



28 August 2013

Our ref: ICAEW Rep 113/13

Your ref:

Replies submitted via online questionnaire on the FRC's website

Invitation to Comment: Share-based Payment – Employee Share Options of Private Companies

ICAEW welcomes the opportunity to comment on the *Share-based Payment – Employee Share Options of Private Companies* published by the Financial Reporting Council, a copy of which is available from this [link](#).

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

Yours sincerely

Eddy James FCA
Technical Manager
Financial Reporting Faculty

T +44 (0)20 7920 8701

E eddy.james@icaew.com

APPENDIX

Invitation to Comment: Share-based Payment – Employee Share Options of Private Companies

Replies submitted via online questionnaire on the FRC’s website

ICAEW REP 113/13

Preliminary review: Types of employee share option schemes and number of private companies that hold them:

- A coherent way of describing the different types of employee share option schemes is by reference to the tax status of the scheme. There are three approved (tax-advantaged) employee share option schemes, namely CSOP (Company Share Option Plan), EMI (Enterprise Management Incentives) and SAYE (Save As You Earn), and the other schemes are unapproved (not tax-advantaged) schemes. There is a fourth approved scheme, the SIP (Share Incentive Plan), but this is a share scheme, not a share option scheme.
 - Approximately 9,000 private companies have at least one approved scheme, approximately 7,000 of which are EMI (Enterprise Management Incentive) share option schemes (a scheme that is only available to companies that have less than 250 employees). However, it is understood that unapproved schemes are more common, which would suggest that more than 9,000 private companies have at least one such scheme. It should be noted that these figures relate to all private companies inclusive of subsidiaries of listed companies, not just to ‘standalone’ private companies.
 - The information gained from the limited review performed indicates that employee share option schemes are common amongst high-growth, technology-focussed and (if the shareholders are seeking an exit) venture capital backed companies, but uncommon amongst other ‘standalone’ private companies.
1. **Describing the different types of employee share option schemes by reference to their tax status may not be the only way of doing so. What different types of employee share option schemes of a private company have you come across in your work (please, if possible, provide specific examples)?**

We note that this consultation refers only to share option schemes, while share-based payment schemes – including those which meet the definition of equity-settled under FRS 20 – are much wider than only share option schemes. We question whether it is appropriate to only consider share-option schemes in looking to reduce the burden on private companies in accounting for these arrangements. In our view, it would be more appropriate to consider all share-based payment schemes which are equity-settled under FRS 20.

We have come across a wide range of share-based payment schemes in private companies.

- 2. There is a view that, since private companies do not have a public market (i.e. a stock exchange) for their shares where employees can realise their interest, many of them provide an internal market or means of cash-settlement so that there are, in reality, few genuine examples of private companies with equity-settled share based payments. Of the private company employee share option schemes that you have come across, how many are settled in cash and how many are genuinely equity-settled? For those that are genuinely equity-settled, how does the employee realise the value of the share options?**

It unclear what is meant by 'genuinely equity-settled' and whether this is intended to be narrower than those schemes that meet the definition of 'equity-settled' under FRS 20. That said, in our experience, private companies are more likely to have cash-settled schemes than equity-settled ones.

Many share option schemes in private companies will vest based on the occurrence of an exit event, such as a sale or listing, or a new round of investment. In these cases, the scheme is typically equity-settled. Employees realise value either through sale of their shares on the same terms as other shareholders or by obtaining shares which are listed on a public market. There are also similar schemes where the settlement method depends on the nature of the exit, for example where the exit is a share sale or listing, the employees receive shares, and where it is a sale of trade and assets, they receive cash. A further type of exit event is where share options vest on the retirement of a key individual. Such schemes are used in succession planning by owners of private companies.

There are some schemes where the company provides an internal market for the repurchase of shares. In our experience these do not always provide a guarantee that the employee will be able to realise the value of their shares. This may be the case if, for example, the employee does not have the right to sell to the company, because the company can refuse to buy the shares. In such schemes, the employee retains the risk of share-ownership. Such schemes may be equity-settled under FRS 20 if the company has no constructive obligation to buy back the shares. Where the company is obliged to repurchase the shares from the employee, we agree that the scheme would be cash-settled.

Other schemes have a mechanism for settlement whereby existing shareholders, rather than the company itself, have the option to buy shares from employees after vesting. Such schemes would also be considered equity-settled under FRS 20.

