ASB planning to remove a free lunch?

Stephen Pugh of The Economist Group dissects the Accounting Standard Board's recently published discussion paper on share-based payments.

Towards the end of July the Accounting Standards Board (ASB) issued a discussion paper on 'share-based payments'. While the report covers any payment a company makes using its own shares, the main target – and the one to which almost all the paper is devoted – is the treatment of remuneration linked to shares.

Should this concern treasurers? Should they worry that an attack on share schemes may mean having to make more payments in cash? Should they attack an accounting proposal that increases the gap between profit and cash? Should they instead accept that the target is a fair one and that something needs to be done to improve reporting of such payments? Or should they ask whether there is there a parallel between the granting of share options to improve unit labour costs and the granting of options to lower interest costs (ie, issuing convertible bonds)?

This article seeks to outline and then to comment upon these proposals. It will concentrate on the treatment of plain vanilla share option schemes to try to illustrate the points involved, although it is noted that, in practice and in the ASB paper, that share option schemes are of many types and contain many intricate variations.

The proposals

The ASB proposes that the cost of granting a share option be measured as the fair value of that option at vesting date – being the date on which any performance criteria have been met and the employee becomes unconditionally entitled to the option. In order that the cost of the option is matched to the period over which it is earned, the ASB proposes that the value on vesting date is estimated in advance and the cost is accrued in the profit and loss account over the performance period, if any.

These proposals are in marked contrast to the current UK position, where the issue of an option is not usually recognised in the employing company financial statements provided the exercise price is no less than the market price when the option is granted. Even this criterion is waived for SAYE options.

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The ASB suggests that, in most cases, an option-pricing model should be used to assess the fair value of the options granted.

The criticisms

The ASB has sought to forestall some criticism by addressing some of the counter arguments within the paper.

The 'no cost, therefore no charge' argument – the ASB characterises this as being about not needing to make a charge against profit if no cash or other assets have been sacrificed. Its main counter-argument is that the value of the option is part of the cost of employing staff, and failing to recognise this value is to fail to fully account for staff costs.

Stephen Pugh

The argument the ASB is attacking perhaps runs deeper than the Board suggests and revolves around the long-term equality of profit and cash. The question is whether it is right to charge against profit amounts that will never be settled by payment of cash or other assets. It can be accepted that a cost is being incurred by shareholders without it being accepted that it is appropriate to charge this cost against profit. It is argued that there is an analogy with shares issued at a discount or purchased at a premium to market value. There is no charge made against profit in these circumstances. But, generally, this analogy may be questionable, since the discount or premium may represent a temporary fluctuation in what is still considered a market price.

The 'earnings per share is hit twice' argument – this states that the issue of options is already reflected in the EPS number, and to add a charge against profit would be double counting. The counter-argument is that the issue of options is similar to issuing shares for cash and then spending that cash on wages. This depresses earnings and increases the number of shares, but the 'double hit' merely reflects what has happened.

The 'adverse economic consequences' argument – the argument here, and the one that may prove to be the strongest in practice, is that the proposed change may lead to fewer share schemes, because companies are reluctant to take a hit to their income.

The ASB's response is that the cur-

rent accounting treatment leads to an economic distortion, unfairly favouring certain types of share scheme, and the elimination of such distortions must be desirable.

Measuring the value of the options
Having dismissed other methods of valuation (notably historical cost and intrinsic value), in its paper the ASB concludes that option pricing models "provide the only practicable means of determining a fair value in the absence of an observable market price". It is obviously conscious of some of the more difficult aspects such as estimating the inputs to the model, choosing between different types of model, and dealing with non-transferability of options.

In really complex cases, such as an unlisted start-up company, options might be valued by estimating the fair value of the employee services received. Comparing the remuneration excluding options with that received by similarly qualified employees elsewhere who are not in receipt of options could be used to do this. If all else fails, the option should be valued at exercise date when its value will become known.

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Measurement date
The ASB has set out the following possible dates for measuring the option value:

- **grant date** – the date on which both employer and employee enter into a contract that will entitle the employee to receive an option when certain conditions are met;
- **service date** – the date (normally a period) upon which the employee services are performed necessary to become unconditionally entitled to the option;
- **vesting date** – the date of unconditional entitlement; and
- **exercise date** – the date at which the option is exercised.

In making its choice, the ASB falls back on its conceptual framework and asks whether a financial instrument has been issued on the proposed date, and whether that instrument is debt or equity.

