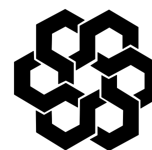

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International Accounting Standards Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting:	**2 November 2006, London**
Project:	**Review of published tentative agenda decisions**
Subject:	**IFRS 2 *Share-based Payment* - Incremental fair value to employees as a result of unexpected capital restructurings (Agenda Paper 7(ix))**

Tentative agenda decision published in July-2006 IFRIC Update

The IFRIC was asked to consider a situation in which the fair value of the equity instruments granted to the employees of an entity increased after the sponsoring entity undertook a capital restructuring that was not anticipated at the date of grant of the equity instruments. The original share-based payment plan did not provide for any adjustments to the plan in the event of a capital restructuring. As a result, the equity instruments previously granted to the employees became more valuable as a consequence of the restructuring. The issue was whether the incremental value should be accounted for in the same way as a modification to the terms and conditions of the plan in accordance with IFRS 2 *Share-based Payment*.

The IFRIC believed that the case presented was not a normal commercial occurrence and was unlikely to have widespread significance. [The IFRIC, therefore, decided] not to take the issue onto the agenda.

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22nd September 2006

Allan Cook
IFRIC Co-ordinator
IASB
30 Cannon Street
London EC4M 6XH

Dear Mr Cook,

Incremental fair value to employees as a result of unexpected capital restructurings

Thank you for inviting me to send a formal response to the 'Tentative Agenda Decision' published by the IFRIC after its July meeting concerning Agenda item 10(X). I have included with my response an Appendix setting out the main issues about adjusting share options after unexpected capital restructurings.

My General Comment
This item is on the agenda because of an article I wrote. The article, with its supporting papers, points out that share option values are changed when companies return money to shareholders, consolidate or dilute their share capital. If companies wish to preserve the value of issued share-options, the terms and conditions of the share-options must be adjusted. It is common practice after returning capital to shareholders to adopt a non-neutral way, by consolidating the share capital. Often this has the effect of enhancing share option values, sometimes very significantly. There is a neutral way of making such adjustments.

Although I have presented these arguments in the papers I have submitted, (now at www.roseacrebroadband.com/shareoptions and http://homepages.which.net/~nick.stevens), the arguments are hidden in the Information for Observers Paper circulated for the IFRIC meeting. Share consolidation and share dilution are described as if they were separate problems, in which share dilution (caused by share splits/bonus issues) is the only widespread condition raising the issue of how you preserve option values. The issue of capital return with its link to share consolidation is not specifically mentioned.

The correct approach should have been to look at IFRS2 share-based payments in the circumstances of an unexpected capital return or a capital restructuring or both events combined. When unexpected, you might conclude (as does paragraph 16 of the Information for Observers Paper when considering extreme cases) that whatever the benefit conveyed to staff by adjusting option terms and conditions or by consolidating company shares, there were no staff services being given in exchange. Without the notion of an extra service, there is no cause to work out a surrogate value of that service. But it is still important for a proper understanding of the issues in modifying terms and conditions on which share-options are granted (Paragraphs 26 to 29 of IFRS2) that the principles of a neutral adjustment be described in IFRS2. . It will alert those calculating the value of equity instruments of the factors they need to take account of. Some kinds of capital restructuring such as share buybacks often happen regularly and need to be anticipated.

By describing the principles of a neutral adjustment, you will be able to explain why reducing the exercise price of an option does not necessarily imply that extra staff services must have been given as is now assumed in BC228 in IFRS2. If IFRS2 does not recognise this possibility, it will penalise companies making a neutral adjustment after returning capital to shareholders by requiring them to act as if they had issued new equity instruments. It could be said, using the words of one member of the IFRIC committee, that IFRS2 now 'franks a device' for embellishing share-option values.

A correct approach is a consistent and complete approach.

- I submit it is not consistent to treat share consolidation differently from share dilution and no approach is complete without dealing with the issue of capital return.

- I note that the IASB works on the assumption set out in BC223 of IFRS2 that a company is always acting in the best interests of the company and its shareholders. If this is so, and a company (as many if not most do) says that its share-options terms and conditions may be modified merely to preserve their value, then an enhancing adjustment of terms and conditions (or an enhancing act through changing the company's capital structure) must imply a new service.

My Detailed Comments

Concerning the Information for Observers Paper.

