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ASIC Issues Final Guidance on Valuing Options for Directors and Executives

A copy of ASIC's guidelines are available on ASIC's website at ***www.asic.gov.au****.*

On 30 June 2003, the Australian Securities and Investments Commission (ASIC) issued its final guidelines about the way listed companies in Australia should include the value of options in the disclosure of directors' and executives' emoluments in the directors' report under section 300A of the *Corporations Act 2001*.

This *Accounting Alert* provides an outline of these ASIC guidelines, and discusses some practical issues that may arise in their application.

Overview

Section 300A of the *Corporations Act 2001* requires the directors' report of Australian listed companies to disclose, inter alia, 'details of the nature and amount of each element of the emoluments of each director and each of the five named officers of the company receiving the highest emolument'.

The guidelines require option values to be included in the amount of emoluments disclosed in the directors' report

The guidelines, which apply to financial years ending on or after 30 June 2003, outline the approach that ASIC believe should be adopted to value options granted to directors and executives for the purpose of disclosing emoluments in the directors' report under section 300A.

The key implications of the ASIC guidelines are as follows:

- ASIC believes that, for the purpose of disclosing emoluments in the directors' report, all Australian listed companies should value options as at their grant date using an appropriate option pricing model – it will therefore no longer be appropriate for Australian listed companies to exclude the value of options from emoluments disclosed in the director's report;

- Directors will need to determine the most appropriate valuation methodology, having full regard to the ASIC guidelines – departure from the guidelines may lead to public and/or regulatory scrutiny; and
- Recognition of an expense in net profit or loss, arising from the granting of options to directors and executives, is *not* required at this stage, and is not covered by the guidelines – ASIC views the expensing of options as a matter to be resolved by the issue of an Accounting Standard, which is currently being addressed by the IASB and AASB.

Although the guidelines are intended to deal only with the treatment of options for the purpose of disclosing emoluments in the directors' report of Australian listed companies, ASIC encourages all entities preparing financial reports under the *Corporations Act 2001* to apply the guidelines in determining the amount of directors' and executives' remuneration disclosed in the notes to the financial statements under Accounting Standards AASB 1017 'Related Party Disclosures' and AASB 1034 'Financial Reports Presentation and Disclosures'.

Summary of the ASIC Guidelines

The key aspects of the ASIC guidelines are as follows:

- The valuation and disclosure of options should be consistent with IASB ED 2 and AASB ED 108 'Share-Based Payment' – requiring the use of known market prices or an option pricing model, including:
  - valuing options as at their grant date;
  - presuming that service periods will be met, unless it is probable that a particular individual will cease employment at an earlier date;
  - allocating the option value on an accruals basis over the vesting period; and
  - not reversing any prior disclosed amounts where options do not vest;
- ASIC has not included transitional arrangements in respect of the first financial year to which the guidelines are applied. Accordingly, the guidelines apply to all options that have not

An option pricing model should be used, valuing the options at grant date vested prior to the commencement of the relevant financial year. ASIC has assumed that the directors will know the value of all options granted (to enable an accruals basis to be used);

- The amount of emoluments disclosed in the first financial year to which the guidelines are applied should not be adjusted to exclude amounts disclosed in the directors' report in prior years. ASIC encourages companies to explain the change in basis of valuing options and the effect on the amount of emoluments shown in the directors' report; and
- The directors' report should disclose the methodology and assumptions used to value options.

Practical Questions and Considerations

Set out below are a number of questions that may arise when directors are considering the most appropriate treatment of options, for the purpose of disclosing emoluments in the directors' report, in light of the ASIC guidelines.

Are the guidelines mandatory?

The 'guidelines' may not be mandatory, but directors would need to defend any alternative approach adopted by the company

The guidelines are ASIC's considered view as to the appropriate treatment of options for the purpose of disclosing emoluments in the directors' report and should be interpreted in this context.

Given the on-going international debate surrounding the valuation of options, and the ambiguity of the disclosure requirements of Section 300A of the *Corporations Act 2001*, directors may disagree with some aspects of the ASIC guidance. That is, directors may believe the valuation and disclosure approach currently adopted by the company complies with section 300A of the *Corporations Act 2001* and is appropriate in the circumstances. However, any companies not adopting the guidelines could reasonably expect ASIC to question such 'non-compliance' as part of ASIC's financial reporting surveillance program.

What if the value of options has not been previously disclosed?

An option value should be included in the amount of emoluments disclosed in the directors' report

In the past, some Australian listed companies have not included a value of options in the amount of emoluments disclosed in the directors' report on the basis that it was difficult to value options, or that performance hurdles and other vesting conditions meant that the value of options, as at the grant date, could not be reliably determined or that the value was effectively zero.

Given the recent developments at both the international and Australia levels in relation to the valuation of share-based payments, and the views expressed by ASIC, it would appear difficult to continue to regard this approach as acceptable.

At the very minimum, an option pricing model (Black-Scholes or binomial model) should be used to value options for the purpose of disclosing emoluments in the directors' report.

