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CL 184

Helsinki, March 7, 2003

Sir David Tweedie
Chairman of the International Accounting Standards Board
30 Cannon Street, London EC4M 6XH,
United Kingdom

Dear Sir David:

We are pleased to respond to the invitation to comment on the ED2 “Share-Based Payment” by IASB, This response represents our personal views on the Exposure Draft. It does not necessarily represent the opinion of our employer, the Helsinki School of Economics.

Because we do not consider the expensing of share-based payments to meet the Framework of International Accounting Standards, we start our comments by a general argumentation. This argumentation makes irrelevant answering to some of the questions presented by the Board.

General argumentation

Our major concern in the ED2 deals with expensing equity-settled share-based payments. Our concern arises from five serious misconceptions in expensing these payments:

- the concept of assets is too simplistic;
- the concept of indirect valuation is not in accordance with the Framework;
- it does not meet the definition of expense in the Framework;
- it does not meet the valid concept of entity;
- it does not lead to a fair information of equity.

Each one of these five misconceptions is commented below.

The concept of assets is too simplistic

The analysis the Board presents in BC4O BC48 shows that the concept of assets, both in the Framework and in this analysis, is defined in a too simplistic manner. BC42 states that "[a]lthough services to be received in the future might not meet the definition of assets, services are assets when received". The extended concept of asset contradicts with the common understanding of asset.

According to the Framework (para. 49) an asset is defined as

> "a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise".

Accordingly and taking para. 55 of the Framework into consideration assets can be divided into three different categories:

- cash in the meaning of lawful money or legal tender (including e.g. avista bank accounts)
- receivables (including e.g. deposit bank accounts) and
- capitalised expenses.

The misunderstanding in defining services as assets when received may originate from the reason that IAS's do not deal with bookkeeping and therefore does not make difference between

- expenses recorded either on cash or accrual basis during the accounting period and
- expenses recognised in the profit and loss statement for the accounting period.

In preparing the annual accounts expenses are divided into two groups: The expenses, for which respective income has been received or no future income is expected, are recognised in the profit and loss statement (e.g. procurement price of sold inventory and part of the procurement price of machinery in the form of depreciation). Those expenses for which any respective future income is probable are capitalised in the balance sheet (e.g. residual value of the procurement price of machinery).

From the above perspective, the analysis in BC42 seems to be inappropriate. The work performance or services do generally not meet the definition of asset, i.e. capitalised expenses, especially not at the moment when received. On the contrary, they cause expenses, which are or are not eligible to be capitalised for the balance sheet (generally not, but it does not make any difference in this context'). Generally, a work performance or a service is not an asset as it was claimed in the ED2 2

The concept of indirect valuation

Instead of considering a equity-settled share-based payment only as a reward for work performance or service it has to be considered also as a settlement for issued equity instruments. From this point of view it is crucial to decide if the settlement for the equity is at least worth of the value of the equity issued and recognised as an increase of equity.

The two transactions in question of equity-settled share-based payment are:

- Raising equity capital. This means that in the double entry bookkeeping the entity credits an equity account and debits an asset (including expenses eligible to be

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[1] Work performances or services may be considered eligible to be capitalised if e.g. they form part of the construction cost of a building.

[2] The entity does not control employees neither their future work performance as an asset.

capitalised at the time point of the settlement) account: If the payment is made by cash, the entity debits cash account. If the payment is postponed to a later time period the entity debits a receivables account. If the payment is made by goods or services the entity debits an appropriate asset account. It does not make any difference whether the entity consumes or uses the goods or services immediately or later. The payment of capital is not possible, however, by means that are not capable of economic assessment at least of worth the value of the equity instruments issued.

