IN THE SPOTL

New accounting rules are designed to increase the transparency of financial statements, but **Matthew Stibbe** questions the implications

New accounting standards will apply to employee share schemes from 1 January 2005 for public companies and a year later for all UK businesses. Share-based payments, including executive share options, share purchase plans and all-employee schemes, must all now be treated as a cost on a company's profit and loss statement (P&L).

The stated objective of the new standards is to make information on financial statements reliable, transparent and comparable. Corporate scandals, the end of the dotcom era and a change in sentiment (investment expert Warren Buffet, for example, has been particularly vocal on the topic) have catalysed the change. The objective of giving the best possible representation of a firm's performance seems, on the face of it, quite reasonable.

Critics don't dispute the principles but question the resulting standard. The first objection is philosophical: it blurs the distinction between capital and revenue. Shareholders are concerned about the double whammy that will occur when their earnings per share are diluted by the shares granted or promised and by the cost of doing so via P&L.

The second worry is an accounting one. Colin Paterson, a partner at share scheme consultancy RM2, reckons that option pricing is something of a black art that will result in "a wholly false, ersatz number in the P&L".

A more practical objection, borne out by experience with American companies that have complied with the standards early on, is that analysts will discount the cost and continue to evaluate companies on the existing basis. The cost of compliance is another concern but by far the biggest anxiety has been that firms will simply eliminate share-based incentive schemes altogether because of the effect on the bottom line.

Ginette Chapman

Nevertheless, the standard-setters are confident of their actions. Kevin Stevenson, director of technical activities at the International Accounting Standards Board (IASB), says: "It's a full-blooded standard which is the result of due process and we're very content with what's gone out." In other words, the debate is over and the standard is here to stay. "There's a growing, weary, resigned acceptance that expensing is going to come in anyway so we might as well get on with it," confirms Paterson.

Final formula

Now that the standard setters have come out with the final formula, companies are working through what it means for their bottom line. They are costing schemes and setting the P&L hit against the anticipated benefits.

"It's a huge balancing act," says Janet Cooper, a partner at law firm Linklaters, "people are looking over their shoulders to see what other firms are doing." The balancing act is made more difficult because the tax deduction can come long after the P&L hit. "It's complicated. If there were easy answers, we'd have heard them." She expects more variation in schemes as they are increasingly tailored to individual needs.

However, the worst fears of the standards' opponents do not seem to have materialised. Although it is early days, advisers report that companies do not seem to be planning to scrap schemes wholesale.

At present, Lloyds TSB sees no planned changes to its shares offerings, a conclusion that was reached after it put a six-person team to work for several months on the impact of the standards. Phil Ainsley, a senior manager in its share scheme group, says: "We know what the effect on our P&L account will be. It's focused everybody's minds on the costs of the plans and what we get out of them and what we should be doing to maximise their impact."

Lloyds TSB is using the so-called binomial model for pricing options, but it still has some technical areas to resolve, for example what happens when someone pulls out of an old scheme and goes into a new one.

It is ironic that the creation of a 'cost' has refocused employers on the 'benefit' side of the equation by reminding them why schemes were introduced in the first place. Employee share participation can encourage motivation, identity of interests and loyalty.

A 2001 survey by Professor Richard Freeman looked at 300 UK companies before and after share schemes had been introduced and found a 17% increase in productivity where employees were given shares and a 12% increase where they were given options. Another study found that public companies with employee share schemes significantly outperformed the FTSE All Share index and the FTSE 100 over a five-year period.

HR teams will need to work more closely with the finance department and become more savvy about the whole issue. "Some HR people are highly switched on to this and they

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are well-tooled up on valuation techniques but some are in an area where its more of a mystery and people will need access to expertise," says the IASB's Stevenson. However, he warns that existing models may not be adequate. "People have been plugging numbers into the Black Scholes model [a valuation scheme for options] for years, but they may find they need a more sophisticated tool."

Professional advisers foresee a number of possible reactions to the new regime. Most firms will want to do some research, such as staff surveys, into the business benefits of share schemes, if only to justify their existence to the finance director.

Some will keep their existing schemes unchanged. Some will modify them to reduce their costs, for example by cutting discounts on shares offered to staff or by marking up option prices to reflect their extra value (because they have no downside). For instance, IBM has recently introduced premium-priced options. In other words the option price is actually higher than the market price for the underlying shares at the time of the grant.

Others may emulate Microsoft's restricted stock unit programme (known in the UK as a long-term incentive plan) where bonuses in shares are given based on company performance). Everyone using stock-based incentives is expected to look closely at how the benefit is communicated to staff to make sure that the expected benefit to the company is actually achieved. For example, Lloyds TSB gives total reward statements to staff to reflect benefits such as pensions and stock options as well as basic pay.

Unwelcome or not, the new standard makes the costs of share schemes much more visible. Assuming – as seems likely – most companies keep their schemes, albeit with tweaks, getting value for money will become a priority ●

CASE STUDY

Firm milks option plans

Cow PR, a public relations firm with 16 staff, is typical of the kind of entrepreneurial start-up that sees options as a cash-efficient way of attracting new staff and keeping them loyal.

Frustrated in his attempts to recreate a John Lewis-style employee partnership scheme, co-founder Dirk Singer bought an off-the-shelf share incentive plan with the intention of giving away up to 30% of the company's equity.

He wasn't aware of the new standard. His initial reaction: "We'd have to reconsider. If this happens, we'll probably charge people for the shares at a fair market price." Setting up and running a scheme like this is a challenge for a small firm and changing the rules in the middle of the game is frustrating. To Singer, it also seems to run counter to the government's intention of encouraging wider share ownership. Share participation "should have value on its own rather than being a fancy dotcom style bonus scheme".

CASE STUDY

Plan designed to share

PDD, a medium-sized design firm, represents the middle tier of businesses affected by the change.

It has an all-employee share incentive scheme under which staff receive 5% of their salary in shares with the opportunity to buy more and earn free shares.

The scheme is now three years old and managing director Helen Gray is pleased, "it seems like a great scheme, employees understand it, the Inland Revenue loves it and everyone is very positive". There's also an enterprise management incentive scheme for senior management. So, for her, the new treatment comes at a very bad time. She's concerned that it will create a bad impression when people take an uninformed or quick look at the accounts, for example when doing credit checks, and as a result people could make bad decisions.

She's certainly considering her alternatives: "Depending on what happens, I'm more likely to transfer shares from the employee benefit trust (for senior managers) into the share incentive plan based on the fact that the latter issues actual shares rather than options so there's no problem with valuation." Her biggest concern, however, is with management time. "I'm the MD and I really don't have time to keep up with all the rules. It took me six months to set the scheme up in the first place but now I have to rethink everything and spend even more time."