- Paragraph 8 and 18 argues that because terms and conditions of an original share option plan are not changed, no modification or expense should be recognised. This will encourage companies to make non-neutral adjustments in the same way that BC228 does as I have argued above.
  IFRS2 would seem to have been written without anticipating the effects of capital restructuring. If you can accept the need for terms and conditions to be changed to avoid a loss of value in employee share options, it is only proper to recognise the need for changes to avoid increases in value; and that the absence of such changes represents a modification or expense.
- Paragraphs 9, 13 & 19 assume we are dealing with a share scheme in which there are no generic terms and conditions laying down a procedure for adjustments. That was not the case I was submitting for your consideration. The proposition I would like you to consider is that there are generic terms and conditions but they are inadequate, at least in the UK because of a lack of recognised standards.
  According to the Association of British Insurers who monitor UK schemes, most will claim their schemes will be adjusted as necessary to preserve the value of share options. The manner of the adjustment is often not described and it is usually left to Company's auditors to say whether the adjustments are fair and reasonable. There are no laid down standards as to what constitutes a neutral adjustment that companies and auditors can access. Share options that are issued by market traders are subject to adjustment laid down by the relevant market authorities. As is explained in the Appendix, these adjustments are not intended to be neutral. It is possible however that they are used by auditors and others as having the imprimatur of an impartial authority.
  I don't know the position of other countries, but a request is being put to the European Shareholders Group in case they can give further information.
- It is wrong for Paragraph 10 to dismiss the issue of consolidations enhancing share option values as being 'without widespread relevance'. I suspect there has been misunderstanding about the events being considered. They do not consist just of a share consolidation. The event submitted for IASB consideration was where companies combine paying a special dividend (or in other ways return capital) with a consolidation of the company's shares with no adjustment to employee share-options. This is not a rare event and the same process is inherent when companies buy back shares and cancel them. I have not been able to find figures showing the extent of share consolidations but there are statistics on share buybacks. In 2004, quoted companies in the UK were involved in making £14 billion of buybacks in a market valued at around £1200 billion.

Concerning the IFRIC discussion of the issues posted on the IASB website, I would make the following points:

- There seemed to be some confusion about the nature of company share repurchases. It was suggested that this would not in the end raise share prices. This might be true if the shares are later reissued but normally they are not. In the papers I have submitted to you, there are academic references on the price effects of share repurchases or buybacks.
- The particular case I brought to your attention was not a share option scheme with out rules for adjustment. The rules had met with the requirements of the Association of British Insurers that tries to vet such schemes and the Inland Revenue.

- You cannot expect regulators to define what proper neutral adjustments are. The issue was in fact put to the FSA (UK Listing Authority). I pointed out that the proposed terms and conditions of the warrants (share options) being offered to British Energy existing shareholders did not provide for a neutral adjustment. The company denied this but offered no contrary evidence. The Regulator, after commenting that I had raised '*some pertinent and challenging points*' decided:

"(since) …the Listing Rules do not dictate the specific terms and conditions of the warrants for listed Companies generally….. the nature of the specific terms and conditions of the warrants are a matter for the Company and its advisers. Further, the UKLA (UK Listing Authority - a division of the FSA) would consider it inappropriate to publicly opine on the terms and conditions of the warrants of any one particular listed Company."

One might think that the UK Tax authorities would have something to say about tax approved schemes, since they claim to "*consider whether the value of the adjusted share option (after a variation of capital) reflects what it would have been had the new share structure been in place when the options were first granted."* In practice when share options are not adjusted, they leave "*The issue of fairness (neutrality)….in the hands of companies and their shareholders."* with the knowledge that "*the company auditors will usually confirm that the adjustment is fair and reasonable."*

- If Regulators cannot be expected to lay down the nature of neutral adjustments, the onus must surely fall on IASB in the description being given in IFRS2. This does not mean creating a 'rule book'. The general principles of a neutral adjustment are very simple.
  - a share consolidation ought to prompt a like consolidation of the equity instruments,
  - a share dilution with an instrument dilution, and
  - a capital return with a compensating extra instrument benefit (in the case of share-options, a reduction in the option strike price.)
- A distinction was made between unanticipated share consolidations made for commercial reasons and those for enhancing share-option values. It was suggested that only the latter should trigger action to re-evaluate the fair value of the equity instruments. The problem with such a distinction is that it is not proposed to apply the same criteria to share splits. Moreover it raises the question of what is meant by a 'commercial' share consolidation. In my experience, companies often say that they are consolidating shares after a capital return because shareholders would not understand why otherwise the share price had fallen. If this is accepted as a commercial justification for share consolidations, there will be no occasions when consolidations are not commercial.

