CL 214

Response from FULLER SMITH & TURNER P.L.C.

7th March 2003
PAC/JCM

Accounting Standards Board
Holborn Hall
100 Gray's Inn Road
London WC1X 8AL

Dear Sirs,

Reply to FRED 31 - Accounting for Share Options

You have asked for comments on the proposed Accounting Standard 'Share Based Payments' by 7th March. My views, and those of my Company, follow.

Summary

It can be summarised that we are against these proposals on the grounds of (a) concept, (b) cost of preparation and (c) no improvement in shareholder understanding.

Introduction

Accounting Standards and basic accounting concepts have existed for a long time, indeed basic book-keeping has existed for over 700 years. In the initial parts of the 21st century it has now been determined that we should introduce opportunity costing into our basic accounting procedures, whereas for many years we have managed to survive without this.

It is evident that much of the pressure on accounting for share options as a cost to the business arose from the recent perceived marketing abuses in a number of, probably, high-tech companies at a time when there was a boom in share prices and activities of those companies. It was felt by many that shareholders should be aware that the granting of options on such a large scale would eventually deprive the shareholders of some value in the company - being the dilution of their earnings and conceivably, for some companies, in increased dividends.

Pressure on standard setters

Therefore there has been pressure on accounting standard setters to regulate what is conceived to be incorrect accounting for a long time by changing accounting standards. It is the view of the writer that accounting standards should be about basic principles, and if there is perceived to be an abuse in the market-place on the grounds of corporate governance then it should be regulated by those who control corporate governance, and if there is abuse of company law then it should be controlled by those who regulate company laws.

It is almost as if accounting standards bodies are moving to the moral high ground of regulating accounting treatment based on the perception that 'somebody is getting something for nothing and the shareholder has not woken up.' They may not have done, but should the ASB be the regulator?

I think the Accounting Standards Board should further reflect that this 'politically correct' solution needs to be tempered by the realities of many share options. The writer, in a previous employment, received over 100,000 shares at a nominal price of 19p on the date that he joined the Company. These options, at that time approved by the Inland Revenue, were non-exercisable for 3 years or at any time when the Company was in a 'close period.' There were times when the options were worth considerably more – 3 months after being granted they were showing a gain of 105p per share, and 6 months later 170p per share. The writer can honestly say that he had done nothing to create a benefit to the Company by the granting of these shares and that the Company had not incurred any cost in issuing the shares to the writer. The realities of economic life in the UK in the midst of a recession resulted in the writer eventually leaving the Company when the shares were valued at 2½p. Apart from the very minor cost of setting up the Scheme, the writer did not gain a benefit and the company did not incur costs. Any gain that had arisen on paper was due to a boom in share prices fuelled by a particular open market perception of the sector in which the writer worked which thought it would go from strength to strength. The parallels 10 years later have only enhanced my view that a share option is worth nothing until somebody exercises the right to the option. Up until that point any option granted could be a cost or it could be nothing.

Speculative Valuations

For accounting standards to start asking us to establish speculative valuations of the supposed cost, using esoteric financial models, is leading us into un-chartered waters on a grand scale. There are many things that a Company can do that could possibly bring benefits for the future and the benefit of hindsight often reveals a different story. If accounting leaves its basic core principles of recognising cash payments for goods and services rendered (within a reasonably short time frame) based on the perception that the business is a going concern, within the economic framework of the day, then accounting is setting off down a very uncertain path.

There is always the implied suggestion that shareholders are misled by having "hidden options" granted to directors on a grand scale. In the UK there is full disclosure of these options and the exercise price and dates of possible exercise is also disclosed. There is also disclosure of the effect on earnings.

Shareholders invest in companies for many reasons – large institutions because they believe in the management of the business, and reasonable returns over a reasonable time-frame. Private investors will invest for a multitude of reasons ranging from providing for their future retirement to those who regard buying shares as the equivalent of putting money on the horses, but with probably slightly better odds.

Setting a standard to meet numerous different viewpoints to 'avoid some shareholder misunderstanding' will be very difficult to achieve. Therefore I, and my Company, must reject this Accounting Standard as not meeting the basic requirements of the accounting principles that have safe-guarded the majority of companies in this country, and indeed other parts of the world, following sensible accounting practices for a long time.