Given recent developments, the use of a method other than that based on an option pricing model would be difficult to support.

What valuation techniques are unlikely to be acceptable?

Given the recent developments at both the international and Australia levels in relation to the valuation of share-based payments, and the views expressed by ASIC, it is unlikely that the following valuation techniques would be considered acceptable when valuing options in the context of section 300A of the *Corporations Act 2001*:

- assigning a nil value on the basis of difficulty in measurement;
- use of 'intrinsic value' – assigning a value based on the difference between the option exercise price and the market price of the underlying share; or
- measurement at other than grant date – such as at vesting date, or exercise date.

How should the probability of an individual meeting the service period conditions be assessed?

The guidelines state that individuals are assumed to provide continuous service until vesting date, unless it is probable that the particular individual will cease at an earlier date. The approach proposed under ED 108/ED 2 of using a weighted probability analysis is not supported by ASIC on the grounds that this approach is not suitable for each individual director and executive.

The assumption that service conditions will be met will generally be adopted

Given the 'all or nothing' approach to the expected satisfaction of service conditions in relation to grant date measurement, it might be considered rare that an individual would not be considered 'probable' of meeting the service conditions at grant date. For instance, in the case of directors and executives, it may reasonably be presumed that such individuals will provide continuous service until vesting date, unless the company or individual has instigated resignation, termination, or retirement.

Therefore, in the vast majority of cases, it might be expected that the option value would be included in full, unless there is strong evidence to the contrary.

How should performance hurdles other than service period conditions be taken into account?

The ASIC guidelines are silent on how performance hurdles other than service periods – such as profit, EPS or share price targets – are to be taken into account in the valuation of options. It is unclear whether the guidelines intend an 'all or nothing' approach to these types of performance hurdles in a similar manner as for service period conditions, or whether a weighted probability approach should be adopted.

Performance hurdles (other than service period conditions) may be assessed on a probability basis

ED 108 and ED 2 require the probability of performance conditions being achieved to be taken into account in the determination of the value of an option. Therefore, in the absence of specific ASIC guidance on this matter, it would appear reasonable to adopt a similar probability basis as that which is proposed by ED 108 and ED 2.

The guidelines also encourage disclosure of how option values have been determined, including how performance conditions have been taken into account.

Should the guidelines be adopted for the purpose of the AASB 1017 and AASB 1034 disclosure of directors' and executives' remuneration?

The requirements of section 300A of the *Corporations Act 2001* and Accounting Standards AASB 1017 'Related Party Disclosures' and AASB 1034 'Financial Report Presentation and Disclosures' differ in some respects. However, in the interests of comparability and consistency, ASIC encourages all entities preparing financial reports under the *Corporations Act 2001* to apply the guidelines in determining the amounts of directors' and executives' remuneration disclosed in the notes to the financial statements.

It might be expected that the directors report and financial report disclosures would be determined on the same basis

Therefore, it might be expected that Australian listed companies would prepare the disclosures in the directors' report and notes to the financial statements on a consistent basis.

Directors of non-listed entities will need to make a determination as to whether it is appropriate in the entity's circumstances to adopt the ASIC guidelines in determining the amount of directors' remuneration disclosed in the notes to the financial statements.

Where an entity changes its method of determining directors' and executives' remuneration, comparative information must be amended to conform to the current basis of preparation. Where comparative information is restated, the financial report should disclose details of the change in method of valuing options and the effect on the amount of directors' and executives' remuneration disclosed for the comparative period.

Are the guidelines consistent with recent IASB/AASB developments?

Whilst the ASIC guidelines are based on the proposals in ED 108 and ED 2, there are some differences, for example, the guidelines apply to all options that have not vested prior to the commencement of the relevant financial year, whereas ED 108 and ED 2 exclude options granted before 7 November 2002.

There are differences in treatment between the guidelines and ED 108/ED 2

Furthermore, the IASB has recently reached a tentative decision to fundamentally change some aspects of ED 2, in particular that adjustments are made for granted options that do not vest. It is unclear how these requirements will translate to the remuneration disclosures for individual directors and executives.

The AASB also intends to issue an Accounting Standard based on ED 106, but amended to be consistent with any Standards issued as a result of ED 108/ED 2. Therefore, the approach under the ASIC guidelines is likely to be different from that ultimately adopted by the AASB.

Action Points

Directors should consider the following points:

- Review and understand the ASIC guidelines;
- Develop and approve an appropriate methodology for valuing options granted, benchmarked against the ASIC guidelines, international accounting developments and past practice;
- Obtain the information necessary to update the value assigned to options granted in prior periods that remain unvested in the current reporting period.

Feedback and Assistance

We welcome your feedback on the matters covered in this Accounting Alert – please email your comments to accounting_alerts@deloitte.com.au.

For assistance in applying the requirements outlined in your organisation, please contact your local Deloitte office or contact our Lead National Technical Partner, Bruce Porter on (03) 9208 7490, or by email to **bruporter@deloitte.com.au**.