SETTLING ON SCHEME STANDARDS

BY 1 JANUARY 2004, COMPANIES WILL NEED TO HAVE GOT TO GRIPS WITH NEW ACCOUNTING STANDARDS FRED 31 AND ED 2, SAYS **MATTHEW PEARLMAN** OF LANE CLARK & PEACOCK LLP.

From 1 January 2004, companies operating share option plans for their employees will see their reported earnings reduced, if a new draft accounting standard comes in to force. In November 2002, the UK Accounting Standards Board (ASB) published draft accounting rules (FRED 31) requiring share-based payments to be recognised in reported earnings from the first accounting year beginning on or after 1 January 2004. The International Accounting Standards Board also published a similar draft standard (ED 2) at the same time (see December Hotline, p10).

There has been considerable press speculation that this will lead to the demise of many share schemes, with a poll by ProShare indicating that about a quarter of the top 500 companies would abandon their employee share schemes. It is therefore important to understand what the new rules will mean.

CURRENT POSITION: NO PAIN, NO GAIN. Under current accounting rules, if employee share options are issued without discount (that is, the strike price ultimately paid by the employee is set to equal the share price at the point of grant), no charge passes through the profit and loss (P&L) account. Further, if an employer runs an Inland Revenue-approved Save As You Earn scheme for all its employees, even though the strike price is typically at a 20% discount to the current share price, there is still no charge recognised in the P&L, because of a specific exemption for this class of plan.

Some schemes, for example, long-term incentive plans (LTIPs), provide free shares to certain executives, usually with performance criteria that must be achieved before receiving the shares. These schemes give rise to an expense, even under current arrangements.

The net result of this is that, provided the share option plan is designed appropriately, it has no effect on company profitability, and so the finance function usually does not get heavily involved in the design. Companies do have to report the potential dilution effects on earnings per share, but this does not directly affect reported profits.

ALL CHANGE AHEAD. All this will change under the new draft standard (see *Box 1*). The ASB's argument is that options are granted to employees as part of their pay package and in return they provide additional services to their employer. It reasons that the value of these services should be charged as an expense in the accounts. However, because it is difficult to place a value on these additional services directly, the best way to measure them is to look at the fair value of the options that were granted.

The fair value is then spread over the vesting period, when employees are assumed to provide their services, rather than the exercise period.

There is a big difference in the proposed accounting treatment of equity and cash settled options (see *Box 2* for definitions). For equity settled options, no subsequent adjustment is made to this initial valuation, even if the share price over or underperforms. Which means that you could have charged an expense in your P&L even if you never actually deliver any benefit to the employees. Adjustments are made if employees leave the service of the employer. Despite the P&L charge there is no corresponding additional liability on the balance sheet.

A completely different treatment applies to cash settled options. These will be accounted for in the same way as a normal provision on the balance sheet, with the fair value of the outstanding options re-measured each year. An expense will be charged of the difference between the balance sheet liabilities from one year to the next.

The new accounting rules will apply to any equity settled options granted since the date of its publication, November 2002, and to cash settled options even if they were in place before then. This means you should be planning in advance for the effect on the 2004 accounts of any options that are granted from now on, or even for re-pricing any existing option plans.

A SHIFT OF RESPONSIBILITY. Up to now, the design and implementation of share option plans has typically fallen within the brief of the company secretary or human resources. They will make sure that the plans provided are competitive with the peer group, and fall within guidelines laid down by the Association of British Insurers (ABI), and that they are designed in a way that currently avoids a charge to the company's profits.

As a result of the new draft standard, the responsibility is moving much more towards finance, and many finance directors are asking the following questions:

Box 1
Main points of FRED 31/ED 2

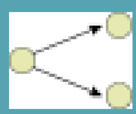
- FRED 31 and ED 2 are practically identical.
- Proposed that charges apply to accounts from 1 January 2004.
- Charge based on fair value of options granted.
- Attributed over vesting period of the option.
- Equity and cash settled payments treated differently.
- Proposed to cover all grants from November 2002.
- Also covers existing cash settled grants.

Box 2
Equity and cash settled options

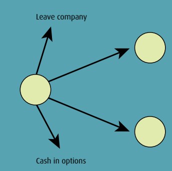
- Equity settled options deliver shares to the employee when he or she exercises the option.
- cash settled options, otherwise known as share appreciation rights, or 'phantom options', deliver a cash payment when the employee exercises the option. The payment is the difference between the share price and strike price.
- Arrangements where the employee has the right to take payment as equity or cash, or where the employer has the right to make payment as equity or cash, but has a standing practice of paying cash, will be treated as cash settled.

Box 3
The actuarial binomial tree

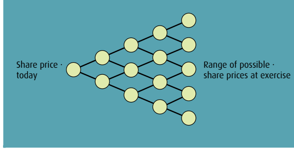
At each node, the share price can go up or down.



More complex behaviours can be added at each node.



To build up a full binomial tree.



- how will my profits be affected by the share plans that we currently operate?
- what changes can I make to the forthcoming grant to mitigate the impact?
- do the existing plans really deliver the value to the business that is implied by the accounting charge? and
- should we convert our cash settled options into equity settled options?

Answering these questions requires a detailed understanding of the mechanics of FRED 31 and a robust model to perform the necessary calculations.

A NEW MODEL. New models are therefore being built to value share option schemes. Any model will always look to the Black-Schöles model as a starting point. However, when it comes to valuing the complexities of employee share option plans, despite its brilliance, unfortunately, Black-Schöles falls down.

For example, one major supposition of Black-Schöles is that the option can only be exercised at a single point in time, but employee options can almost always be exercised over an extended period, of up to seven years or more. Moreover, when it comes to allowing for employees who may have to cash in their options early because they are leaving employment, or who may want to cash in their options when they are, say, 30% 'in the money' to go on that dream holiday or buy a new car, Black-Schöles does not have the parameters to cope.

Attention has therefore been focussed on the binomial model, which uses the powerful mathematics underlying the Black-Schöles approach, but remains flexible enough to allow for the extended exercise periods noted above.

In essence, the binomial model is straightforward (see *Box 3*). The life of the option is broken down into small units of time, usually weekly intervals. At each point in time, called a 'node', the model projects forward share prices by allowing the price to move up or down since the previous node – the extent of the price movements depends on the volatility of the share. Once the full tree of possible prices is built up, the model values the option by working backwards from the end-point share prices, at each node comparing the discounted value of the two 'daughter nodes' with the value at the 'parent node' if it falls within the exercise period.

LCP has developed this model one step further to produce an actuarial binomial model that can allow for further complexities. In this model, each node can be programmed to behave independently: for example, to allow for employees who leave the company and opt to cash in their options beforehand, or complex behaviours like employees who will cash-in their options if they are 30% in the money. If appropriate, it can even allow for company behaviour, like re-pricing the option if it is underwater.

THE WAY AHEAD. Big changes are on the way and now is the time to reconsider the impact of your share schemes on reported profits, before the next grant is made. You will need to ask hard questions, and potentially make hard decisions, which might involve redesigning or possibly removing your schemes. If necessary, you may need to take advice from experts, and actuarial models can help you understand the sensitivity of your reported earnings to the design of your plan. You will then be able to offer a cost-effective incentive package to your employees.

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*Access a trial version of the model on **www.lcp.uk.com**.*

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