The Quoted Companies Alliance

CL 159

Exposure Draft 2, "Share-Based Payment":

The Reply from the Quoted Companies Alliance

March 2003

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1. INTRODUCTION

1.1 On 7 November 2002, the same day as the IASB published ED2, the UK Accounting Standards Board published FRED 31, thereby effectively endorsing ED2 in terms of both content and timing. Interested parties were asked to furnish the IASB with comments on the proposals by 7 March 2003.

1.2 This paper constitutes the reply of the Quoted Companies Alliance ("QCA"). The response has been prepared by QCA's Accounting Standards Committee and reviewed by its Share Schemes Committee.

1.4 FRED 31 lists a number of questions in respect of which specific comment was invited. For reasons that should become apparent QCA does not support the proposals. This response therefore addresses the wider issues rather than providing comment on the specific matters raised in the exposure draft.

2. SUMMARY OF QCA'S RESPONSE

2.1 QCA does not believe that the proposals as described in ED2 should be adopted for a number of reasons:-

- *The principle* –The proposals relating to equity incentives (share schemes), rather than share based payment for goods and services, has attracted most attention from members. QCA rejects the principle of recognising a cost associated with equity incentives schemes despite recognising that opinion is divided as to whether or not the concept is flawed.

- *The method* - Opinion is united in the view that the solution proposed is flawed to the extent that it is debatable whether or not the information produced will ever meet the proposal's objectives of providing "….high quality, transparent and comparable information to users of financial statements".

- *The effect* - It is likely that the proposals will not only reduce the number of new share schemes, but may well also discourage companies from continuing to operate the share schemes they had previously operated. QCA is of the opinion that there is sufficient evidence to believe that companies should be positively encouraged to (rather than discouraged from) establishing and operating share schemes for their employees.

3. THE PRINCIPLE

3.1 QCA accepts that an issue of options represents compensation in the form of potential future monetary value but would argue that whereas the treatment of cash compensation is clear, it is debatable whether or not options represent a "cash equivalent". Rather than having a cash flow impact, the conversion of options dilutes the interests of shareholders. Similarly, the argument that options represent an opportunity cost is weakened both by the fact that there is no certainty as to there being a market for share issues and because the expensing of opportunity costs is generally inconsistent with current GAAP.

3.2 The arguments set out above are supported by the fact that the attribution of a theoretical value to options which has not only proved to be problematic but has also undermined the support of those who are sympathetic to the argument that equity incentives have an intrinsic value and that a cost should perhaps be recognised.

3.2 The interests of shareholders is, to a certain extent, protected by the existing disclosure regime in connection with share schemes which is both well established and understood. Share plans require shareholder approval and are subject to dilution limits. Furthermore, the potential impact of shares under option is disclosed by way of fully diluted earnings per share calculations.

4. **THE METHOD**

4.1 QCA believes that the logic of recognising a cost in connection with equity incentive schemes has not only been significantly undermined by the proposals relating to the calculation of that cost but, as a result, the proposals will fail in their stated objective.

4.1 *Fair value*

QCA believes that the degree of estimation required in defining and attributing cost must call in to question whether or not the information produced will ever meet the proposal's objectives of providing "…. high quality, transparent and comparable information to users of financial statements". For transactions involving employees, it is proposed that the expense to be borne by an entity will be the fair value of equity instruments granted. Fair value must be based on market prices if available and if no such price is available, fair value must be calculated using a model that takes account of all the terms of the options. In most cases, no market price will exist and option-pricing models will have to be used. Employee options tend to be subject to special terms and conditions and as a consequence are not only non-tradable but also of less intrinsic value. Option pricing models, such as Black-Scholes, were designed to value traded options. The proposals recognise this fact by specifying that in order to determine fair value not only would exercise price, anticipated price volatility, dividends and the life of the option have to be taken in to account, but also the terms of the option. Further speculation is then required to spread cost across the life of an option.

4.3 *Non reversing entries*

In order for an expense to be recognised by an entity, value does not have to be delivered to an employee. Therefore in instances where an employee ceases to have a right to exercise an option, neither will further cost accrue nor costs recognised to date reverse. By the same token, where a share falls in value to less than exercise price, an expense will have to be recognised despite the fact that the employee is unlikely to exercise such options. QCA is not convinced by the argument that the above-mentioned factors should (or could) have been factored in to the calculation of fair value.

4.4 *No link between cost to entity and fair value ultimately received*

The Discussion Paper "Share-Based Payment" produced by G4+1 in July 2000, proposed that the cost to be recognised by an entity should be based on the value received by a participant at vesting. The uncertain and speculative nature of forecasting value at vesting led many to advocate adoption of a fair value calculated at the date of grant, a recommendation adopted by the current proposals. As a result, the logic of equating a cost to the entity and value ultimately received by an employee has been lost and in so doing, the case has been strengthened of those who argue that the process of determining cost undermines the objectives of the proposals.

4.5 Many responses to the original G4+1 proposals suggested additional disclosure as being a more appropriate approach to share based payment – an approach adopted by the U.S. Financial Accounting Standards Board in SFAS 123. Unfortunately, ED2 has adopted the concept of detailed disclosure with alacrity and the level of disclosure now required is extensive. Much of the required information would not only be repetitive year on year, but would also bear little relevance to the calculation of the expense. It is difficult to see any benefit in such disclosure other than for the purposes of good corporate governance.

5. THE EFFECT

5.1 It is unfortunate that for the rest that the likely effect of these proposals will be a reduction in the number share incentive schemes operated. In particular, the potential loss of all-employee share incentive schemes would be an expensive price to pay for an imperfect accounting standard.

5.2 The proposals will result in companies having to recognise a potentially significant charge through their P&L in relation to the operation of share schemes. The effect of this on a company's willingness (or, indeed, ability considering the fact that such charges could cause the company to become technically insolvent) to establish and/or continue operating share schemes would be neutral at best. Consequently, it is likely that the proposals will not only reduce the number of new share schemes established by UK companies, but may well also discourage companies from continuing to operate the share schemes they had previously operated.

5.3 Companies should be positively encouraged to (rather than discouraged from) establishing and operating share schemes for their employees. This is because there are a number of benefits that a company should enjoy by operating such schemes, including:-

- the retention of existing employees;
- employee motivation;
- improved business performance; and
- widespread employee share ownership.

5.4 There is strong evidence to suggest that companies operating employee share schemes do perform more successfully than those that do not. Many UK companies cite employee shareholding as a major factor in their success and an essential a feature in the remuneration packages they offer, particularly in light of the increased number of international companies that operate share schemes for the benefit of their employees.

5.5 Indeed, the Department of Trade and Industry published a paper entitled "Consultation on Share Ownership" in 1998 in which the Government's full support of employee share ownership was clear. The paper stated that the Government viewed increasing employee stakeholdings as having a positive effect on productivity in UK industry. To quote a passage directly, "*employee share ownership offers the prospect of bridging the gap between employees and shareholders to the long term benefit of employees, managers and outside investors. By aligning more closely the interests of the workforce and the owners of the company, employee ownership can help increase co-operation."* The DTI paper also stated that employee share ownership has a "*part to play*" in bridging the gap in productivity levels between the UK and Europe. QCA continues to support the principles of wider share ownership and employee participation.

6. CONCLUSION

6.1 QCA believes that the attempt to make entities recognise a cost in relation to equity incentives is intellectually flawed. The unfortunate effect of the proposals will be a reduction in the incidence of share schemes and very probably, the death of All Employee Schemes. QCA remains opposed to the principle and will continue to voice opposition.