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From Richard Hayes Our reference RWH

To fred31@asb.org.uk

Dear Sirs

FRED31

We are responding to the invitation to comment on FRED31. Addleshaw Booth & Co is a full service commercial law firm based in Leeds, Manchester and London. Within the practice we have a specialist unit advising on the design, implementation and operation of employee share schemes. We have conducted a survey among client and contact companies. Responses to that survey inform the contents of this letter.

The following are our principal concerns about the effect upon employee share schemes of the proposed accounting standard if implemented in the form of ED2:

1 Whilst we acknowledge the intellectual rigour of the arguments put forward by the IASB in ED2, we believe that the proposals in the Standard are disproportionate. The preface to FRED31 suggests that the draft Standard is a response to a call for improvements from users of financial statements. Those users are not defined and we question whether, apart from stock market analysts, the proposals are relevant to other users of accounts. We do not consider that they can be of any relevance to those interested in cashflows and asset values such as bankers, whatever the size or nature of the company. The proposals will not provide any benefit for a closely held private company offering an element of share participation to its workers, either to its existing major shareholders if they are long term holders, or to any prospective trade purchaser of the company who, far from relying on the accounts, will invariably require detailed due diligence before forming an assessment of the value of the company.

2 There is now a political consensus in the United Kingdom in favour of encouraging employee share ownership. The beneficial tax regime for enterprise management incentives (EMI) introduced in 2000 specifically to encourage employee participation in smaller companies to encourage their growth. At the same time, the introduction of the share incentive plan (SIP) was specifically designed to encourage wider equity participation in companies of all sizes by

employees. The aims of both these pieces of legislation will be compromised by the introduction of the proposed standard.

3 Part of our share scheme practice involves advising venture capital houses, such as 3i plc, on employee share schemes proposed to be introduced by investee companies. In many cases, the investments are in management buyouts where the senior management are already incentivised by investing in the initial equity, the value of which is capable of being ratcheted up on a successful exit. Share option schemes, which, wherever possible, will take the form of EMI schemes, are an important tool in incentivising employees other than the senior managers participating in the MBO itself. Their value is recognised both by the venture capitalists and by the management team as a tool to drive the business towards a successful exit, whether that is a trade sale or an IPO.

To these companies, low cost and ease of operation of any employee share scheme is vital. Such companies do not have the resources available to meet the compliance requirements of ED2 using their own staff and the costs of engaging professional assistance are likely to be unacceptable. As indicated above, we do not believe that the adjustments to the accounts which would arise through the operation of the Standard will provide any meaningful assistance to any of the stakeholders in such companies, by which we mean the management team, equity providers, lenders, creditors and employees. Nor do we consider that the adjustments will affect the behaviour of any purchaser of such a company on a trade sale.

4 We are, therefore, of the view that, if the Standard is to be adopted, it should be limited to companies whose shares are publicly traded on any exchange. We do not think that such a distinction will be problematic in the case of the acquisition of an unquoted company by a quoted company, as it is our experience that in almost all cases employee options over shares in the target will be exercised at the time of acquisition. In the case of an IPO, where options were granted some time before the IPO, we would argue that the cost and difficulty of constructing an appropriate charge for the relevant accounts at and after IPO would be disproportionate to the distortion, if any, for a limited period between the reported profits of such a company and those of its peers.

5 We are aware, through our membership both of the Share Schemes Lawyers Group and ProShare, of the representations made to you concerning the applicability of the Standard to all employee share schemes such as savings-related schemes and SIP. We endorse the view that SAYE schemes cannot on any conceptual basis be considered to be remuneration. The most that the company does is to give its employees an opportunity to choose whether or not they wish to save and have the opportunity to acquire shares to the value of those savings. It is entirely the decision of the employee whether or not to save and to determine the amount of saving. A senior and well remunerated employee may have financial commitments that mean that he or she is unable to save a substantial amount per month. A very much more junior employee paid at a much lower rate may be the second earner in a household whose earnings represent pin money which is not required for household expenses. Such an employee may determine that, in the absence of immediate requirements, a substantial saving in a SAYE contract represents appropriate financial planning. Such an example points up the absurdity of applying ED2 which seeks to value the services of these employees by reference to the value of the shares under option.

