PRESSING MATTERS

NEW ACCOUNTING RULES MEAN FIRMS WILL BE UNDER PRESSURE TO REVIEW THEIR RISK MANAGEMENT STRATEGIES FOR EMPLOYEE SHARE SCHEMES, SAYS COMMERZBANKS' **PETER LOVIBOND**.

In the post-bubble era, equity investors are increasingly aware of the costs associated with substantial grants of stock options and other equity based executive incentives. Over the past three years market volatility has weakened the 1990's assumptions that "stock prices always rise in the medium term" and that "shareholders will tolerate dilution of returns in a casino where everyone is winning".

The result is that companies are now under real pressure to limit the number of new shares created for employee incentive programmes, as well as to tighten the performance tests on which they rely.

This increased shareholder awareness of the potential cost of such schemes has been accompanied by a fresh drive from the accounting standard-setters to improve recognition of value transfers associated with employee share option schemes.

So what impact will the new accounting rules have? And how will companies react to this intense scrutiny of the structure and management of equity-based incentives?

A NEW ERA IN COST RECOGNITION

Historically, many companies have resisted calls for fair value earnings recognition of share option schemes. The first proposal to treat share option grants as an accounting expense was hard-fought in the US in the early 1990s. At that time, the opt-out permitted under FAS 123 (the relevant US accounting standard) reflected a victory for its opponents, presaging what Robert Monks called "the greatest non-violent transfer of wealth that history has ever seen". Even when the International Accounting Standards Board (IASB) took up the case in July 2000, its chances of success seemed low.

Yet three years later, following the high-profile collapses in corporate America, a harmonised IAS and US GAAP regime for mandatory expensing from 2004 looks a near certainty. The IASB has made clear its intentions in the Exposure Draft ED 2 and the UK Accounting Standards Board (ASB) has backed recognition, publishing its own Exposure Draft FRED 31 in line with ED 2. In its parallel Invitation to Comment, the US FASB laid out the differences between the IASB's Exposure Draft and FAS 123, including the stipulation that no opt out will be available.

WHAT DO THE NEW ACCOUNTING RULES MEAN?

The proposed accounting treatment for share-based payments will mean that the fair value of options granted to employees will be reflected in the profit and loss account from the date of grant (*see Box 1*). The fair value will be based either on market prices (where a liquid market in directly comparable instruments exists), or on valuations derived from option valuation models (*see Box 2*).

BOX 1

KEY PROPOSALS OF IASB ED2/ASB FRED 31

- **Physically-settled options (new or existing shares):** fair value at grant date amortised over the period to vesting.
- **Cash-settled (synthetic) options:** fair value at grant date amortised over the period to vesting, with mark-to-market adjustments at period end.
- **Valuation method:** absent direct reference to market prices, estimation using a financial model.
- **Adjustments:** reductions in fair value explicitly encouraged to reflect conditionality and non-transferability.
- **Implementation:** from 2004 for grants after the publication in ED2 in November 2002.

To view the ACT's submission to the ASB on FRED 31/ED2 visit http://www.treasurers.org/technical/papers/index.cfm#share-based

BOX 2

ILLUSTRATIVE EXAMPLE: POTENTIAL REPORTED EARNINGS IMPACT UNDER ED2

To estimate reported fair value for an executive option which can be exercised after three years and within 10 years.

ASSUMPTIONS

- Annualised share price volatility of 40% (constant in medium term)
- Dividend yield of 3.9%.
- Average life of options estimated at 6.5 years (accounting for early exercise).
- Cumulative 10% of grantees will leave the company (allowing options to lapse unexercised).
- 5% probability that in-the-money options lapse (based on likelihood of performance criteria not being met).

Based on these assumptions, the fair value of an option granted at-the-money would be 28% of the exercise price. Under ED 2 this cost would be amortised over the three-year vesting period.

'THE MOVE TO FAIR VALUE WILL HAVE A NUMBER OF EFFECTS, NOT LEAST EMPHASISING THE COSTS OF UK OPTION PROGRAMMES THAT ARE LONG-DATED BY CONTINENTAL STANDARDS'

The earnings figures for companies with the largest proportional commitments to employee share schemes will obviously be most affected. However, because of the elements which contribute to option valuation, companies whose shares display particular characteristics will have higher valuations attributable to their share options and therefore a greater cost to recognise against earnings. The companies that will be most impacted in accounting terms will typically be those in sectors which combine low yield, high price volatility and a high earnings per share multiple.

