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Mr. Andrew Lennard
Accounting Standards Board
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3 November 2000

Dear Andrew

Accounting Standards Board Discussion Paper—Share Based Payments

I have pleasure in enclosing our response to the above discussion paper. I have enclosed four copies for your own distribution, and it will also be available on our web-site at www.qcanet.co.uk in due course.

I look forward to seeing you at the combined meeting of our Accounting Standards and Share Schemes Committees on Wednesday next, 10.30am, at the offices of Arthur Andersen, 20 Old Bailey, EC4.

Yours sincerely

John Pierce

John Pierce
Chief Executive

The ASB Discussion Paper on Share-Based Payment: The Reply from the Quoted Companies Alliance

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1. INTRODUCTION

Quoted Companies Alliance

The Quoted Companies Alliance (QCA) is a non-profit association dedicated to promoting the cause of Smaller Quoted Companies (SQCs) defined as those quoted companies outside the FTSE 350, and thus the great majority of quoted companies in the UK.

We believe that the future prosperity of Britain depends on business enterprise - what our Government calls the "Enterprise Economy". We are committed to improving the ability of growing companies to obtain the capital growth necessary to research and to develop their innovative ideas, and to market them effectively on a global scale.

Together SQCs employ over two million people and play a vital role in the UK economy. Recruitment, retention and motivation of high quality management and employees is a pre-requisite for today's smaller companies to become tomorrow's giants.

This Paper

1.1 In July of this year, the Accounting Standards Board (the "ASB") published a Discussion Paper entitled "Share-Based Payment" which proposed fundamental changes to the accounting treatment of transactions by which goods or services are procured in exchange for shares or share options. Interested parties were asked to furnish the ASB with comments on the proposals by 31 October 2000.

1.2 This paper constitutes the reply of the Quoted Companies Alliance to that Discussion Paper. The response has been prepared jointly by two specialist working groups, the Share Schemes Committee and the Accounting Standards Committee, of QCA.

1.3 The remit of the QCA Share Schemes Committee was to consider and comment upon the far-reaching commercial ramifications of the proposals. The remit of QCA's Accounting Standards Committee was to consider and comment upon technical issues arising from the proposals.

1.4 The ASB's Discussion Paper lists a number of questions in respect of which specific comment is sought. For reasons that should become apparent QCA has sought to address the wider issues and to suggest an alternative approach.

2. SUMMARY OF QCA'S RESPONSE

2.1 Commercial ramifications

- the proposals would have a materially prejudicial affect on a UK company's ability and willingness to operate equity-based incentive arrangements, thus not allowing UK

- companies to enjoy many of the benefits of operating such arrangements which will, in turn, affect UK companies' ability to offer competitive remuneration packages in the global market.

- the US Financial Accounting Standards Board recently tried to introduce similar rules. Their proposals were unsuccessful. Should the ASB be allowed to push through these changes in 'the UK while the same provisions do not apply to US companies, it would significantly undermine UK companies' competitive position.

- Any disincentive on a company to operate a share scheme placed by UK GAAP is clearly contrary to the importance the Government places on share participation by employees.

- 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. As the proposals would effect not only executive share schemes but also all-employee arrangements, this could prejudice a company's entire workforce.

2.2 <u>Technical issues</u>

- QCA would not be willing to support a change in the accounting treatment of share based payment that would place UK companies at a competitive disadvantage. For this reason QCA would have preferred to see an international accounting standard on the subject;

- the conceptual foundations of the proposals are unclear and appear to be inconsistent with the ASB 's own conceptual framework, "Statement of principles for financial reporting";

- inconsistencies of treatment have been noted in the Discussion Paper. Inconsistencies obfuscate underlying principles and will not aid users of accounts in appreciating the issues or, indeed, the substance of transactions;

- the inclusion of volatile share price movement in profit and loss accounts will not aid comparative performance analysis;

- if the proposals are adopted, not only will shareholders bear the dilution cost of the share schemes, but the company will be required to account for the perceived cost, thus reducing distributable profits. Perversely, the more successful the company, the greater this reduction in distributable profits will be, and

- regardless of the validity of the recognition of "cost", QCA is not convinced that the argument that "Vesting Date" is the point at which "cost "should be measured.

2.3 A suggested alternative approach is that consideration be given to increasing disclosure in relation to both the actual and potential dilutive effect of share awards granted and capable of grant. By adopting this approach, current and potential future shareholders would be able to calculate the dilutive effect on their shareholdings of such awards.

DETAILED RESPONSE

3. COMMERCIAL RAMIFICATIONS The Response Of QCA's Share Scheme Committee

3.1 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
- the recruitment of new employees;
- employee motivation;
- improved business performance; and
- alignment of employees' and shareholders' interests.

3.2 These benefits are described in more detail below and are also alluded to in the paper entitled "Rewarding Leadership" published by QCA, then know as CISCO, in February 1998.

Retention

3.3 It is important for any organisation that valued employees remain with the business. Staff turnover could be particularly problematic when one considers the experience and expertise that a company (particularly a new economy company) loses when an employee leaves and the time and expense required to train a replacement.

