ED 108 — exposing the flaws

Recent Professional Development seminars covered new accounting rules for expensing employee share plans, corporate governance and the future of listed property trusts.

Even the staunchest opponents of compulsory reporting of employee stock options as an expense concede that the argument has been lost. But other arguments continue to be fought out over provisions contained in ED 108 Share Based Payments, the draft accounting standard that will make expensing mandatory from 1 January 2004.

The exposure draft, according to Kerry Clark of Ernst & Young's National Accounting and Auditing Services, is laden with "unnecessary complications" regarding valuation methods, definitions and trust implications.

Clark was addressing a Securities Institute Professional Development seminar on "Expensing Stock Options".

The positive effects of the new standard would be to increase the visibility and disclosure of company remuneration packages by having the value of share and option plans included in financial statements, she said. However, it could also result in lower reported profits, lower dividends and lower share prices.

"Those who are big users of options will take a hit on the P & L," Clark said. "The accounting outcome has become something you cannot ignore."

Responses to ED 108 included apparently unanimous opposition to its proposed method of recognising the option expense over the vesting period —the "service attribution method", which relied heavily on estimation of the length of future employee service. The form of measurement required would be open to manipulation and could distort reported amounts.

Clark pointed out that the exposure draft lists three kinds of employee share plans—equity-settled transactions, cash-settled transactions, and a choice of the two—but fails to mention other forms of share payments. And the draft provides different measurement rules for different plans.

An option-pricing model was not specified, although the required inputs are. However, some of these, such as share price volatility and expected levels of forfeiture, create confusion because of the degree of judgment involved.

Disclosure proposals were complicated and would require the reporting of pages of additional information, Clark said. "They do not make it easy for users to understand," she said. "The extra information required will make it difficult to complete financial statements."

Transitional arrangements would also be "a headache"—they were difficult to understand and clarifications could not be readily obtained.

Stephen Cornwell, of PricewaterhouseCoopers Human Resource Services, also addressing the seminar, said the new expensing rules would bring a change in the instruments used in employee remuneration. There may be a shift away from options towards remuneration plans such as performance share plans or performance rights plans.

"These are basically shares for nil consideration," Cornwell said. "They boil down to zero-priced options but are more popular than options because there is no dilution of existing shares. There is also no exercise price, so performance hurdles are important."

Cornwell said he expected there would be more focus on the linkage between rewards and performance and a move away from large grants. More attention would be paid to the design of performance hurdles, with more stringent testing.

Calling companies to account

The launch of the Australian Stock Exchange's "Principles of Good Corporate Governance and Best Practice Recommendations" was a significant step—but not the end of the process. This was the message delivered by Kathleen Farrell, a consultant with Freehills, at a Securities Institute seminar.

Farrell, who was a member of the ASX Corporate Governance Council, said the guidelines would continue to evolve. "Only one thing is true and certain," she said. "Change will occur constantly."

She pointed to the comparison between corporate governance practice in Australia and the United States as evidence of the success of the Australian approach. "I think the Americans have got it wrong," she said. "The US rules are too prescriptive, creating a too-rigid system that restricts market development, and a set of values that may not be durable."

The Australian guidelines' disclosure requirements enable boards to explain their credentials and activities to investors, underpinning the independence of directors. The guidelines represent an opportunity to improve communication in the market. The "downside"— the cost to small companies of an insistence on "independence"—could be managed through the process of change.

Asian flavours

The changing nature of Asian property markets offered big opportunities to Australian investors, Stuart Stuckey, of Principal Global Investors, told a Securities Institute seminar. The recent advent of real estate investment trusts (REITs) in Asia had shifted the emphasis from capital returns towards liquid income-biased investments.

Combined with the maturity of the Australian real estate market and its heavy domestic weighting, the Asian developments could see significant international diversification by Australian property investors over the next five years, according to Stuckey. J

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