

**URGENT BY FAX AND BY HAND**

(2868 5028)

Our Ref.: C/ACLTR

30 June 2000

Listing Division,  
The Stock Exchange of Hong Kong Ltd.,  
11/F., One International Finance Centre,  
1 Harbour View Street, Central,  
Hong Kong.

Dear Sirs,

Consultation Paper on  
Chapter 17 (Shares Schemes) of The Rules Governing  
The Listing of Securities on The Stock Exchange of Hong Kong Limited

Further to our letter of 16 June 2000, we would like to set out below our concerns over the proposal to require disclosure of fair values of options granted (clause 3.9 refers).

- (1) *whether it is appropriate to introduce the requirement to disclose fair values of options granted by listed issuers*

We consider that it is not yet appropriate to introduce the requirement to disclose fair values of options granted by listed issuers. Disclosure of fair values of options granted without a generally accepted standard of measurement in Hong Kong would not be meaningful. We are, however, supportive of the proposal to require disclosure of other quantitative information as set out in the first consultation paper issued in May 1999.

**International development**

--- We advised earlier in our letter dated 15 March 2000 to your Ms. Estella Ng (copy enclosed again for ease of reference) that there is no consensus internationally among the major accounting standard-setters in respect of the accounting treatment for share options at present. We are aware that representatives of standard-setters from Australia, the US, Canada, the UK and New Zealand (the G4+ 1 group of standard-setters) is considering the financial reporting requirements for employee share options. With such a wide representation on this group, the Society does not consider it appropriate to develop its own guidance on the financial reporting requirements for employee share options before the G4+ 1 group of standard-setters comes up with some sort of consensus.

**Limitations of adopting the US approach**

The Consultation Paper seems to suggest that the Exchange is taking US accounting standards, in particular FAS 123, as a reference in formulating the proposed rules. Although FAS 123 has already been in place for over four years, it is our understanding that many enterprises in the USA continue to apply the intrinsic value based method of accounting as set out in APB 25, with pro forma net income disclosed in accordance with FAS 123. It is our

understanding that the use of the fair value based method of accounting for options as suggested in FAS 123 remains contentious, even within the US financial and investor community, and that disclosure of fair values is often accompanied by a warning that spells out the uncertainty and unreliability of the figures calculated because of the subjectivity of the assumptions on which they are based, and the limitations of option pricing models. An additional problem in Hong Kong is the high historical volatility of even “blue chip” stocks, which makes the selection of an appropriate estimate of future volatility for input into the model much more difficult and subjective.

(2) *whether any additional disclosure should be made*

As mentioned above, we are not supportive of introducing the requirement to disclose fair values of options granted by listed issuers at present. However, in the event that the Exchange decides to press ahead with the proposal, we recommend that the following be disclosed in addition to the method used to calculate such fair values in order that the figures disclosed can, at least, convey some meaning; otherwise, the name of the method used and the fair value figure themselves do not actually give users of financial reports any meaningful information at all, and could potentially be misleading.

**Recommended additional disclosure**

- policy for measurement date (e.g. grant date, vesting date, service date, exercise date etc.)
- significant assumptions used during the year to estimate fair values of options, including risk-free interest rate, expected life, expected volatility, expected dividends, expected vesting proportion etc.
- policy for treatment of forfeiture prior to the expiry date

In addition, in the case of options granted under multiple stock-based employee compensation plans, in line with the requirements under FAS 123, the proposed disclosure in the first consultation paper issued in May 1999 should be expanded to provide information separately for different types of awards to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the listed issuer’s use of stock-based compensation. For example, separate disclosure of weighted-average exercise prices at the end of the year for options with a fixed exercise price and those with an indexed exercise price is likely to be important, as would segregating the number of options not yet exercisable into those that will become exercisable based solely on employees’ rendering additional service and those for which an additional condition must be met for the options to become exercisable.

Furthermore, it is very important that fair values of options and the pro forma net income figure, wherever they are disclosed, must be accompanied by a **warning statement** that spells out adequately the subjectivity, uncertainty and unreliability of the figures calculated because they are based on a number of assumptions, and the limitations of option pricing models. Such a warning statement is not uncommon in the financial statements of US companies.

**Understandability of information**

Despite the necessity of having the additional disclosure mentioned above, in

order for fair values disclosed to be put in the right perspective, it is important to consider whether users, or even preparers, of financial reports have adequate understanding of the conceptual meaning of the valuation methods and the significance of the figures calculated.

The concept underlying the use of the Black-Scholes model to measure fair values of options at the date of grant is to recognise at the grant date in the income statement or to disclose in pro forma net income the cost which would have been borne by the enterprises at the date of grant had it purchased the options from a third party to distribute to the beneficiaries. However, it is equally arguable that the real cost to shareholders is the dilution effect at the exercise date and therefore recognising or disclosing fair values at the grant date can potentially be misleading. It is important that both the preparers and users of financial statements understand the purpose of disclosing the figures. In any event the actual dilution in the period due to the exercise of options, measured by the difference between the exercise price and market price at the exercise date, should also be disclosed.

