



Share based employee payments have become a very popular form of employee benefit in Ireland in recent years. From 1 January 2005 the cost of such schemes must be recognised as an expense in the profit and loss account. This new accounting treatment may have a significant effect on reported profits for some companies. The technical accounting rules may also bring about changes in the future design of such schemes, and in some cases may mean that schemes could be withdrawn.

What are Share Based Payments?

Share based employee payment schemes come in a variety of forms. The range of schemes includes Sharesave schemes, Share Option plans, and Long Term Incentive Plans. Common to all schemes is the fact that the gain to the employee is not immediate and that the ultimate value of the benefit will depend on the future value of shares in the employing company or its ultimate parent.

Sharesave schemes typically involve employees making regular savings for predefined period, with the option to use the proceeds to buy shares in their employer at a discounted price. Under Share Option plans employee are granted a fixed number of options at a specified exercise price. These options usually vest (become exercisable) after a set number of years. In both Sharesave schemes and Share Option plans the options are normally forfeited if the employee terminates his or her employment before the options vest.

Long Term Incentive Plans (LTIPs) involve the conditional granting of shares to the employee. The shares vest only if some predefined company performance conditions are satisfied.

Share based employee payment schemes vary in their complexity. The simpler schemes are typically used for the broad range of staff. Sharesave schemes and simple Share Option schemes are used in these cases. Senior executives, as a rule, benefit from potentially more generous schemes or LTIPs, but there are usually performance hurdles attaching, which must be satisfied in order for the scheme benefits to vest. Two common hurdle designs in Ireland are:

- Total Shareholder Return must beat a chosen Market Index
- Earnings Per Share must grow by at least Inflation + x%

What is the new Accounting Standard?

IFRS2 (or FRS20 in Ireland and the UK) is the new accounting standard which will apply to Share Based Payments. The scope of IFRS2 extends beyond payments to employees, but we consider only employee (including director) payments for the purpose of this article. IFRS2 requires that the cost of Share Based Payments be reflected as an expense in the P&L. The expense is calculated at the grant date of the scheme, and recognised over the period during which the options vest. The standard is mandatory for all listed companies for annual periods beginning on or after 1 January 2005. Unlisted companies will need to comply from 1 January 2006.

Prior to the introduction of IFRS2, the common accounting approach was not to include any allowance for share based payments. Details of share options and similar benefits to senior management were disclosed in the notes to the accounts. The introduction of the new standard comes on the heels of high profile international corporate governance scandals in recent years and reflects the new “fair value” approach to accounting. Put simply, the argument is that if such schemes have a value to employees then they must involve a cost to employers.

Some of the opposition to IFRS2 was based around the difficulty in determining the value of employee and executive share options. The standard requires that a suitable “option pricing model” be used to determine fair value. The methodology and calculations require a particular expertise, and by and large companies are looking to outside providers to assist in choosing model assumptions and produce the necessary calculations.

Impact on Accounts

Many companies have already given consideration to consider the impact of the standard on their P&L, in advance of the 2005 year-end. The effect has the potential to be quite significant as shown by the following three examples for ISEQ companies who have disclosed the effect to date:

Company		Profit Before Tax €m	Reduction due to IFRS2
Kingspan Group	2004 Accounts	88.0	(1.8)
Anglo Irish Bank	2005 H1 Indicative	308.4	(4.0)
Grafton Group	2004 Accounts	131.9	(0.9)

Impact on Scheme Design

It is likely that there will be some fallout from the new accounting standard in terms of scheme design, as companies attempt to ensure that the hit to their profits is minimized.

The accounting charge can be influenced by the type of performance hurdles used. For example, performance conditions related to Total Shareholder Return are deemed “market based conditions”, whereas hurdles related to earnings per share are considered “non-market conditions”. The accounting treatment of market based conditions means that where the hurdle is not realised the accounting charges *cannot* be reversed. However for a non-market hurdle which is not achieved, the past accounting charges are reversed in later years.

Share based payments inevitably lose part of their attraction when they produce accounting charges for the company. Could this mean that companies abandon share option plans in favour of an alternative type of employee reward?

What should you be doing?

If you are involved in or responsible for the production of accounts for a company which makes share based payments there are several steps you should be taking. The first step is to familiarise yourself with the new standard and assess whether your company will be affected.

For those who will be required to comply with IFRS2 it is likely you will need to seek external expertise, particularly in relation to the option pricing model. Your external advisers should also be able to assist you with data gathering, setting of assumptions and the production of the required accounting disclosures.

If you are responsible for the design of share based payment schemes, you will need to consider the impact of the new accounting rules on future schemes.