- Using or consuming the assets received as settlement for the issued shares. If the settlement was in the form of cash, its use will be credited on the cash account (source of cash). If it was receivable, its collection will be credited on the receivables account (source of cash) and cash account (use of cash) debited. If it was in the form of goods or services their procurement price will be transferred into the profit and loss statement to the extent they have been used or consumed during the accounting period. The resting amount of the procurement price will be transferred into the balance sheet as capitalised expenses.

To solve this problem ED2 introduces a new way of valuation, indirect valuation. The value of the goods and services received is replaced by a "surrogate measure"[3]. While the traditional basis of valuation of goods or services is procurement or market price, the "surrogate measure" is based on the value of equity instruments given in exchange for goods or services or work performance. The choice of the valuation basis is based on the availability of the information![4]

As a matter of fact the value of the settlement for equity instruments is depending on the simple fact: The value is equal to the capability of economic assessment of the substance of the settlement *per se.* Consequently there is no basis for whatsoever recording of the issue of equity instruments against work performance or service or goods not embodying future benefits in the form of cash flow issuing shares against work performance or service or goods not embodying measurable future benefits does not add any value to the entity. It only affects to the division of ownership between shareowners5. If the shares are subscribed by new shareholders, the ownership of current shareholders is diluted. That does not belong to the entity but to its owners.

What is said above can be clarified by an example:

> Suppose the entity buys gas from a pipeline and pays it by issuing shares to the seller of the gas. The gas is consumed immediately as it is delivered to the entity. The entity has, however, the opportunity to resell the gas instead of consuming it immediately. Even if it does not use this opportunity, it saves other means of payment to the extent of the purchase price of the gas.

Quite another is the situation if the shares are paid by work performance or service not embodying measurable future benefits. In this case the entity has not received anything,

[3] The term is used at least in BC 191.

[4] The choice of valuation is based on the availability of information. No attention is paid to the fact that the valuation of work performance need not directly or indirectly depend on the value of any equity instrument of the entity.

[5] See Flowers, John: The G4+1 's paper on share-options: a critical analysis, a paper presented at the 24th Annual Congress of the European Accounting Association in Athens, Greece 2001.

which would be eligible to be recorded either cash or receivable or other asset.[6] It is sometimes even unclear for which work performances or services equity-settled share-based payments are made! for (see BC1 92).

It is admitted in the ED2 that there is a rebuttable presumption that the fair value of the goods or services received is more determinable for transactions with parties other than employees (14b). “For transactions with the employees, the entity is required to measure the fair value of the equity instruments granted, because that is more readily determinable than the fair value of employee services received.” No explanation or argumentation is given for this statement. As a matter of fact there is a circular reasoning here: The calculated value of equity instruments issued is applied to the valuation of work performance or service, the value of which is then accepted as a settlement for those equity instruments. Why to make an exception here in the valuation of work performance or service? The paragraph 14(b) is logically the absolutely weakest point of the whole set of ED 2. Not even one additional example of the need of “surrogate measure” is mentioned in addition of work performance and service of an employee.

The concept of “indirect valuation” is not in accordance with paragraphs 83, 86 and 99-1 01 of the Framework. Paragraph 100 does not include opportunity cost as a measurement basis nor there is in any of these paragraphs mentioning of “surrogate measure” or “indirect measuring”. On the contrary it is explicitly stated in paragraph 86 that a criterion for recognition of an item is “that it possesses a cost or value that can be measured with reliability”. (Emphasising by the authors)

The indirect valuation easily leads to either over- or undervaluation of the value of assets. The overvaluation of assets leads to major misstatement of entity value, since shares are rights to the assets of an entity. Issuing shares is an entity’s means to collect equity capital. The value of the assets and the earning power of the entity determine the value of the shares, although there are also lot of psychological and emotional factors affecting their market value. Usually the entity receives the payment for the issued shares in the form of cash. It is also possible to use other assets given as subscription in kind as settlement. To entitle to the shares the value of the assets has to have at least the value of the subscription price. If the value of the assets for the shares does not meet at least the issuing price, it is not possible to balance the settlement in the double entry bookkeeping.