Preliminary review: Objective of employee share option schemes:

- In general, based on the limited work performed, a primary objective in issuing share options appears to be to give employees a stake in the company so that they are incentivised to work harder and more effectively.
- There were mixed views on the importance of share options as an alternative means of remunerating employees. The remuneration objective may, however, be important in relation to start-up companies that are short of cash and so less able to remunerate employees in the usual way.
- The preliminary review suggests that tax efficiency is a secondary objective; tax efficiency is not a reason, in itself, for issuing share options, but it generally makes sense for a company that intends to introduce such a scheme to introduce a tax-efficient one.
- Succession-planning was also not identified as being important as a primary objective for introducing a share option scheme.
- The relative importance of recruitment and retention as reasons for issuing a share option scheme is unclear from the limited work performed, although one contributor to the review was of the opinion that the existence of such schemes was not sufficient to delay an employee's intended departure by more than a few months.

3. Do you have any comments on the above? Are there any other reasons why private companies issue employee share options – what are their objectives?

We agree that a key objective in issuing share options in private companies – including those that are private equity based – is for employees to feel that they have a stake in the business, providing an incentive for them to work collectively to improve performance and the value of the company. In our view, the effectiveness of this as an incentive will depend on the ability of the employees to realise this value at some point, which will depend on the mechanism of settlement, as discussed in question 2.

We also agree that share option schemes are not often seen by companies, or their employees, as remuneration. One possible exception to this is in small start-ups, where share options are sometimes awarded as there are no funds available to remunerate people sufficiently in cash. Where schemes require employees to remain in employment for a specified period of time, as is often the case, they may appear to be a form of remuneration. However, in our view, employees do not often see a correlation between the services they provide and the value they realise from a share option scheme, suggesting that the scheme does not act as remuneration, but incentivises the employees as equity owners.

We also agree that tax efficiency is not often a primary objective in introducing a share option scheme, however, where schemes are put in place, companies do aim to make these tax efficient, both for the company and their employees. As noted above, a key objective of share option schemes is to make employees feel like owners, having a stake in the business. Consequently, companies often look to implement awards for which the tax treatment for the employees is equivalent to that if they were owners.

Preliminary review: Recognition:

- Employee share options are recognised as an expense in the profit and loss account because they are viewed as compensation provided by employers in exchange for employee services received. However, the majority of contributors to the preliminary review favoured a disclosure-only approach to accounting for employee share options in the financial statements of private companies, in preference to an expense in the profit and loss account. At least one of these contributors, however, made the specific comment that disclosure should be “a prominent disclosure on the face of the P&L”, rather than in the notes.
 - Some responses questioned the expensing of employee share options in principle, on the basis that it gives rise to a “nonsensical reserve”, is “not remuneration”, can generate a “cash inflow” (if the employee purchases the share options) and can give rise to a “double [EPS] expense”.
 - Other responses questioned whether it is practical for private companies to expense share options, on the basis that the valuation is “costly” to do, is a “made-up” number and gives rise to “spurious accuracy”.
- 4. Do you have any comments on the above? Should the accounting for employee share options in the financial statements of private companies involve including them as an expense in the profit and loss account (or only disclosure in the notes)?**

There has been much discussion over the years about whether or not employee share options should be accounted for by recognising an expense in the profit and loss account. This debate has been most vociferous in relation to private companies, where some continue to argue that no expense should be recognised on the basis that the options create a cost that is borne directly by existing shareholders through the dilution of their ownership, rather than being a transfer of economic benefits by the company itself.

Others have argued that recording an expense creates a significant burden for private entities and that this should be removed, either by introducing some simplified form of measurement for them or by moving to a disclosure-only regime.

We are aware of the arguments on all sides and acknowledge that views are often deeply rooted and passionately held. While we appreciate the cost-benefit arguments relating to private companies and are in principle open to simplifying the approach for such entities, we do not support the proposal that these companies should not record an expense for equity-settled share-based payments. This would create an inconsistency between companies applying UK GAAP and would therefore reduce comparability. The only circumstances in which we might support such a change would be if there was a wholesale review of the application of the standard. See also our response to Question 8.