It is argued that there is no financial instrument at 'grant date', as the company has no enforceable right to the employee's services and the employee has no enforceable right to subscribe to the entity's shares. Similarly, service date is dismissed on the grounds that a financial instrument must be issued on a particular date and not progressively over a period. Issue of the financial instrument is argued to take place on vesting date.

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The ASB's stance against use of exercise date is based on the view that the option is an equity instrument and, as such, should not be revalued in the financial statements after issue (because any change in value does not alter net assets). The Board also argues that if exercise date is felt to be appropriate then it should be applied to all share subscription rights, not just employee options.

The ASB proposes that, over the performance period, profit should be charged and equity should be credited with an estimate of the value of the accruing equity instrument to be issued. This value would be 'trued up' on vesting date. While using the conceptual framework as the basis for its choice of vesting date, ASB clearly struggles to use the same framework to justify its accrual policy.

So, what is going to happen?
Comments on the ASB's paper were due by the end of October. Past attempts to crack down on share option accounting in the US created storms of protest and this discussion paper is expected to do the same in the UK. The combination of widespread use of share option plans, the personal financial interest of influential individuals and government interest in fostering share schemes comprise a potent set of forces arrayed against the ASB.

Although it will undoubtedly often be painted differently, the ASB is not arguing against share schemes as such, but is trying to find a way in which they can be fairly reflected in financial statements. Has the ASB got it right?

Is it right to charge profit with the value of the options?
Perhaps the biggest question revolves around whether it is right to put equity, non-cash items through the profit and loss account – perhaps there should be a separate financial statement to show the impact of such movements on shareholders. In response, it can be said that the reality of many employee share options is that the shares are promptly sold. Looked at in this way, it might be imagined that a different deal is done.

Instead of issuing an option, a company might tell its staff that, provided its share price is higher three years hence than it is today, it would issue new shares. Out of the proceeds of this issue it would pay the excess over the current price to the employees as remuneration. The end position for the employees and for the company will mirror the situation when options are exercised and the shares sold. However, if the transaction took place in this manner, it would be clear that the remuneration element would be charged against profit.

Is vesting date valuation the best method?
The answer given to this question depends upon the measure of the transaction. The ASB's measure is the value of the option, but the Board makes clear that it believes options should be recognised against profit because they are part of employee remuneration. Except where measurement is otherwise impractical, the ASB does not extend this argument to say that the value of that remuneration should be the measure of the charge. To do so might lead it towards concluding that exercise price is a superior measure.

It is on exercise of an option that the benefit to the employee crystallises and it is at that point that the true value of the benefit can be measured. Exercise date measurement also puts different companies offering similar benefits in different ways on a more equal footing. In particular, companies offering stock appreciation rights, under which a cash payment is made equal to the increase in the share price, are required to charge profit with an amount equivalent

to the charge that would be made on the exercise date. Such payments are most often used by private companies, which are more constrained from issuing equity and whose equity is less acceptable to their employees.

Finally, and importantly, exercise date measurement is relatively certain and does not require the use of option pricing models.

The ASB's rejection of valuation at the exercise date comes from trying hard to follow its conceptual framework. It argues that a share option is an equity financial instrument coming into being on vesting date and, because it comprises equity, it should not be revalued after issue. Having a conceptual framework is a useful way of trying to resolve accounting treatment, but it cannot be said that the ASB's framework commands universal acceptance.

Furthermore, it is questionable whether the ASB has applied this consistently throughout the discussion paper, not to mention in other ASB documents. Above all, the ASB may be accused of having failed to invoke its cherished belief of 'substance over form' in coming to its conclusions.

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The substance of the discussion paper focuses on employee remuneration through share options, and the substance of this remuneration is that it depends upon the value at the exercise date. This should be the first exercise date allowable, rather than the actual exercise date, since the latter is subject to employee whim.

Conclusions

Share option accounting has, for the most part, been a free lunch. It has been possible to pay people through options and not account for the fact that it is being done. The ASB is quite correct to turn its attention to this issue.

Whether the ASB's solution is the best available is more contentious. In my view, it is justified in suggesting that the option value should be charged against profit because an employee share option transaction can be restructured in a way in which it is clear that this needs to be done.

I would differ from the ASB in its proposed use of vesting date, I feel that a better practical argument can be made for the use of exercise date. In particular, it would help to even things out between quoted and unquoted companies. ■

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