3.4 In most share schemes operated by companies, employees are encouraged to remain employed as cessation may result in them receiving no awards, lower value awards or awards in a less tax advantageous manner. Consequently, a share scheme that is properly structured can genuinely encourage the retention of employees within the organisation as participants could be financially prejudiced should they leave.

Recruitment

3.5 In what has become an increasingly competitive international employment market, it is important that the recruitment package offered by a company is seen as competitive by prospective employees who are, therefore, encouraged to join that company over another company.

3.6 It is 'becoming increasingly more common, as employee share ownership becomes a regular feature of remuneration, for a prospective employee to look at the opportunities that would be made available to him to acquire shares as one of the most important elements of a job offer. A company that does not operate share schemes will, therefore, be at a disadvantage in terms of recruitment to one that does.

Employee motivation and improved business performance

3.7 The value of an award an individual receives under a share scheme will ultimately be dependent upon the market value of the underlying shares when the employee eventually receives those shares. Therefore, employees will be motivated to maximise their own efforts so as to do as much as they possibly can to increase the value of the shares and, therefore the ultimate value of their awards

3.8 Of course, by encouraging employees to maximise their own performance, it is likely that the performance of the business as a whole should improve.

Alignment of employees' and shareholders' interests

3.9 An obvious output from the operation of share schemes by a company is that employees acquire shares in their employing company (or perhaps its ultimate holding company).

3.10 Employees who own shares identify more closely with the long term objectives of their employing company, rather than their own individual short term objective of maximising their current take-home pay. Further more, employees who have a stake in their business are more likely to actively participate in the decisions of management as they perceive their own long term prospects as more closely tied to those of shareholders and management in general.

Evidence of the benefits of operation of employee equity-based incentive schemes

3.11 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.

The views of the Government

3.12 It is important that there is no material conflict between the views of the Government and the architects of accounting standards. If such conflicts existed, considerable energy would be wasted by both parties m pulling in different directions

3.13 The Government's views on employee share participation are clear. 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 stated. The paper stated that the Government viewed increasing employee stakeholdings as having a positive effect on productivity in UK industry

3.14 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 paper also accepted the "part to play" employee share ownership has in bridging the gap in productivity levels between the UK and Europe

3.15 In a Treasury paper published in November 1998 and entitled "Smaller Quoted Companies: A report to the Paymaster General", a potential barrier facing the growth of such companies that was focussed upon was the difficulty in recruiting and retaining high quality managers and the way in which this problem could be eased by *"enhancing prospective remuneration through equity-based incentives which reward growth"*.

3 16 This paper also suggested that share schemes could be made more attractive to employees from a tax perspective, and alluded to the problems such companies face in being unable to match the high base salaries of larger companies which could be addressed by the use of equity incentives

3.17 Therefore, any disincentive on a company to operate a share scheme placed by UK GAAP is clearly contrary to the importance the Government places on share participation by employees.

The effect of the proposals on the incidence of share schemes

3.18 As set out above, the proposals described in the Discussion Paper will result in a company being required to recognise a potentially very large 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.

3.19 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. As the proposals would effect not only executive share schemes but also all-employee arrangements, this could prejudice a company's entire workforce.

3.20 For the reasons set out above, and as confirmed in the Discussion Paper, share-based incentive arrangements now form an important part of an employee's remuneration package. Any fetter on a UK company's ability to operate such schemes (and, therefore, provide employees with the opportunity to acquire shares) will, in itself, fetter such a company's ability to attract and retain the high calibre employees that are required to compete in the global market

3.21 Although not relating directly to QCA's constituents, recent research has been undertaken on the estimated impact on FTSE 100 companies of the adoption of the proposals. The potential value of options granted to employees in each of the 86 companies in the FTSE 100 that have stated in their report and accounts that they operate an executive share option scheme was considered. The research estimated the reduction iii profit before tax that might occur if each such company placed 0.5% of its share capital under option to executives each year. This is consistent with institutional shareholder guidelines permitting *5%* of the share capital in any 10 year period to be put under option for executives

3.22 Looking at the profit before tax projected for next year (where analysts forecasts are available) and taking the prospective dividend yield and current market capitalisation at 31 August 2000 for each of these companies, the research identified that for approximately two thirds of the companies the cost would not exceed 5% of profit before tax. The "median" company would have a profit charge of approximately 3% each year. However, this means that one third of companies would have a charge 'in excess of 5% of profits and for eight companies this cost would be in excess of 20% of profit. These costs are also exclusive of any NIC charges that may apply to non Inland Revenue approved options.

3.23 If each of these companies also operated an SAYE scheme over approximately the same number of shares, then the impact on profits would be approximately twice as great.

