental effect upon the take up of Employee Share Ownership Schemes.