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European Commission Report – The Legal and Administrative Environment for Employee Stock Options in the EU

In June 2003, the European Commission released a report on the legal and administrative environment for employee stock options in the European Union (EU), prepared by experts in the field of employee stock options[1]. This letter focuses on the report's analysis and conclusions on the issue of stock option accounting.

> The European Commission report advocates delaying a mandated accounting expense for employee stock options until a "widely-shared international consensus" on how to account for such options is developed. In the interim, the report recommends development of "comprehensive and unambiguous standards for the disclosure of information on shareholder-based payments".
>
> If these recommendations are adopted by the European Commission, it may slow the IASB's effort to require employee stock option expensing, and also provide support for opponents of mandatory option expensing in the United States.

Background

In order to get a better understanding of employee stock options and their potential for creating a more entrepreneurial Europe, this report was compiled by the European Commission's Enterprise Directorate in consultation with a group of experts. The experts were nominated by the member states of the EU as well as certain EFTA (European Free Trade Association) and candidate countries. The report describes the environment necessary for employee stock options to be effective, and the advantages and risks of employee stock options for investors, companies and employees. The report also examines employee stock options with regard to taxation, accounting and labor laws. Although the report was prepared under the guidance of European Commission officials, it carries the disclaimer that the views expressed in the document do not necessarily represent the opinions of the European Commission.

Current Accounting for Employee Stock Options in Europe

- Currently there are hardly any detailed and explicit accounting rules for employee stock options to be found in European national codes

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[1] Full text of report may be accessed at:
http://europa.eu.int/comm/enterprise/entrepreneurship/support_measures/stock_options/final_report_stock_en.pdf

- In July 2002 the European Parliament adopted a regulation providing for the application of International Accounting Standards (IAS) for the consolidated accounts of all publicly-quoted companies as of January 2005

    — However, these standards will not be automatically applicable. The new Accounting Regulatory Committee, which is chaired by the European Commission, will decide on the endorsement of these standards for the EU

- While as yet no IAS on employee stock options exist, the IASB had issued an Exposure Draft[2] in November 2002 for a new IFRS that would require:

    — Employee stock options and other equity compensation be accounted for as an expense at the date of grant on a "fair value" basis

    — For equity-settled share-based payment transactions, the compensation cost will be measured at the grant date, and recognized over the service period (i.e., the vesting period)

    — "Fair value" will probably have to be estimated according to a Black-Scholes model or a Binomial Model or a variation of these models

    — For equity grants settled in cash, the charge will be re-measured at each reporting date and a provision will be built up over the service period so that, at the time the payment is eventually made, the amount of the expense should equal the amount of the payment

Discussion on How to Account for Employee Stock Options

The following paraphrases the important section of the report that deals with employee stock option accounting.

The report makes two important distinctions for future decision – whether the value of stock options should be an expense of the issuing company; and, if so, how that expense should be measured.

- In most cases, companies issue new shares to settle employee stock option exercises. Since there are no direct payments by the company and there is no direct cost of acquiring the newly issued shares, it could be argued that there is no cost to the company. Rather, costs are borne by shareholders in the form of dilution

    — However, since employee stock options are granted by a company to its employees for valuable services, the transaction could require an accounting entry just as a transfer of cash would have to be registered

[2] See our letter dated 12/23/02 at:
http://www.fwcook.com/alert_letters/12-02FASBReleaseInvitationTo%5B1%5D....pdf

- According to the IASB, employee stock options represent an expense since any depletion of assets constitutes an expense. For this purpose, the term "asset" is not restricted to such items that could be recorded in a balance sheet

- The report does not attempt to judge the quality of the above arguments. Employee stock options were not foreseen when accounting standards were drafted and therefore the correct way of treating them cannot be deduced from historic standards

- The report rejects the argument by opponents of employee stock option expensing that it will be detrimental to economic development since reported profits would be lower

  — There is no empirical evidence that companies that changed their accounting practices to expense employee stock options have suffered relative to companies that have not

  — For the sake of full disclosure, companies must be obliged to provide complete and accurate employee stock option information to investors. Information on employee stock options is vital for sound investment decisions

- The key question addressed by the report is whether it is enough to present information on employee stock options outside the profit and loss account, or whether the information is more appropriately presented in the cost figures. This raises practical problems, including:

  — How should employee stock options be valued for expense purposes?

  — How are the costs to be spread over the options life?

  — What happens if options lapse or expire valueless?

  — Where should the offsetting entry be registered (e.g. capital reserve)?

- The report states that it is important that future standards conform to a "widely-shared international consensus. Developing such a consensus will need further consideration and discussion"

  — However, since information on employee stock options is vital for sound investment decisions, at the present time emphasis should be placed on "quickly developing comprehensive and unambiguous standards for the disclosure of information on share-based payments"

  — "Parallel to this but without undue pressure, standards could be developed on the expensing of employee options and similar instruments"

Implications

The conclusions reached in the European Commission report suggest that more time is needed to develop a comprehensive global approach to addressing the expense issue. They do not suggest that expensing is inappropriate, but rather that uniformity in reporting and full disclosure of all relevant information (whether in the footnotes or directly in reported results) is needed.

The report could slow down the IASB's effort to require employee stock option expensing, which could have a commensurate impact on the FASB in the US.

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This letter is intended to alert compensation professionals about developments that may affect their companies. General questions may be addressed to DJ Shetty in our New York office at 212.986.6330 or by email at djshetty@fwcook.com. This letter and other published materials are available on our website, www.fwcook.com.