Accounting for share options

In the November edition of *The Treasurer*, Stephen Pugh from the Technical Committee summarised the main points of the Accounting Standards Board's proposals for accounting for share-based payment, that is, share options. In summary the proposals are that all share options should be accounted for as a cost at fair value (using Black Scholes) on vesting date, with an accrual in the profit and loss account over the performance period, if any, based on an estimate of what the fair value will be.

The Association has responded to these proposals by producing a discussion document, which can be found on its website at www.treasurers.org.

The discussion document reviews the arguments for and against making a charge for share options in the accounts and concludes that there is logic supporting it. However the practical obstacles are significant.

The two main points we seek to make are that:

- Accounting treatment of share options should be both practical in application and able to produce reasonable figures that most people can go along with, otherwise accounting itself will fall into disrepute.
- Any proposals for new accounting standards should seek to remove or reduce inconsistencies in standards rather than increase them. We have mentioned two related areas where this is a consideration that should be taken into account. One area is the already inconsistent accounting treatment of equity options embedded in convertible bonds and those relating to bond with warrant issues.

The conclusions of the paper are as follows:

- This paper accepts the logic of the ASB's aim of bringing share option costs into the profit and loss account, but recognises that this is not a universally accepted view.
- Even if the argument is accepted that share options represent a cost to be charged in the profit and loss account, the practical problems of doing so are considerable.
- The economic consequences of doing so (for example, on taxation and government economic policy) should not be ignored.
- Nothing should be charged unless a reasonable approximation to the right value can be agreed.
- The theoretically correct approach to valuing equity options is extremely difficult to implement in the case of employee share schemes, particularly for unquoted or start-up firms.
- The only apparent alternative, based on exercise price valuation, may reflect the actual value passing from shareholders to employees at the time of exercise, but this is flawed in a number of ways and fails the test of consistent valuation for all equity options.
- Any approach based on the use of the market value of shares could, given the volatility of today's stock markets, lead to unacceptably volatile charges to earnings.
- For some firms, such payments are very significant, and we risk major distortion in profit reporting by ignoring this issue.

The Technical Committee would welcome your views on this controversial issue. The full text of the Association response is on our website www.treasurers.org. Please contact me with your comments on 020 7213 0738 or at cbradley@treasurers.co.uk ■

How will the new regulations affect you?

There have been several developments on the regulatory scene that are likely to affect the majority of corporate treasurers.

Non-Investment Products Code

The Bank of England has published for consultation its draft Non-Investment Products (NIPS) Code, which is the replacement for the London Code for Deposit and FX Business. It is available at www.bankofengland.co.uk/markets/nips.htm and a link to it will also be provided on the Association's website.

Although the Technical Committee has been involved in the working groups developing this Code, there may still be some aspects treasurers would like to change. Comments can be directed either to the Bank of England or to myself at the usual address, and I will collate them and pass them on.

Market abuse rules – the impact on treasurers

The Technical Committee has written to the Financial Services Authority (FSA) expressing its concerns about the possible impact of the new market abuse regulations on the activities of corporate treasurers.

Since no one appears to have much idea about how the regime will work in practice, we have suggested, first, that the FSA provides speedy guidance on particular issues and, second, that the FSA publishes a regular bulletin of issues raised and guidance given, to make market participants more comfortable with the new rules.

The letter to the FSA is published in the technical update on the Association website.

Regulated activities – are you affected?

Readers may remember that the Technical Committee made representations at the time of the first consultation on the scope of regulation in support of companies currently operating under the 'permitted person' regime, including those trading in energy derivatives.

Other respondents to the first consultation requested a regime be included that would replace the permitted persons regime, without which a large number of persons (including energy traders not currently regulated) would become regulated. It was suggested that a hedging exemption be included for firms whose main business is not investment business to be able to deal in derivatives for risk management purposes.

HM Treasury has now published for consultation a draft of the Regulated Activities Order which will determine the scope of the new Financial Services and Markets Act.

It appears the dealing activities of most corporate treasurers will be unaffected, since the current rule that principal transactions in securities will be excluded from regulation, unless there is a 'holding out' as a market participant, will be continued.

'Holding out' is difficult to define precisely, but it is the term used to indicate someone who stands ready to deal as a market participant as opposed to acting as a customer of the market.

In addition, derivatives transactions with or through authorised persons will also continue to be exempt, as will principal-to-principal intra-group transactions of any kind.

However, the current permitted persons exemption, already largely withdrawn as a result of the Investment Services Directive, will be completely withdrawn. This may affect certain companies which now deal in commodity derivatives as permitted persons.

A new exemption for 'hedging' is proposed, for derivatives transactions between non-authorised principals where the purpose of the derivative transaction is to hedge an underlying commercial transaction, such as one in commodities.

There are a number of problems with the drafting as it stands: a dedicated treasury vehicle (within a group) conducting hedging activities would not get the benefit of the exemption. It is necessary for the hedging company itself to be a commercial company.

The current drafting also envisages that hedging activity relates to underlying commercial transactions. This would therefore not encompass hedging of states or events, such as the weather or oil in the ground. Another concern is that the drafting does not address the situation where the hedging company is acting as agent for another member of its group.

The Technical Committee is not planning to make a formal response to this consultation, but is contributing to others' responses and will be happy to pass on any comments from any members who are likely to be affected. ■

Rules governing commercial paper

The same draft order includes some changes in the rules governing debt securities. Mostly these seek to liberalise the markets. For example, the minimum net assets requirement for issuers of commercial paper (CP) has been deleted as has the minimum denomination rule for longer term (over one year) debt securities. However, the minimum denomination of CP has been increased from £100,000 to £500,000. Is this likely to cause any problems for CP issuers? As usual, please contact Caroline Bradley with your comments. ■

Hotline is prepared by Caroline Bradley, the Association's Technical Officer. For any comments or new items, please contact her at cbradley@treasurers.co.uk. Additional technical updates are available on the website: www.treasurers.org.

New president for ACT

Anthony Stern has been elected as the new President of the Association, a role with a term of two years to the end of 2002. He has been Director of Treasury at Bass PLC since 1988 and previously held appointments at Chase Manhattan bank and in the treasury of Marks & Spencer and Dixons.

Anthony has served on the Association's Technical Committee, chaired its Editorial Committee and is currently its representative on the Chancellor of the Exchequer's Business Advisory Group.

His aim is for the Association to continue to strengthen its role in a changing financial and regulatory environment and through the further development of its award winning website to extend the Association's reach to students, to regional groups and to treasury professionals throughout the world.

He pays tribute to the work of the professional team involved in the running of the Association and to his predecessor Philippa Foster Back saying that "She has been a great ambassador for the Association and will be a tough act to follow." ■