

# ACCOUNTING FOR EQUITY BASE IS KEY TO ACCURATE REPORTING

**The Accounting Standards Board's issue of FRED 31, Accounting for share-based payments, has reopened the debate on how to account for employee share options. This article argues that FRED 31 falls short of what is necessary to ensure adequate reporting to shareholders.**

It has been argued that share options granted to employees are not a cost to the company since the company can issue shares to satisfy its obligations. From the entity's perspective this is true, but it is clear that from the viewpoint of an existing shareholder a cost is incurred. The employee's gain from receiving the option is the shareholders' loss.

Our accounting standards need to change their emphasis, go beyond entity accounting and begin to develop disclosure and accounting standards designed to test whether the management of a company has added to, or subtracted from, the ordinary equity holder's value from holding his or her shares. A performance statement, which I will call the equity stewardship account (ESA), is needed to report on the issue of shares and options, and the outcome of such issues.

## FRED explained

FRED 31 proposes that the cost of the goods or services received by a company, and paid for with shares, be reported in the profit and loss account. In the case of employee options, the value of the

option is taken at its grant date as a proxy for the cost of the services provided by the employee. However, the cost to the original shareholder is the difference between the market price and the exercise price on the date the option is exercised, since this is the value conceded.

If the p&l account is to show the grant date value as a cost, the ESA needs to show the grant date value as income, and the difference in share value at exercise as a cost. If this approach is adopted, the cost in the p&l account and the gain in the ESA would cancel each other if the option is abandoned, but the two performance statements would show in aggregate the right result when an option is exercised.

Convertible debt instruments have embedded equity options that are similar to options granted to employees. Under present accounting standards, the charge to the p&l from straight debt is higher than from convertible debt because of the reduced interest on the convertible debt. The value lost to shareholders from granting an embedded equity option to debt providers is not reported.

Although split accounting (ie, accounting separately the debt and equity elements of a convertible) is being developed by the International Accounting Standards Board as part of its review of financial instruments accounting, their proposals will not cover the loss of value on exercise of the option. An ESA that reports on the management

of the equity base would do that.

A further shortfall in FRED 31 is its different treatment of share options that are, or may be, cash settled, rather than equity settled. Since the same value is being given to employees in both cases, whether they take cash or shares, it is difficult to see why the reported cost should be different. Again an ESA performance statement would make it clear when value was being lost through issuing shares at less than their market value. Cash-settled options would generate a cost in the p&l account, and share-settled options a cost in the ESA. Taking the two statements together would give a fair assessment of management's performance in incentivising staff.

## Different schemes

It is one of the greatest oddities in our present accounting standards that employee share option schemes are accounted differently, depending on how the shares are provided by the company when the options are exercised. They may be provided by a new issue by the company, bought in from the market when needed to meet the exercise, or bought into an employee share trust when the option plan is set up. Because the first of these alternatives has not been reported to date as a cost, it has been the most frequently used approach. But from a treasurer's perspective, the risk inherent in issuing an uncovered option is large and can only be hedged by using the last alternative. However that alternative will incur a p&l cost since no new shares are issued. It is unreasonable to tempt finance directors with different accounting treatments that may cause them to choose a higher risk strategy.

Shares issued at a discount to their market price constitute a loss of value to the original shareholders, unless issued by

way of rights to existing holders. This discount would be reported in the ESA as a loss.

The ESA approach will also correctly report the activities of a company in buying-in and reissuing treasury shares. From next autumn, companies will be able to buy shares into treasury without cancelling them, and be free to reissue them within revised pre-emption guidelines being developed between the Association of Corporate Treasurers and representatives of the two main investor associations – the ABI and NAPF.

If treasury shares are bought-in and reissued, a gain or loss will have occurred, which will have generated or consumed cash. This result is just as much a part of management's performance as its management of the assets and liabilities. The ESA would be the right place to report the outcome of dealings in treasury shares.

Accounting for equity management is key to the architecture of our accounting principles. The confluence of the IASB's and ASB's examinations of financial instruments and share-based payments makes the study of the management of the equity base a natural next step.

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