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Kimberley Crook
Project Manager
International Accounting Standards Board
Via email

Dear Ms Crook

Share Based Payments

The Australian Venture Capital Association (AVCAL) wishes to comment on *Exposure Draft 2: Share-Based Payment*. AVCAL believes that the accounting treatment of Share Based Payments is an issue that is of critical importance to the venture-backed SME sector, and is appreciative of the opportunity to contribute.

While AVCAL is supportive of increased transparency and improved corporate governance we have several concerns with regard to the treatment of share based payments as outlined in the November exposure draft. These concerns primarily relate to the scope of the IFRS. AVCAL believes that the inclusion of employee share options (ESOs) as an expense is fundamentally flawed and particularly punitive when applied to unlisted, high growth companies.

AVCAL cannot support the proposed standard, as we believe that it is inappropriate that ESOs are bundled with share-based transactions for goods and services with clearly attributable value. Our concerns in this area are set out below.

Inclusion of ESOs is detrimental to financial statement transparency.

Paragraph 20 of the November Exposure Draft specifies that the fair value of options granted shall be either:

1. measured at the market price of traded options with similar characteristics, or;
2. estimated by applying an options pricing model, such as the Black-Scholes model or Binomial model.

When applied to venture-backed unlisted companies the proposed methodology produces spurious valuations that do not reflect actual costs to the company. It was never intended that the Black-Scholes and Binomial methods should be applied to the valuation of options where the underlying securities are not traded on the open market. Using these models in the context of expensing ESOs in unlisted entities is therefore a misapplication of the theory underlying both methods that will contribute to accounting inaccuracies.

The inaccuracies of the proposed valuation methods are highlighted by the differences in value that are obtained with differing timings of recognition. Recognising the expense upon grant of an option produces a valuation substantially lower than at the vesting date (*The Economist*, November 9th 2002), despite the fact that balance sheet effects of the options at both of these times are identical. If the expensing of options is justified on the basis that dilution of earnings represents a cost to shareholders, then the valuations applied at these stages should be similar.

AVCAL accepts that in the instance of goods and services received from third parties that the cost to the company is easily attributed to the fair value based on the established market price, and they should therefore be expensed. However, granting employee options generates neither assets nor liabilities, and there is no associated consumption of goods or services. It is therefore unclear that employee stock options meet the generally accepted definitions of an expense.

The proposed valuation methods effectively guarantee that the costs reflected in financial statements of unlisted companies will be inaccurate. Consequently the transparency of financial statements will suffer. Moreover, the requirement for qualitative estimations of share price volatility – a fundamental parameter determining option value - raises the prospect of manipulation. AVCAL therefore regards the proposed valuation methods as a backwards step that will be detrimental to corporate governance.

Expensing options will act as an impediment to commercialisation

Early stage businesses face especially difficult contingencies that require them to attract and retain some of the best and brightest managers that are available. Often these businesses are comprised of small teams that are attempting to commercialise innovative new products and develop new markets. They have uncertain earnings, and are highly dependent upon the brilliance of individuals to drive the business forwards. In these circumstances there is a real risk for managers that the company may prove to be unviable. High calibre individuals will require compensation for accepting this employer risk. Options are the currency that empowers innovative start-up companies to attract skilled managers into high-risk environments.

The expensing of options will effectively prevent start-ups from offering competitive remuneration to executives. This will in turn be detrimental to innovation, jobs creation and economic growth.

This circumstance is worsened by the proposed methods for valuation. Early stage businesses are characterised by highly volatile revenue and earnings. This affects the inferred volatility of the underlying shares. Therefore options granted to employees of early stage businesses would, under the proposed standard, represent a greater expense than similar options granted to employees of businesses with stable maintainable earnings. Similar effects would be observed across industry sectors. The proposed IASB standard is therefore disproportionately punitive to early stage businesses and should not be adopted.

Expensing options fails to address the real issues of corporate malfeasance

Much of the momentum that has built up around the expensing of employee options has resulted from recent corporate malfeasance (e.g. Enron, WorldCom, Adelphia). During the furore that eventuated as a result of these events, corporate remuneration, particularly options, was misattributed as the motivation for this criminal behaviour.

The true reasons for these scandals were inadequate control and governance systems, and individuals colluding to misrepresent the facts. Enron and company represent a betrayal of the fundamental tenets of honesty and integrity. Expensing options cannot address problems arising from moral turpitude and the willingness of individuals to lie for personal gain.

While AVCAL condemns the actions of the people involved in these frauds, we do not believe that the broad-brush approach of expensing options successfully addresses the underlying issues. Additionally, application of these rules is entirely inappropriate for the private sector, where shareholders are typically more involved and activist in the operations of the company. On this basis arguments for the expensing options in the interests of shareholder protection are less compelling in the private sector.

The actual cost to shareholders is unclear

Most arguments for the expensing of options are predicated on the cost to shareholders via earnings dilution. In the public sector, the principal driver of market value is diluted earning per share. Therefore the market 'looks through" balance sheet effects of employee options and applies them as a discount to market capitalisation. This is generally accepted methodology. Expensing employee options via the P&L therefore represents “double counting” of the cost to shareholders.

In the private sector, the cost to shareholders is offset by A) the value generated by the ability to attract and retain high calibre staff, and B) generally higher levels of shareholder involvement and activism that acts as a systemic counter balance to excessive shareholder dilution.

Conclusion

AVCAL is of the opinion that the scope of the proposed standard is too broad. Employee share options should be excluded from the requirement to expense, as they are an integral part of executive remuneration in the start-up sector. Forcing unlisted companies to expense employee share options will severely impede their ability to compete for the best and brightest.

Market-based option valuation methods are inappropriate for unlisted entities. They produce incorrect expense results that are detrimental to the integrity of financial statements, disproportionately punitive to high growth companies, and open to manipulation.

Consequently we believe that expensing employee options will inhibit commercialisation and innovation, to the detriment of jobs growth and economic prosperity. AVCAL cannot support the proposal.

Thankyou for the opportunity to express our views.

Yours Sincerely

Jake Burgess
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