

# UKSA

## UK SHAREHOLDERS' ASSOCIATION

The independent voice of the private shareholder

### UKSA'S RESPONSE TO THE ACCOUNTING STANDARDS BOARD'S DISCUSSION PAPER "SHARE-BASED PAYMENT"

29 October 2000

#### INTRODUCTION

The UK Shareholders' Association warmly welcomes the ASB's discussion paper.

We consider that the impact of share options on existing shareholders is not properly recognised by existing accounting procedures, and that the ASB's proposals should result in a significant improvement to reporting standards.

We have not been able to give the discussion paper the detailed consideration that it deserves, and we are approaching the response as shareholders concerned with issues of corporate governance, rather than as experts in accounting principles, so we are limiting our responses to those questions that appeared to us to be most relevant and important.

For clarity, throughout our response

- **the discussion paper questions are reproduced in bold, underlined text;**
- **our basic positions are stated in bold text;**
- our more detailed comments are in plain text.

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## **RESPONSES TO THE QUESTIONS**

### **Recognition in the financial statements**

**Q1. Do you agree with the proposal that transactions whereby an entity purchases goods and services by issuing shares or share options should be recognised in the financial statements, thus resulting in a charge to the income statement when those goods and services are consumed?**

**We are strongly in agreement with this proposal.**

It is essential that the effective cost to shareholders of all share options issued by a company, to directors, employees and others, is properly recognised in the financial statements, as these can have a significant dilutive effect on existing shareholders' assets.

However, we particularly welcome the proposals because of their potential impact on reporting of boardroom costs.

UKSA has been concerned since its foundation with the operation and effectiveness of controls on directors' remuneration. An essential aspect of those controls is the way in which remuneration is recognised and reported: we are entitled to expect that the full costs to shareholders will be properly reflected in the profit and loss accounts and in any statement of directors' remuneration.

Current practice of allowing the value of share options issued to directors to be under-reported, or not reported at all, already results in the gross understatement of boardroom costs in many instances, and the problem is worsening dramatically as the use of option-based incentive schemes mushrooms.

Once the costs to shareholders of share options issued by a company are properly recognised, the reporting of boardroom costs should be immediately improved.

### **Measurement basis**

**Q2 Do you agree with the conclusion that the appropriate measurement basis for such transactions is the fair value of the shares or options issued?**

**Yes.**

We agree that measuring the value of these transactions by the "historical cost" basis can result in a valuation that bears no relation to the value of the options at the time of the transactions, and that the "intrinsic cost" basis fails to recognise the "time value" of an option.

**Measuring the fair value of share options**

**Q3. Do you agree that, where an observable market price for an option does not exist, an option pricing model should be used to estimate the fair value of a share option?**

**Yes.**

It is important that the option pricing model used should not require or allow for subjective assessments, such as the "expected life" of an option discussed in Q4: there is a clear conflict of interest if a board of directors is expected to make subjective judgements that determine the value stated in the accounts of awards made to themselves.

**Q4. Assuming that the use of an option pricing model is required, do you agree that: (b) in the case of employee share options, the assumptions used in the option pricing model should be adjusted to take into account the non-transferability of such options by using expected life rather than contracted life in the calculation?**

**We strongly disagree: "expected life" should not be a factor in the valuing of a share option.**

If an employee chooses to exercise an option well before the end of its life, the employee is voluntarily sacrificing some of the option's time value and there is no reason for this to be reflected in the initial valuation of the option.