3.24 Therefore, QCA is extremely concerned that the proposed new accounting treatment will leave many companies with no alternative but to cease to offer employees the opportunity to acquire shares, or materially scale back this opportunity. This will result in these companies being unable to enjoy the benefits of operating share schemes described above which will in turn prejudice then ability to compete on an equal tooting in the global market

3.25 This inability to compete in the global market will become more acute if, as suspected, the proposals are only (initially at least) adopted in the UK. We question the prudence or need for UK GAAP to break this new ground at the expense of UK industry, rather than waiting

- for a true international standard to be agreed which would provide a level playing field on which UK and overseas companies could compete on an equal footing

3.26 The ultimate result of this is obvious. The activity of entrepreneurs in the UK will be materially hampered and these individuals will have no option but to pursue their business in other, less oppressive from an accounting point of view, jurisdictions. This would appear particularly at odds with the publicly expressed intention of the Government to increase share ownership and create a favourable environment for entrepreneurs to flourish, as evidenced by the establishment of the new Inland Revenue approved All-Employee Share Ownership Plan and the Enterprise Management Incentives Scheme respectively.

4 TECHNICAL ISSUES: The Response Of QCA's Accounting Standards Committee

4.1 Should the proposals be introduced, UK companies will suffer a significant competitive disadvantage. Regardless of other issues QCA is of the opinion that the subject of share based payment should have been addressed in the first instance by the IASC and not the ASB

4.2 QCA would like to think that the ASB always seeks to achieve a balance between academic theory and commercial reality. In this instance we believe that the ASB has not succeeded. The proposed method of accounting will have the effect of influencing and ultimately changing remuneration and reward structures. As explained above, adoption of the 'proposals will result in a reduction in the incidence of share schemes operated by UK companies.

4.3 Should the proposals be adopted, not only will shareholders bear a dilutive effect of the operation of share schemes, but the company will also be required to account for this cost. Shareholders will therefore suffer not only real dilution but also a potential reduction in earnings. Perversely, the greater the success of employees in driving performance, the greater the cost to the company mirrored by a reduction in distributable profits

4.4 The introduction to the profit and loss account of potentially volatile share price movement will not aid comparative performance analysis.

4.5 QCA believes that employee 'share option schemes and non-employee share based payment schemes should have been differentiated.

4.6 With regard to the detail of the proposals, QCA perceives' two fundamental problems, measurement and consistency of approach.

Measurement

4.7 The Discussion Paper proposes that "cost" should be measured by reference to the value of shares at vesting date. Vesting date will, for many options, be the date of exercise. As a consequence:-

- a profit and loss effect may impact the profit and loss account alter the relevant period of service;

- a legal form test is proposed which may provide scope for the manipulation of results and adversely affect comparability; and

- measurement at vesting date is inconsistent with the argument that the issue of options represents any cost. If indeed an issue of options does represent an opportunity cost, that cost should be measured at the date of grant.

4.8 For both conceptual and practical reasons, QCA is unconvinced that vesting date as opposed to date of grant is the correct point at which "cost" should be measured.

Consistency of approach

4.9 QCA perceives an uneasy fit between the proposals and the ASB's recently published Conceptual Framework. We accept that the Conceptual Framework was intended as a point of reference, nevertheless, it is a benchmark against which the ASS have asked to be judged. In particular:-

- the proposals will not aid present and potential investors in evaluating financial performance;

- the proposals will not aid comparability;

- in many instances the results of what is likely to be a complex measurement process will be immaterial. It is debatable whether or not omission may reasonably be
- expected to influence the economic decisions of users and whether or not most users will understand the issues involved; and

- inconsistencies have been noted in proposed accounting treatments. For example, different and opposite approaches are suggested in respect of lapsed options and phantom options. Inconsistencies do not aid understanding.

5 AN ALTERNATIVE APPROACH

5.1 QCA would recommend that consideration be given to increasing disclosure in relation to both the actual and potential dilutive effect of share awards granted. By adopting this approach, both existing and potential future shareholders would be able to calculate the dilutive effect to them of both existing and future equity-based awards to employees.

5.2 In this regard, QCA note US accounting practice as prescribed in APB Opinion 25 and SFAS 123 under which (assuming the relevant company can adopt "fixed" accounting in relation to its share awards) a company can merely disclose what (under SFAS 123) would be deemed to be the "fair value" of options granted, this fair value being calculated by reference to the value of the option at grant (calculated using a methodology such as Black-Scholes).

5.3 While not recommending that the US approach to disclosure of share grants be adopted wholesale. QCA believes that consideration be given to the introduction of requirements to disclose sufficient information in relation to share awards to allow shareholders to identify the cost associated with such grants, including:

- the value of awards previously granted to employees;

- the current potential benefit accruing to employees (assumin2 all awards were vested on the balance sheet date); and

- the total potential dilution that will be suffered by shareholders (both in relation to existing and future awards).

5.4 The disclosure of such information will enable existing shareholders to determine whether or not they should continue to approve the operation of the share based incentive schemes. Similarly; the disclosure will allow potential shareholders to determine whether or not they wish to invest.

6. CONCLUSION

QCA does not recommend that the proposals outlined in the Discussion Paper be adopted. We do recommend fuller disclosure would meet the needs of the majority of users of corporate financial statements.