6 Exactly the same argument will apply to the partnership share element of a SIP. Indeed, it is difficult to see how the principles of ED2 would apply in any event to purchases at market value of partnership shares. The provision of free or matching shares under a SIP involves the company in real expenditure, which is recognised as being tax deductible and will be charged to profit and loss account. We can see no reason why these real costs should be replaced by the theoretical costs of ED2 for accounting purposes.

7 The cost impact of ED2 on the operation of all employee share schemes by companies of all sizes will, in our view, result in many companies reviewing the provision of such schemes. Many of our clients operating SAYE schemes and SIPS are small quoted companies, either on the full list or on AIM. These companies do not have large internal resources to meet the compliance requirements of ED2 and, in judging the overall benefits package made available to their employees, the cost of such compliance is likely to weigh heavily in their decision on the types of benefit made available.

8 We therefore believe that the overall effect of ED2 will be to reduce the availability of all employee share schemes in all but the largest companies which have the resources to meet the compliance requirements and to whom the costs are, in relative terms, small.

9 The smaller quoted companies referred to will continue to be obliged, in order to recruit and retain senior management, to offer share based incentives. Here it will be the normal case that the share incentive is part of a balanced remuneration package, also involving fixed salary and variable performance related pay. As the number of participants is likely to be much smaller, the compliance burden will be that much less and we can see no reason for excluding such smaller quoted companies from the ambit of the Standard, if it is to be introduced. Conversely, however, the arguments for excluding all employee share schemes apply to all companies including the largest quoted companies.

10 Those responding to our survey are virtually unanimous in their concerns about elements of the proposed level of disclosure, in particular, those relating to expected future dividends, assumptions concerning the likelihood of employees leaving employment, assumptions regarding expected volatility and assumptions concerning the meeting of performance conditions. All of these are seen as requiring forecasts to be made. In addition, disclosing assumptions as to participants leaving employment will be extremely sensitive, and virtually impossible to make, in circumstances where management is contemplating the possibility of major redundancies or of the disposal of certain businesses and where no announcement has yet been made. The need for adequate disclosure of the following aspects in respect of all schemes and not just those schemes in which directors participate is overwhelmingly recognised:

(a) description of each share scheme operated;

(b) identification of number and class of employees participating;

(c) identification of performance conditions and vesting requirements;

(d) details of options granted, exercised and lapsed during the financial period;

(e) identification of the range of exercise prices at the end of the financial period.

Conclusions

1 We consider that the imposition of the Standard on unquoted companies will impose upon them compliance costs which are disproportionate to the usefulness of the information to the stakeholders and potential stakeholders in such companies. Indeed, we believe that such information is of almost no relevance to such stakeholders.

2 The compliance costs will deter all but the most substantial companies from introducing or extending all employee share schemes and will accordingly run counter to the enterprise culture being fostered politically through the introduction of EMI and SIPs.

3 Nevertheless, there are in relation to all employee share schemes deficiencies in the disclosure currently required about those schemes. We therefore support an enhanced level of

disclosure, but not disclosure of price sensitive and otherwise confidential information which ED2 proposes in order to support understanding of option pricing models used.

4 If companies cannot prudentially disclose the basis of their option pricing models, this calls into question the whole concept of requiring the use of such models.

5 It is our view that enhanced disclosure will give users of accounts all the information they require to assess the impact of schemes. If the consensus view is that disclosure is not of itself adequate, then we believe that current proposals are flawed and in this respect lend our support fully to the comments in paragraphs 3, 4 and 5 of the response from the Share Schemes Lawyers Group dated 28 February 2003.

Yours faithfully

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