- 5. Should employee share options be recognised in the profit and loss account from grant date as per FRS 20 '(IFRS 2) Share-based payment' and FRS 102 'The Financial Reporting Standard applicable in the UK and Republic of Ireland', or should they first be recognised on exercise date (with disclosures prior to that date, but no expense in the profit and loss account)? Or do you have a further alternative suggestion?**

We do not believe that there is any reason to change current practice.

In our view, the expense should continue to be recognised by spreading it over the vesting period, as this is when the services that are being rewarded are being rendered. Allowing or requiring private companies to defer recognition of the expense until the exercise date would contradict the principles of the standard, create inconsistency and reduce comparability.

Preliminary review: Measurement basis:

- The majority of contributors to the review considered it to be either 'difficult' or 'very difficult' to reliably calculate the fair value of employee share options of a private company. Required inputs for an option pricing model are share price and the volatility of the share price distribution, so 'standalone' private companies can encounter particular difficulties given that neither of these inputs are readily available for private companies and so often have to be calculated theoretically.
- Contributors to the review also highlighted the costs associated with calculating fair value (third party valuation fees, audit fees, etc.).
- Minimum value and intrinsic value are slightly easier to calculate than fair value, but not much easier, and all are difficult to calculate. {Minimum value: "...the calculation [of minimum value] is: (a) the current price of the share, minus (b) the present value of expected dividends on that share during the option term (if the option holder does not receive dividends), minus (c) the present value of the exercise price" – Basis for Conclusions on IFRS 2. Intrinsic value: "...[intrinsic value is] the difference between the market price of the underlying shares and the exercise price of the option" – Basis for Conclusions on IFRS 2.}

6. Have you encountered difficulties in calculating a reliable* amount for the fair value of employee share options of a private company? What measurement basis would you suggest, and why?

*** (Paragraph BC68 of the Basis for Conclusions on IFRS 2 explains that the value of employee share options is used as a surrogate measure of the value of the employee services received in exchange for them, so a 'reliable' amount is one that is reliable in the context of this purpose.)**

It can, of course, be challenging to calculate the fair value of employee share options of a private company. It is not always easy to understand option pricing models and the need to calculate inputs such as share price at grant date and volatility mean that using them can not only be perplexing but also costly. Moreover, calculating the fair value will inevitably involve a greater degree of estimation than is required for public companies where the necessary inputs are more readily available.

In principle, we could support a simpler measurement approach if a suitable alternative could be agreed upon. However, we are not at present convinced by the merits of the alternatives currently being proposed as, in our view, using either minimum value or intrinsic value would not result in an expense that is a reliable surrogate for the value of the employee services rendered. For private companies, both alternatives would also rely on the use of estimates in their calculation and therefore are neither more reliable nor significantly easier to calculate. Therefore, in the absence of any better alternatives, we believe that option pricing models should continue to be used.

In our view, rather than looking to provide an alternative to using option pricing models, the board should focus its efforts on providing practical guidance on how private companies can best use option pricing models. It would also be helpful to clarify what valuation methods the board had in mind when drafting paragraph 26.10(c) of FRS 102.

Preliminary review: Disclosure suggestions:

- Contributors to the review gave specific suggestions for how the disclosure of employee share option schemes could be improved, which included improved disclosure of the dilutive effects of the schemes (i.e. the extent to which existing shareholders' proportionate ownership interest in the company may be reduced by the issue of share options).

7. What information, concerning employee share options, would you like to be included in the notes to the financial statements of private companies, and how would you use that information?

In our view, the disclosures required in the accounts of private companies should be focussed on providing information that allows users to understand the nature and extent of the schemes that existed during the period. This is currently one of the disclosure principles of FRS 20. Consequently, disclosures should – at a minimum – include information such as the number of shares covered by each grant of share options, their exercise price and the conditions associated with the award.

In our experience, users are interested in the principal terms of the option, including the performance targets to which the award is subject and the maximum award to which individuals – particularly directors – may be entitled.

We would also welcome disclosure of the potential level of dilution that may result from the award.

Preliminary review: Other comments:

Some contributors to the review expressed a wish for there to be a more fundamental review of share-based payment accounting.

8. Are there any other comments, not covered by your answers to previous questions, that you wish to make?

Broadly the same approach is applied to share-based payments under IFRS, US GAAP and UK GAAP. The consistency that this creates is clearly desirable. Therefore, if any review of current practice is to be undertaken, we believe that it should be at an international level so that consistency can be maintained.