Many investors are individuals rather than institutional investors and very often do not have sufficient financial knowledge to interpret sophisticated and complex financial information. We suggest that prior to the implementation of the proposed disclosure requirement, it will be necessary for the Exchange to issue appropriate guidance to listed issuers and to ensure that there is an adequate education, both for listed issuers and public investors, on the meaning of the required disclosure. In addition, it is also important to address the effect of potential misinterpretations by the mass media.

- (3) *whether the Exchange should dictate in the rules which model to use or leave it to the listed issuers to decide as long as the model used is fully disclosed*

There is no international consensus as to which the best model is. While the Black-Scholes model is widely used in certain jurisdictions, we are not aware of any empirical evidence suggesting that it applies equally well in Asian markets where the volatility of shares is significantly higher.

Despite the above deficiency, we consider that, if fair values of options granted are to be disclosed at this stage, the Exchange should prescribe in the rules which model to use rather than leaving it to the listed issuers to decide so that the disclosure would be comparable to some extent.

- (4) *whether it would be practical and appropriate to require auditors to confirm the matters relating to the calculation of fair value of options as required under the proposed rule*

### **Place of disclosure**

The Consultation Paper proposes that auditors must give confirmation to the listed issuer. We presume this would mean that fair values of options and the proforma net income figure are to be disclosed outside the financial statements, i.e. outside the scope of the auditors' report. Please let us know if our understanding is incorrect.

## **Matters to be confirmed**

Clause 3.9(a) states that the auditors must confirm to the listed issuer that the method used to calculate fair value of options is correctly disclosed. Presumably this would require stating the name of the method used only. Question 4 under clause 3.9 which deals with “matters relating to the calculation of fair value of options”, however, appears to be inconsistent with clause 3.9(a) and covers a much wider scope of matters to be confirmed. It is unclear from the Consultation Paper the scope of assurance required.

If the scope only covers confirming the name of the method used, auditors would normally have no problem in doing it. However, we doubt the usefulness of this confirmation. We would also have serious reservation in giving such a confirmation and thereby lending auditors’ creditability to a highly subjective calculation. This is particularly the case where the listed issuer does not apply the stated method properly or where there may be serious concerns over the accuracy and reliability of the data used in the calculation.

If the scope of matters to be confirmed covers more than the name of the method used, we would like to see that the Exchange makes this requirement clear in the Listing Rules so that we can provide guidance to our Practising Members on the level of work to be carried out and the level of assurance that can be provided.

In case auditors are required to provide some form of assurance on the computation of fair values (for example, reperform the arithmetic computation of fair values according to a given model), the Listing Rules should require that there is a segregation of responsibilities for the valuation of fair values of options and its review by the auditors. Accordingly the assumptions and underlying data used in the valuation, such as the appropriateness of the assumptions used, the data used in computing fair values, and in particular, the expected volatility, must be independently confirmed by an appropriate professional (for example, the merchant banker) who should have the expertise in this area.

If you have any queries on the above comments, please do not hesitate to contact our Stephen Chan, Deputy Director of Professional Standards, in the first instance.

Yours faithfully,

LOUIS L.W. WONG  
REGISTRAR  
HONG KONG SOCIETY ACCOUNTANTS

LW/EC/al

c.c. Corporate Finance Division, SFC (2810 5385)

**BY FAX AND BY POST**

Your Ref. : LD81014/2000/EN/OC/sc  
Our Ref. : C/FASC

15 March 2000

Ms. Estella Ng,  
Senior Director,  
Listing Division,  
The Stock Exchange of Hong Kong Ltd.,  
11/F., One International Finance Centre,  
1 Harbour View Street,  
Central,  
Hong Kong.

Dear Madam,

Share Option Schemes

We refer to your letter of 21 January 2000 informing us of the Exchange's intention to amend the Listing Rules on share option schemes by introducing new disclosure requirements and requesting the Society to consider providing guidance to its members on the accounting and auditing in this area.

We understand that the proposed disclosure requirements will soon be exposed by the Exchange for public consultation. We also understand that there is no consensus internationally among the major accounting standard-setters in respect of the accounting treatment for share options at present, but the G4+ 1 group of accounting standard-setters is working on this subject.

Before we proceed to consider the appropriate form of guidance to be issued to our members, we would need to be given more definitive requirements resulting from the proposed amendments to the Listing Rules on share option schemes. Accordingly we request that you keep us informed of the progress of the Exchange's project in future and let us have any other relevant information that you can make available to us now so that we can plan our work.

Thank you for your attention.

Yours faithfully,

LOUIS L.W. WONG  
REGISTRAR  
HONG KONG SOCIETY OF  
ACCOUNTANTS

LW/EC/al

c.c. Mr. David Stannard, Securities & Futures Commission (25231181)  
Mr. Charles Grieve, Securities & Futures Commission (28105385)  
Mr. Lawrence Fok, The Stock Exchange of Hong Kong Ltd. (28104475)