No Cost Reversals

Even if this Accounting Standard is adopted we still have objections to the way it will be implemented. For example, under the Accounting Standard, once the option is granted there is a cost, even if those options become "under the water" or the recipient leaves the company (which he often does if he under-performs). There is no means of reversing the so-called opportunity cost. If accounting standards are about prudence, then accounting must also recognise the need to release provisions no longer required.

The calculations models

There are many more writers than me who can comment on the intellectual weaknesses proposed in the Accounting Standard, including the Black-Scholes model. However, the application of a model design for short-term trading futures in a well-defined market-place is totally inappropriate for the majority of companies whose shares do not trade extensively and where the time-frame can stretch for up to 10 years. Independent surveys carried out, for example by Oxford Metrica, have shown that the majority of options outstanding are well over 5 years. Secondly, studies would seem to suggest that the value of the options created by this model are very close to the finally traded value, which is contrary to all options markets elsewhere. Thirdly, the options model does not seem to recognise that employees are not tradeable items and an employee only collects if he is there on the day. Death, retirement and resignation are normal facts of life and somehow do not feature in these models.

Cost of Preparation
The majority of public companies in the UK are small by the standard of the FTSE100, or even the FTSE 350. They will be required to comply fully with the Standard and because they are public companies they will be measured by the same level of standards of reporting as their larger brethren. The costs of preparing these models for many companies will be substantial and the majority of those companies will not have share options that give a material effect on the profit and loss account. Companies of the size of mine (market cap £100m) do not have vast resources available to prepare such esoteric calculations which, at the end of the day, will not change our shareholders' perception of our business one iota. We will incur costs to our shareholders with no benefit whatsoever. There are many other factors that explain the reason why people invest in my Company or do not invest in my Company. Share options, even if they were substantially larger than they are now, would not be a major consideration. Factors such as high freehold asset valuations, low gearing, strong cash flow are positives, restricted share structure, lack of take-over potential, steady and uninteresting growth are negatives, and these factors are far more relevant to a shareholder's decision whether or not to invest.

SAYE Schemes
The costs of reporting are further compounded by the inclusion in this Exposure Draft of employee share save schemes. The creation of employee share save schemes is a matter of public policy, reinforced by the Chancellor very recently. There are strict rules for their application and limitations that employees may individually benefit by. SAYE schemes have a maximum of £250 per employee per month and SAYE schemes are open to all employees. Of course all employees create value by working for a Company and that is often reflected in that Company's results at the end of each trading period because without those employees the Company could not have a business. However, to say that granting options to those employees is an extra cost (when in fact employees are paying 80% of the share prices themselves under SAYE schemes) is almost laughable. Taking on an extra driver in this business in this Company who by right is entitled to an SAYE scheme does not, in our opinion, meet the basic premise that the granting of a share option has immediately cost the Company money, yet we must include these calculations on all our schemes in this proposed Draft. This is of course contrary to the original proposals presumably on the grounds that if we believe in the theory we must include everything even though materiality and common-sense logic would suggest there is no point.

We as a Company would seriously consider not running these Schemes if all it does is add to our corporate bill. Again, Accounting Standards seem to be setting the way business runs, rather than reporting the results of how a business is running.

Auditors

There has been in recent months almost complete dismissal of the role of the auditors in preparing company accounts. If a particular company has such a large percentage of its share options issued to one or two individuals at favourable prices such that the earnings would be substantially diluted in the future for little benefit in cash, then this would, in my opinion, need to be reported on by the directors in their Directors Report or something akin to an 'OFR.' If the auditors felt the Company was misleading its shareholders it should then be in a position to qualify the accounts on the grounds that they do not show a true and fair view to the shareholders. One feels that the Accounting Standards Board is so dismissive of the role of auditors following corporate scandals, mostly in other parts of the world, we are now having to comply with standards to the most extreme degree to compensate.

I would suggest that we give more authority to auditors in their reporting before we believe companies are abusing their position vis-à-vis shareholders. For the majority of companies this would be the most practical, cost-efficient and realistic solution and one which most companies thought existed.

I note that the views of the writ er and his Company, are not dissimilar to those views expressed by a number of people, especially with reference to the method of calculation and the inclusion of employee share save schemes. However, on top we even reject the basic premise.

Yours faithfully,
For and on behalf of
FULLER SMITH & TURNER P.L.C.

P. A. CLARKE
Finance Director