As a result of the accounting impact, it is reasonable to expect many companies to look again at the underlying structure of their incentive programmes. In the shifts between restricted grant (LTIP) and option-type schemes in recent years, it is not clear that the ideal balance between shareholders and managers has yet been reached.

The move to fair value will have a number of effects, not least emphasising the costs of UK option programmes that are long-dated by continental standards. Applying market-based valuation to these liabilities may also suggest a number of refinements (capped returns being a simple example) which would both reduce fair value and improve the balance of incentives.

In some countries, we have seen companies taking the more radical step of outsourcing the whole process, passing on to employees third-party products customised to their particular requirements.

In addition, given the present emphasis on shareholder activism and corporate governance, more companies, under pressure from institutional investors, may also seek to examine opportunities for actively managing their exposures under share-based incentive schemes. This can include executing hedging transactions both in the company's own equity and in related derivatives.

NEW OPPORTUNITIES IN OWN EQUITY RISK MANAGEMENT

Many UK companies have traditionally met obligations arising from employee share options schemes by issuing new equity. Where capital structure dictated a preference for market purchases, physical shares have been bought through employee benefit trusts. To date, more active management of own equity risk via derivatives has meant employee share-option plan (ESOP)-related financing and risk management transactions for those trusts.

In general, the management of own equity risk remains a controversial area. Comparing the company law and regulatory regimes across Europe, English Law exhibits a high degree of sensitivity to speculative dealings in own shares, going back to *Trevor v. Whitworth* in 1887. Combine this with a conservative approach to derivatives generally at Board level and it is easy to see why UK companies have moved cautiously into this area of risk management practice. Yet the time may now be right for developments in such techniques.

TRANSACTIONS IN PHYSICAL SHARES. The long-delayed Treasury Shares regime, which is due to come into effect from December 2003, will allow UK companies to hold and re-sell their own shares on balance sheet and for a wider variety of purposes than is possible through employee benefit trusts.

Where this facility has been available in continental Europe, it is commonly used to establish a stock of shares available for employees and to fund smaller acquisitions, without the mechanics of a new issue; only in France is 'stabilisation' of the share price an explicit additional objective of share buyback approvals.

The key change for UK companies is that shares repurchased will not automatically be cancelled, exposing them to the possibility of cash (but not accounting) gains and losses on resale at the plc level.

BOX 3

ACCOUNTING FOR OWN SHARE DERIVATIVES

UK GAAP: Reflecting the existing company law position, UK GAAP has not specifically addressed the topic of derivatives on an entity's own shares. Derivatives entered into in trust are currently subject to the consolidated FRS 13 disclosure requirement (and typically also regulatory disclosure).

US GAAP: A distinction has been made between:

- Physically settled derivatives, which are treated as equity instruments and recognised as such, with no impact on earnings.
- Cash-settled derivatives, which are treated as a financial instrument with mark-to-market or hedge accounting under FAS 133.

FAS 150: Recently FAS 150 has created a carve-out for physical contracts requiring repurchase of shares, similar to the proposal outlined below for IAS.

IAS: International standards previously lacked a clear treatment for own share transactions, although there is specific guidance on written, physically settled put options, which effectively defines them as financial instruments.

The Exposure Draft published in October 2002 proposing changes to IAS 32 and IAS 39 offers rules that would cover the full range of call and put options, swaps and forward transactions over own shares. The proposed treatment broadly follows the US GAAP approach in its distinction between physical equity instruments and cash-settled derivatives.

However, the treatment set out in the Exposure Draft still also carves out derivatives such as forwards or written puts under which a company is obliged to buy back its own shares for cash consideration and re-classifies the obligation from equity to financial liabilities, with deemed interest accruing through earnings. If, following the current consultation process, this element of the draft is adopted, it offers the prospect of a clear base for future accounting under international standards.

Profile. Tony Chitty

Head of Treasury – UK, AgustaWestland

AGE 45

EDUCATION & QUALIFICATIONS

1991 AMCT.

1994 MCT.

CAREER HISTORY

1982 Finance Analyst – Dunstable Tool & Die; Finance Coordinator – Cowley Toolroom, Finance Coordinator – Tool Manufacturing Consolidation, Rover Group plc.