To summarize, indirect valuation of work performance in the case of equity-settled share-based payment leads to misleading presentation of the equity, since the value of work performance is not measured *per se.*

Expensing equity-settled share-based payment does not meet the definition of expense in the Framework

The definition of expenses of the Framework is repeated in BC4O. To meet this definition, it is crucial that the payment results in a decrease in equity. A share-based payment does not clearly result in decrease in equity because its valuation is due to the valuation of a

[6] In addition of valuation basis it is the transferability of the work performance or service or goods that is crucial here. The gas example given in BC 46 does not hit the point at all. The mode of delivery is not relevant here.

simultaneous increase in equity, and in the financial statements, the expense reduces the equity exactly with the same amount as it was originally increased. Therefore, the equity-settled share-based payment only results in a rearrangement of the equity items.

In paragraph 4 of ED2, the "equity-settled share-based payment transaction" is regarded as comparable with a bonus the entity pays in cash on the basis of the development of the entity's share price ("cash-settled share-based payment transaction"). The cash-settled share-based payment unambiguously results in the decrease of equity whereas the equity-settled share-based payment doesn't. For the cash-settled share-based payment no indirect valuation is necessary and the payment decreases entity's assets. This comparison is one of the indications of the artificial nature of expensing equity-settled share-based payment.

It does not meet the valid concept of entity

The IAS's includes no definition of entity or enterprise. This is a defect because the IAS's include standards e.g. for segment reporting a segment being a part of an entity.

The valid concept of entity can be found in the FASB Statement of Financial Accounting Concepts No. 6 (Elements of Financial Statements). In para. 24 it is stated a.a.:

> "All elements are defined in relation to a particular entity, which may be a business enterprise, an educational or charitable organisation, a natural person, or the like. An item that qualifies under the definitions is a **particular entity's asset, liability, revenue, expense, or so forth**. An entity may comprise two or more affiliated entities and does not necessarily correspond to what is often described as a "legal entity" ... For example, employees, suppliers, customers or beneficiaries, lenders, stockholders, donors, and governments are all 'other entities' to a particular entity." (Emphasising by the authors)

In accordance what is said in the definition above, entity can also be defined to be any economic unit for which the revenues, expenses, assets, and liabilities are recorded to keep them separate from those of other entities. As stated in the definition cited above stockholders are separate entities from the company entity.

As stated earlier in this paper expensing equity-settled share-based payment results in a rearrangement of the equity items. The part of the profit of the accounting period that belongs to the current shareowners is transferred to an item that represents the share of the equity of the new shareowners. It is not the expense for the entity but a wealth transfer from the current shareholders to the company employees, since it dilutes the ownership of current shareholders. This expense does not belong to the company entity but to the entities of the current and new shareholders (i.e. employees). Accordingly it does not diminish the profit of the entity, cannot drive the entity into bankruptcy nor should be presented in the income statement of the entity.[7]

[7] We refer to the response of John Flower to the G4+1 's paper (October 27, 2000)

It does not lead to a fair information of equity

Equity (except accrued profit or loss) in the balance sheet shows that the entity has once received capital either in cash or as other assets given as subscription in kind under the terms of equity. Consequently it informs that the entity has received assets worth at least the value of the equity in the balance sheet, valued independently of the amount of the issuing price. This conclusion holds for any subscriber be it an employee or anybody else. It holds also for capital received under liability terms.

The increase of liability in the balance sheet shows that the entity has received some item with value equal to the amount of the loan or other liability. Applied to work performance it means that the entity is ready to pay to the employee the sum it has recorded as expense (use of cash) and liability (source of cash). But it also means that the expense has to be paid and is an outflow of resources diminishing equity (debiting the loan account = use of cash, and crediting the cash account = source of cash).

If a equity-settled share-based payment is considered simultaneously as capital and expense (diminishing the profit or increasing the loss for the accounting period), it does not give a true and fair view of equity. Actually the entity has not received any equity and consequently there is no respective expense.