Where an employee is obliged to exercise the option early because of a corporate event, such as a company takeover or merger, or because the employee is leaving the company, we have three concerns:

- We do not believe it is possible to find a reliable indicator of such events based on a company's history: for example, it does not follow, because a number of directors have resigned from a company over a few years, that their replacements are equally likely to resign early; it does not follow, because a company has had widespread redundancies in its recent history, that those redundancies are likely to continue; and it does not follow, because a takeover has resulted in early exercise of existing share options, that the company will be taken over again in the near future.
- The estimation of an option's expected life is entirely subjective, and boards would clearly be tempted, as suggested in para.4.34, "to bias estimates towards unrealistically short expected lives because the shorter the expected life, the lower the option value, hence the lower the charge to the income statement". This is particularly of concern in relation to directors' remuneration, since board members would be in a position to understate the value of options granted to themselves.
- Finally, the contracted life of an option is critical in determining the option's fair value: an option with a contracted life of ten years is clearly far more valuable than an equivalent option with a contracted life of five years. This should be given full weight in valuing the option.

**Measurement date**

**Q6. Do you agree with the conclusion that vesting date is the appropriate measurement date, for the purposes of determining the fair value of the shares or options issued?**

**No, for the reasons stated below, under Q7.**

**Q7. If you do not agree that vesting date is the appropriate date, which of the other dates discussed - grant date, service date and exercise date - do you regard as the appropriate measurement date?**

**While fair value measurement at grant date or vesting date would be a major improvement on existing practice, our strong preference is for grant date. Exercise date is the least suitable measurement date.**

The choice of measurement date is important in ensuring the accountability of directors for contractual obligations entered into during their term of office. This can only be achieved if the annual report and accounts show the value of options **granted** during the period. There is relatively little benefit in requiring directors to report the value of options that have vested during the period as a result of commitments entered into possibly years earlier, and for which the current board of directors may not have been responsible.

This is of particular importance in relation to options granted to directors, where members of the board are the direct beneficiaries of contractual obligations entered into by the board.

From the point of view of corporate governance, exercise date is the least suitable measurement date, because it would normally occur and be reported some years after the granting and vesting of the options and far too late for the board of directors responsible for granting the options to be held accountable.

**Q8 If you consider that grant date is the appropriate measurement date:**

**(a) should the transaction amount be subsequently adjusted if the number of options that actually vest is greater or less than originally expected and, if so, how would you reconcile this view with the conceptual framework, whereby equity instruments are not remeasured after issue (paragraphs 3.6-3.8)?**

**Yes: the principle adopted for FAS 123, of making an adjustment for options that have been granted in previous reporting periods but have effectively lapsed without being vested, is appropriate.**

The alternative, of adjusting the valuation method at the time of granting to reflect the likelihood of the performance conditions being met, would raise serious concerns: it would introduce a highly subjective and therefore undesirable element into the valuation process, and would invite abuse by directors wishing to reduce the impact on the profit and loss account, and to minimise their own stated remuneration. It would also make the calculation of fair value considerably more complex.

As regards the conceptual framework, we are approaching the issue of share options from the perspective of shareholders, and seeking those reforms that will provide the clearest benefit to shareholders. While we recognise the importance of establishing a consistent and robust conceptual framework for accounting, we are not in a position to comment on such matters.

**(b) should the transaction amount be recognised as a charge to the income statement in full on grant date or spread over the performance period?**

**The amount should be recognised as a charge in full on grant date.**

Again, our primary concern is to ensure the accountability of directors at the time that they enter into a contractual obligation. Another priority is to achieve a relatively simple and clear statement of the costs associated with share options, so that shareholders may have a reasonable chance of understanding those costs. In both respects, recognising the charge in full on grant date is the most effective and the simplest option.

**Vesting date measurement**

**Q11 Assuming that vesting date is accepted as the appropriate measurement date:**

**(d) do you agree that the transaction amount should not be adjusted for options that lapse, or are expected to lapse, after vesting date?**

Yes.

**(e) do you agree that the transaction amount should be adjusted if the vested option is repriced or other modifications in terms are made?**

Yes.

Clearly, reducing the exercise price of an option or increasing its potential life results in an immediate increase in the value of that option, which might be measured by comparing the fair value of the option immediately prior to the modification with the fair value immediately after the modification.

Any resulting increase in the value of the option must be accounted for. However, it might be clearer to treat this as a new and additional charge, rather than an adjustment to the original charge.