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AASB Exposure Draft ED 108 - Comments

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I am pleased to accept the invitation to comment on AASB Exposure Draft ED 108. Since I broadly endorse the proposed treatment, my comments will be brief.

The central observation I would like to make, previously put forward in the *ustralian Financial Review,* 28 October 1999 (attached as Appendix 1) is that the issue of share options is typically accompanied by a policy of share repurchase. Thus a typical transaction would have the following stages:

Grant date: Option is issued to employee

Vesting date: Option is vested and, if strike price is less than share price, exercised

Vesting date: Enterprise repurchases shares to offset exercise of options

The net impact of this set of transactions is no change in equity and a money transfer from the enterprise to the employee equal to the gain on the option. The question of whether the employee sells the shares acquired from the exercise of the option is irrelevant. In practice, the timing and magnitude of share repurchases is not matched precisely to the exercise of options, but the underlying economic reality is the same.

My substantive suggestion is that companies should be able to choose between:

(i) a treatment based on the assumption that no offsetting share repurchase will be made. In this case, the option should be treated as an expense at the date of grant and valued using an option pricing model, as in the Exposure Draft. The issue of options should be recognised as an increase in equity

(ii) a treatment based on a policy of automatic repurchase. In this case, the actual cost of repurchase, less the strike price, should be recognised as an expense at the date of vesting/exercise. This expense should be equal to zero in cases where the option does not vest or is not exercised. Under this treatment, there are no implications for equity. The option is merely a form of stochastic remuneration similar to bonuses or profit sharing schemes.

As noted in the Appendix, treatment (ii) is broadly consistent with the tax treatment of options adopted in the United States.

Appendix: Quiggin, J. (1999), ‘US shows plenty of options for creative accounting’, *Australian Financial Review*, 28 October.

In every macroeconomic forecast today, the big unknown is the US stockmarket. If the stockmarket stays strong, nearly all forecasters agree that the world economy will recover from its recent slowdown. If the stockmarket falls sharply, no-one knows what will happen.

Stocks are ultimately shares of company profits. In the end, therefore, what happens to the stockmarket depends on what happens to profits. The surge in stock prices over the past few years reflects a belief that profits are growing, and will continue to grow. It is then, interesting to observe that while US companies are reporting rising profits to their shareholders, many of them are reporting declining profits to the taxation authorities.

The simplest interpretation of this apparent contradiction is that companies are getting better at dodging their taxes (the *euphemism du jour*is ‘tax-effective financial engineering’). If so, shareholders are right to focus on the annual reports they receive and ignore the second set of books their companies provide to the taxman.

It turns out that much of the difference between accounting profits and those reported for tax purposes relates to the treatment of options given to executives and other employees as a substitute for higher wages. The accounting principles used by most companies allow them to disregard such options when reporting their profits to shareholders. By contrast, the US tax authorities treat the benefit realised by employees when they exercise options as wage income, and reduce the profit of the issuing company accordingly.

The plot thickens further when we observe that most US companies are net buyers of their own stock and that the main reason for such purchases is the desire to offset the dilution of equity arising from the issue of options to employees. If we put the two sides of this transaction together, we can see that the definition of profit used by the taxation authorities is the correct one. If a company provides employees with an option to buy stock cheaply, then repurchases the stock at the market price, the net effect is just the same as if the company paid the employees the difference between the exercise price of the option and the market price of the stock.

In theory, the employee bears the risk that the price will fall between the issue of the option and the vesting date at which it can be exercised. But in practice, when stock prices drop, leaving executive option-holders 'out of the money', many companies compensate them by lowering the exercise price of the options so as to maintain their value.

Reliance on options as a form of payment is at its greatest among the booming Internet startups. But options are not the only form of creative accounting employed in this sector. For many Internet firms, the main source of revenue is advertising. A lot of the time, ads on one site are provided in exchange for reciprocal advertising on another. The trick is that the advertising services can be treated as payment in kind, and valued at the inflated prices associated with all things .com. Revenues soar, even though no money changes hands. Price Waterhouse Coopers has estimated that 7 per cent of all Internet advertising revenue is derived from such barter deals, and other estimates range as high as 15 per cent.

In fact, the Internet sector is probably a net consumer of advertising services. TV, print and billboard media in the US are plastered with ads for Internet services, but the traditional economy tends not to return the compliment. A few hours surfing reveals that most Internet ads are touting other Internet firms.

US Federal Reserve Chairman Alan Greenspan has been worrying about these issues. In a recent speech at Jackson Hole he estimated that US corporate profits were inflated by as much as 10 per cent by reliance on options as a payment method, as well as reductions in contributions to employee pension funds permitted by the rising stock market. On the other hand, he argued that profits were understated because of the practice of expensing, rather than amortising, purchases of software. More generally, he suggests, accounting profits take inadequate account of knowledge, the main asset in an information economy.

Greenspan expresses the view that the understatement of investment in knowledge is more important than the spurious increases in profits associated with payment by options. In view of the crucial role of stock markets in driving the current expansion, we must all hope that he is right. But those who have not shared in the bonanza of options and capital gains will no doubt feel a justifiable touch of schadenfreude if he is wrong and the bubble finally bursts.