No other IAS refers to any other fictitious transaction eligible to be recognised in the annual accounts. [8]

Answers to the questions

Question 1

Referring to what is stated above, the question is not relevant.

Question 2

Paragraph 4 of ED2 considers an equity-settled share-based payment transaction and a cash-settled share-based payment transaction similar. There is, however, a crucial difference between them. An equity-settled share-based payment transaction does not diminish equity nor increase liabilities and does not lead to any payment. On the contrary, a cash-settled share-based payment transaction leads to an increase of liabilities and a settlement of that increase of liabilities resulting in a decrease in equity.

Question 3

This is the most important question. As shown above the indirect method of valuation is according to ED2 an exceptional valuation method applied in only this special case. As stated above the method is based on a circular reasoning, i.e. the value of equity increase is defined

[8] It is worth of mentioning in this context that in the wake of the recent financial scandals in the US some of the firms were accused to exaggerate their sales by artificial selling and repurchasing of goods and services.

based on the value of work performance, and the value of work performance is defined based on the value of equity increase. That is why the principle is not appropriate.

Question 4

The date when the entity obtains the settlement for shares is the appropriate date at which to measure the fair value of goods or services, because it is in line with the measurement of goods or services in any other transaction.

Question 5

According what is said above about the indirect method of valuation, this question is not relevant.

Question 6

As stated above it is not logical to paraphrase the problem of measuring the value of financial transaction by the concept of determinability. Neither it is in accordance with paragraphs 83, 86 and 99-101 of the Framework. Paragraph 100 does not include opportunity cost as a measurement basis nor is in any of these paragraphs any mentioning of “surrogate measure” or “indirect measuring”. On the contrary, it is explicitly stated in paragraph 86 that a criterion for recognition of an item is “that it possesses a cost or value that can be measured with reliability”. (Emphasising by the authors)

Question 7

As stated above the determinability is not a logical way to paraphrase the problem of valuation. Therefore the determinability is not relevant here. It can also be referred to the paragraphs of the Framework referred to in the answer to question 6.

Questions 8-18

Referring to what is stated above, these questions are not relevant.

Question 19

The proposal is logical because according to the paragraphs 83 and 86 of the Framework the final cash payment or the final equivalent value of goods or services as settlement for the liability determines the value of the liability.

Question 20

As soon as it is probable that the cash alternative will be exploited it should be recorded in the way presented in question 19. Until that time point the case should be informed in the notes to the income statement and balance sheet. (See the answer to question 25.)

Questions 22-24

Referring to what is stated above, these questions are not relevant.

Question 25

As stated above, there is a clear difference between an equity-settled share-based payment and a cash-settled share-based payment. The former one concerns only the owners of an entity, on the contrary to the latter one that causes decrease in the equity of the company entity. In addition, the work performance or service as settlement for equity instruments depends on their nature: To the extent work performance or service meets the requirements of paragraphs 55, 83, 86 and 99-101 of the Framework, they are eligible as payment for equity instruments. Our conclusion is that more analysis is needed before the final formulation of the proposed standard.

In any case we suggest that true and fair information of all share-based payment shall be always given in the notes to financial statements for the current owners and other investors, also for the potential ones. This is especially important with the equity-settled share-based payments.

Although it does not necessarily deal with the theoretical argumentation we cannot avoid mentioning that accepting work performance or service as a payment for shares is in contradiction with the 7th article of the SECOND COUNCIL DIRECTIVE of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by EU Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance. The article reads as follows:

> "The subscribed capital may be formed only of assets capable of economic assessment. However, an undertaking to perform work or supply services may not form part of these assets."

E.g. the Finnish company law includes a similar provision.

To our understanding accepting the proposed accounting standard means a need for amending of SECOND COUNCIL DIRECTIVE.

Yours truly

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