Conclusion

I hope IFRIC will reconsider its tentative decision not to take on the issue of *Incremental fair value to employees as a result of unexpected capital restructurings.* The problem is widespread and needs to be looked at in the round, and not by isolating one facet, share consolidations. The particular case I presented to you was a normal commercial occurrence. It was described wrongly in the Information for Observers Paper as having abnormal features.

Yours sincerely

J N Stevens

Cc Michael Mckersie ABI
Jonathan Finlay FSA (UK Listing Authority)
Dr Nick Steiner Chairman UKSA
European Shareholders Group Brussels
Rosie Carr Deputy Editor Investors Chronicle

Appendix
Issues in adjusting share options following capital restructurings

Unanticipated events, returning capital to shareholders, share splits/dilution (as with bonus share issues), reverse share splits /share consolidations, all impact on the fair value of equity instruments. The impact can only be avoided if the terms of those instruments are changed so as to leave instrument holders no better or worse off than before the event.

The general principles of a neutral adjustment are very simple:

- a share consolidation ought to prompt a like consolidation of the equity instruments,
- a share dilution with an instrument dilution, and
- a capital return with a compensating extra instrument benefit (in the case of share-options, a reduction in the option strike price.)

For a more detailed proof, see www.roseacrebroadband.com/shareoptions or http://homepages.which.net/~nick.stevens/

There can be no neutral adjustment if shares are consolidated but not the equity instruments. To do so, gives the instrument holders a greater share of the potential claims to a company's future distributed profit stream. The value of this increased share is unlikely to equate to the compensating benefit which instrument holders need after a capital return to shareholders. Yet it is often practice after such a capital return, not to provide a compensating benefit, but to reduce the share capital in the same proportion as the capital has been withdrawn from the company. On the day of the capital withdrawal and share consolidation, the share price may thus be unchanged. But the value of the equity instruments will have changed and will in recent years probably be much higher * than had a neutrally adjusting compensating benefit been undertaken.

Traded share options on London's Euronext.Liffe Exchange have their own rules for adjustment after a capital restructuring. The rules are not neutral and when companies give shareholders special dividends follow by a share consolidation, only minor adjustments are made to take account of the market's initial reactions to the share consolidation. In the case of traded options issued and sold by market makers, it does not matter that the adjustments are not neutral. The cost to them of making non-neutral adjustments can be covered in the price at which they sell the options. That price must, if need be, cover the cost holding shares for when the options are exercised, investing any special dividend earned on the holding to buy more shares to meet the consequences of any subsequent consolidation of the holding's shares.

Companies that issue share options have to be mindful of the interests of their existing shareholders. They are not generally in the business of selling share options but in giving options as a reward to staff or shareholders. Companies usually declare that the purpose of any adjustment after a capital restructuring is to preserve option values but not enhance them. There is no obvious reason why it would be in the company's interest to do otherwise.

Given the intention to make neutral adjustments, it may be asked why any adjustment is necessary when there is a market share buyback followed by a share cancellation. In relation to the remaining shareholders, the option holders have no greater potential claim over future distributed profits. Whilst this is true, option holders are in effect being awarded potential benefits before vesting day, before they are entitled to it. A neutral adjustment would treat the share buyback just as if there had been a special dividend followed by a share consolidation. This would entail giving the option holder on vesting day a credit equivalent to the special dividend to offset against the option strike price with his option rights then being consolidated just as the shares had been. It would be up to the holder to invest the credit in extra shares if he wanted this.

Share buybacks do not always represent a return of capital, but may be a way of giving shareholders their dividend in a form which avoids income tax. In such cases, option holders are not entitled to any of the fruits of the buybacks taking place before vesting day. A neutral adjustment would simply consolidate the options rights in the same proportion as the share cancellation.

* The consolidation will increase share price volatility and ensure a higher share price raising the instrument's value compared to a neutrally adjusted instrument having instead compensation abatement – in the case of share-options, a lowered option strike price. If on vesting day, the share price is higher than at the time of the share consolidation, holders of the equity instrument will be better off than had a neutral adjustment been made. At times of rising share markets, holders can benefit spectacularly. Conversely in falling markets they lose out. That is the time to choose a neutral adjustment!