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Ms Kimberley Crook
Accountancy Standards Board
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Dear Ms Crook

Share Based Payment

I am writing in response to the Discussion paper "Share Based Payment".

My Board and Remuneration Committee are strong believers in the value of share options as a motivational tool. The Company's successful competitors are sole traders and partnerships where the more successful the enterprise, the greater the capital reward which accrues to the owners and operators. It is our belief that in order for the Company to be able to attract and retain those employees who would otherwise join our competitors, or set up in competition with us, we should attempt to emulate these conditions through share option schemes. Under these proposals, such would be the impact on our reported profit that this opportunity will, realistically, no longer be available to us. I shall return to this theme of commercial reality later, but will first address the proposal as a Finance Director and Accountant.

The proposal asks for responses to specified questions. I shall answer only Q1 – "No", and lay out my arguments below. Having given this answer, I have no comment to make on the remaining questions.

The proposal covers a lot of ground. This is necessary because of the spurious nature of the basic argument, and the subsequent need to make all circumstances fit the basic assumption i.e. that options are equity when granted. Much of the intellectual support for the proposal contrasts with the underlying principles found elsewhere – the Statement of Principles, FRED 21, FRS12, FRED 19, UITF 13.

There are conflicting arguments within the proposal itself. For example, paragraph 3.13 suggests that assets issued for shares are "resources", and 3.12 and 3.14 suggest that employee services are likewise "resources" which are transferred but consumed immediately . Paragraph 3.25 reinforces this view that employee services are economic resources. However, in rejecting the argument that suggests that share options should be classified as a liability laid out in

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paragraphs 5.14 – 5.16 it is stated that options do not give rise to an obligation to transfer economic benefits. Which is it? Quite clearly, if there is a transfer of resources this ought to mean a liability is accruing. If an employee received no wages but only share options, his employer would undoubtedly have received economic benefits, insofar as (a) the employee could have worked elsewhere for a wage and (b) the net assets of his employer will, in all probability have increased as a result of his work. However, the proposal must reject this simple truth because this 'liability (to issue shares) does not meet the definition of liability found elsewhere in the ASB's shaky intellectual framework.

Another example: paragraph 5.21 rejects the option of creating a pre-paid staff cost, because *"The employee is free to leave at any time ….."*. Contrast this with the proposal to attribute value each year, albeit based on the value at vesting date. In order to justify this treatment, it has to be assumed the employee will remain in employment for the whole period and will exercise his options!

Another example: the inexplicable difference between the proposed treatment of an option lapsing before vesting with an option lapsing after vesting – would it not be fair to say that *"the financial statements would equally fail to reflect economic transactions"* if the Profit and Loss account were not credited with the *"refund"* of the *"cost"* of services where *"the entity made no payment for those services"*. Instead of recognising that this situation undermines the intellectual validity of the proposals, i.e. that options are not really equity, the proposal justifies this totally illogical treatment by comparing options with other forms of equity i.e. warrants, issued for cash!

Contrast the intellectual arguments for "creating something out of nothing" i.e. a staff cost where none exists, with these intellectual arguments which prohibit the creation of internally generated goodwill i.e. "something out of nothing". Surely, those are two sides of the same coin? To return to our competitors, a sole trader can, by applying his services to the entity, create economic value beyond the growth in net assets that accrues to the entity. In due course this value i.e. goodwill, may be recognised by sale or flotation. However, the entity's net asset value has not been reduced in the meantime by the attribution of some fictitious cost to his services! The same is true of a company that rewards its employees through share options. In other words, it could be argued that the granting of share options adds to the value of an entity, not reduces it.

Paragraph 3.12 advances the argument that all issues of shares or options will result in an accrual of resources to the entity. This statement overlooks the issuing of rights or bonus shares where the resources received, if any, are a fraction of the "economic benefits transferred".

Turning to the measurability of the "value" of options. The methodology proposed creates a degree of uncertainty unparalleled elsewhere in the balance sheet. When the factors which can ultimately influence the value are considered, to attribute a value in this way is laughable, – economic conditions; stock market conditions; company specific conditions, risk and valuation; employee "intentions"; performance conditions; length of option period; all are highly uncertain. Contrast the acceptance of this level of uncertainty with the hoops that have to be jumped through to create an FRS 12 liability! It is simply illogical, to suggest that in order to straighten the books, if an employee leaves before vesting, that in some way the organisation gains an economic benefit in that accounting period (the 'write back' of the accrued value attributed to his options), when in all probability the reverse is likely to be true!

Much play is made of the comparison between options and cash rewards – implying that they are the same, and have similar effects. This is not true – for example the tax treatment would be different. As far as I am aware, it is not possible to obtain a Corporation Tax deduction for the "cost" (as defined in the proposal) of a share option. Depending on which measurement methodology is proposed, the effect on Employees' National Insurance and possibly, Income Tax (where a cash reward would be grossed up to provide the same after tax reward to the employee) would also be significantly different. In addition, if the employee loses the tax benefit of an approved option, he could well expect a higher cash reward. As to the assertion that eps comparisons are the same, or the dilutive impact of all three choices, i.e. current treatment, proposed treatment or cash payment, is the same, this simply is not true as a simple arithmetic calculation would show.

No consideration seems to have been given to the added cost to companies and shareholders of calculating option values. In my experience, the option-pricing models in common use in the financial markets are incredibly complex, and would need to be operated by "experts" – such experts do not work for nothing!

No consideration has been given to the desirability or legality of, in effect, issuing profit forecasts, or, as a minimum, dividend forecasts, in the Annual Report and Accounts (see paragraph 4.27 and 4.28)? To what degree will the market assume the company's option pricing revealed in the Accounts reflects its view of the future share price, and thus the pricing becomes a self-fulfilling prophecy?

I turn to the value to investors of these proposals. Paragraph 3.26 asserts that issuing shares and share options is an economic distortion. I have alluded earlier to the economic reality of sole traders and partnerships, and to taxation treatment. Are those arrangements "economic distortions"? I would argue that if an owner (or owners) is prepared to trade employee salary and bonus (both of which are paid in cash – in many start-ups an extremely rare resource) for a share in capital growth, then that is economic reality. If the adoption of these proposals leads to a reduction in these mechanisms then both investors and the country at large will be worse off. The proposals run completely contrary to the government's stated desire to encourage entrepeneurship and risk taking, and wider share-ownership! Most investors are perfectly capable of working out the implications for dilution of the issue of share options, although in my experience most pay little regard to the disclosed fully diluted eps. Equally, many institutional investors prefer to invest in companies where employees are rewarded through share options – they clearly believe in the identity of interest argument. These proposals will not be welcomed by those investors if they result in the decline of share based rewards.

Finally, and to end on a cynical note, I have welcomed the objectives of the ASB in removing many of the spurious accounting practices that had grown up prior to its establishment. I have thus applauded Sir David Tweedie at many a presentation I have attended where he has spoken. I also remember with clarity that, on almost every occasion I have heard him speak, he has vowed to "do away with share options" (I am sure he put it far more eloquently). Do these proposals represent Sir David's last shot at share options before moving on? If so, on this occasion, I fear the undoubted strength of his intellect has obscured the economic realities and value that lie behind share option schemes, together with that well-known law – the law of unintended consequences!

The accounting tail should never wag the commercial and economic dog!

Yours sincerely

Michael C Nower
Group Finance Director

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