1987 Contract Accountant.

1988 Treasury Analyst, Group Finance Manager, Commercial Manager – Westland Engineering Ltd; Treasury Manager, International, Westland Group plc.

1994 Export Finance Manager, Assistant Group Treasurer, Head of Treasury – AgustaWestland UK Operations, GKN plc.

"At school I achieved A levels in Pure and Applied Maths and Physics. This was sufficient, at that time, to get into accountancy as an audit clerk. Having joined a local practice I decided instead to move into industry and joined Rover at Dunstable, which at the time was the last self-accounting plant within the group.

After nearly five years with Rover I decided the time was right to move on south. After a couple of contract accounting jobs I moved into Westland, originally as a temporary accountant performing financial accounts consolidations. The opportunity for my initial job in treasury came up and, to a certain extent, liking the company and the environment, I fell into treasury as a career by accident.

Once within the treasury environment, I felt at home straight away and almost immediately began my ACT studies. My experience as a small company accountant and in provincial practice allowed me to have a wider and more outward-facing view than the accountants within the company who were largely focused on internal matters. I also found this to be true in Rover. My approach to treasury is to be focused more on external factors and influences on the company and to manage and mitigate risks in a proactive way, allowing business to be done where others might find the risks unacceptable.

In essence, I characterise my career as a progression through the financial world, becoming focused more on the future as time went on. As a financial accountant in practice I concentrated on last year's outturn (and quite often the year before that). As a commercial accountant it was short-term history and next year's budget but now in treasury I feel that my focus is, and should be, on looking forward to ensure that the right structures and facilities are in place to allow the business to go forward with confidence. Most of my day-to-day activity revolves around manng risk relating to sales contracts and this also means looking forward as most of our aircraft contracts have three- to four-year delivery programmes."

TRANSACTIONS IN OWN EQUITY DERIVATIVES. The Treasury Shares legislation (and the Inland Revenue proposals to simplify availability of tax deductions for ESOPs) might suggest that UK companies will move away from using expensive and administratively inconvenient trusts and towards a continental model, under which various requirements to deliver own shares are managed on balance sheet. While clarification on the accounting treatment of derivatives on own equity is emerging (see *Box 3*), the UK legal environment for own share derivatives at the plc level still remains unfriendly.

There are still significant legal obstacles which effectively prevent physically settled own share contracts and severely restrict cash-settled derivatives. In key areas (particularly relating to shareholder approvals and financial assistance), employee benefit trusts enjoy an explicit or implicit carve-out, allowing them greater flexibility. The trust structure may therefore still serve as a convenient vehicle for companies wishing to hedge with instruments other than physical shares.

Transactions in own equity derivatives through this route may in fact increase as a result of the accounting changes. One of the inhibitions to hedging in the past was the view that buying matching call options represented bad value, and implicitly companies felt that the market was over-estimating the business risk implied by medium-term traded traded volatility. With the new accounting regime crystallising an equivalent cost through the fair value calculation, purchase of over the counter (OTC) call options (either at grant date or opportunistically) becomes a more palatable alternative.

By encouraging adjustments to reflect non-transferability and conditionality, the standard setters have also left open the possibility of achieving hedge treatment without matching the typical 10-year life of UK executive options.

IS ACCOUNTING THE WHOLE STORY?

So how can the overall impact of the new accounting regime for share-based payments be assessed?

If ESOP accounting treatment was changing in isolation, there would probably not be much impact. However, in this instance, the accounting changes proposed are symptomatic of a more fundamental move to put a spotlight on the hidden costs of share-based incentives and to test whether those incentives create reciprocal value for shareholders. Inevitably, this brings into question both the underlying structure of the programmes and the way they are managed.

For the many companies which have previously relied on newly-issued shares or carried existing physical positions in trust against option liabilities, the incentives to look at alternative risk management methods will increase. As a result, the continuing migration of ESOP management responsibility from the company secretary to the treasurer looks set to continue.

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The Treasurer: *Further analysis on the implications of accounting for share-based payments is included in previous articles by Matthew Pearlman of Lane Clark Peacock (March 2003, p20) and David Creed (April 2003, p17).*