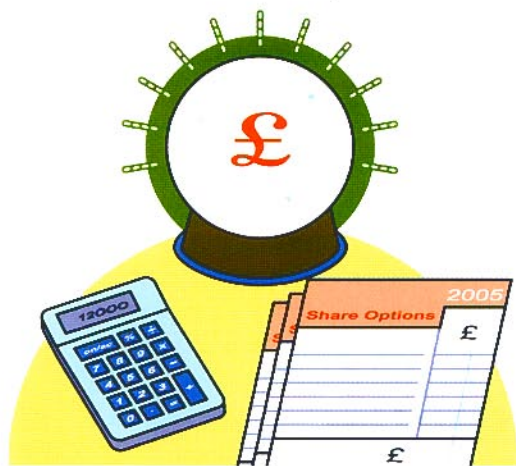
Consider your options



NEW ACCOUNTANCY STANDARDS mean British businesses will have to report for the cost of stock options in their profit and loss statements. The rules apply to public companies from the beginning of January and to everyone else in a year. But if you think international accountancy standards and option-pricing models are a problem for someone else, think again.

This will eventually affect every business that makes share-based payments, including payments to staff. That includes companies with all-employee share option schemes, save-as-you-earn plans, enterprise management incentives or ad-hoc arrangements that haven't been registered with the Inland Revenue.

There have been widespread concerns about the standard, which blurs the line between capital and income and requires companies to use arcane valuation techniques to "price" options granted to staff. Nevertheless, the standards are here to stay. Some multinationals, including Microsoft, Coca-Cola, Amazon and General Electric, have already complied with the new rules on a voluntary basis.

The rules will mean that companies will need to make a provision for the fair value of share-based payments as an expense in the profit and loss account when the payment or option grant is made. Figuring out a "fair value" will require sophisticated financial models, such as the commonly used Black-Scholes option pricing model. Most firms will require expert advice to get it right. While some commentators think these models are little better than crystal balls, the result is "a better number than zero", according to Paul Ebling, director of technical activities at the Accounting Standards Board. It will certainly focus attention onto the cost of such schemes.

"Companies will get used to it," says Geoffrey Bond, director of SM2, a specialist adviser. The government has made wider share participation a priority and there are a number of tax-efficient schemes available. Consultants have not noticed a slow-down in interest despite the new rules. But Bond says: "The level of awareness among potential clients is very low. In fact, the level of awareness of government initiatives in the main is also very low."

For John Leighton-Jones, head of reward and performance at global security firm QinetiQ, the new standard will have an impact on thinking. "We need to come up with tax-efficient schemes that minimise the P&L hit," he says. "It's a fine balancing act."

"The key driver is getting the employees to share in the success of the company"

He is looking at all-employee share purchase schemes for the company's 9,000 staff and performance-based restricted share schemes for executives. The rule change has contributed to a shift of emphasis away from an upside-only options approach to more of a share ownership model that shares the risks with staff. "The key driver is getting the employees to share in the success of the company; getting them lined up behind the owners, the strategy and the direction of the company," he says.

Matthew Stibbe

The economy

Graeme Leach looks at what's in store for the coming year

If you ask Gordon Brown what the economy is going to look like in 2005 you get a different answer than if you ask economists.

The Treasury is right at the upper end of optimism, with Brown and his team predicting three to 3.5 per cent growth this year. He argues he was more optimistic in 2003 and 2004 and was right, so there's no reason he won't be right again. But pride comes before a fall.

The reason he got away with it last year is precisely why he won't get away with it again this year. Strong growth last year led to the Bank of England responding with higher interest rates. That's going to slow the economy this year. The housing market is weakening and that will dent consumer confidence. We expect growth to slow this year to 2.6 per cent.

The technical reason Brown thinks he can get away with it is he thinks there is sufficient spare capacity—the output gap. The Treasury believes underlying growth has improved and trend growth has increased, so potential output is higher. In other words, because of supply-side improvements, there's room to grow without igniting inflationary pressures.

If Brown is right, then great. But the reverse is probably true. Sorry Chancellor, we think trend growth is beginning to fall, not rise, because of higher taxes and rising regulation stifling economic activity. Unfortunately, by the end of the decade UK Plc is going to be paying a lot more tax. So although the bad news is that the long-term outlook is getting worse, the more immediate outlook for 2005 should be OK. It's not going to be a great year, but it shouldn't be too bad either.

The big issue for 2005 is what's going to happen in the housing market. That's an area where directors can follow events easily. Keep an eye on things like house prices, mortgages, consumer confidence and retail sales figures. If some of these figures start to tail off sharply during 2005, we might well be looking at a more serious slowdown.

Graeme Leach is chief economist at the IoD: graeme.leach@iod.com

ILLUSTRATIONS: CYRUS DEBOO