CL 206

Share Based Payments

The following are comments of the Law Society's Company Law Committee on ASB Consultation Document No. ●.

In connection with current proposals by some UK companies to treat grants of options as an expense in profit and loss accounts, we refer you to the comments on the legality of this treatment in our paper of October 2000 in response to the Accounting Standards Board's Discussion Paper of July 2000 on "Share-Based Payment", a copy of which is attached.

The prime questions concern:

1. Where options are satisfied by the company issuing new shares, there is no real expense incurred by the Company, and therefore (for the reasons related to departure from formats given in our paper of October 2000) an expense can only be shown by using a substance over form analysis, which requires the true and fair view override, and also requires the statutory disclosures to be made where the true and fair view override is used. (The European Commission is against the use of the true and fair view override on a general basis of course (see the Interpretative Communication concerning certain articles of the 4th and 7th Directives on Accounting OJC 16/05 20.1.1998 paragraph 6)). This is as much something that requires a change in the law (i.e. to allow something that is not legally a present or future liability of the Company, to be treated as one), as does the International Accounting Standards proposal to show, for example, preference shares as something other than shares. To quote the European Commission's proposal on amending the 4th and 7th Directives (2002/0112 COD; COM (2002) 259 Final):

   "In addition to the recognition of these items is the manner of their disclosure within the prescriptive formats for the profit and loss account and balance sheets specified in the Directive. Under International Accounting Standards certain transactions and arrangements must be disclosed in the profit and loss account and balance sheet within items which reflect the substance of the transaction or arrangement rather than its legal form. This revision [i.e. the proposed revision to the EC 4th and 7th Directives] expressly empowers member states to permit or require that, in determining within which format item an amount should be included, regard may be had to substance as well as form."

   In other words this will be allowed under EU law (and therefore for UK law to permit or require this) only from 2005 (at any rate for listed companies subject to the Regulation, assuming International Accounting Standards by then require this treatment; the wording in the proposed Directive is unclear as to whether the amendment would cover showing something as an expense that was not one). The Accounting Standards Board has, I believe, accepted in FRED 30 that the treatment of preference shares in a substance over form manner (in the balance sheet format) does require a change in the law.

We stress that we are not saying that the Accounting Standards Board's proposals to expense options in the profit and loss account are not a good idea; merely that they need to wait for the law to catch up. In the meantime, as at present, investors can have the fullest disclosure made in the notes to the accounts (or even in a supplementary pro forma profit and loss account), so that analysts (if they do their job properly) can adjust the reported figures to arrive at the desired result. The change in law is only needed for the deduction to be made directly in the company's statutory profit and loss account.

How to accommodate the message we are transmitting about what we believe the current law says with enormous political pressure to do the opposite?

We anticipate that there may be enormous political pressure to ignore these legal reservations (for example, "Enron" is being used by some to justify their proposals). We see the following consequences, on the assumption that no authority in the UK is likely to want to enforce any alleged non compliance with the law on this matter:

(i) it is desirable for companies wishing to adopt the charging of such expenses in the profit and loss account to have a "no action" position on this formally taken by the EU authorities;

(ii) similarly by the UK authorities;

(iii) this leaves the residual risk of challenge by a private sector individual or company. In the UK this is difficult to predict but one example of how this might arise is where a chief executive or finance director runs a company which is not so susceptible to institutional pressure, e.g. a company which is mostly controlled by family or related interests, even though it is listed or traded on AIM. If, for example, the rules were mandatory and action to enforce them was taken by the Financial Reporting Review Panel, then such a company is less likely than other companies to back down and give in but might mount a challenge in a UK court;

(iv) as regards EU challenges, it partly depends on the politics in other member states and the view taken by the European Commission, which we do not know enough about to comment on as regards the risks of challenge (as opposed to the legality of the matter, on which we have commented above).

2. Conversely, where the exercise of the option is satisfied by the purchase of existing shares by a trust at market value, then the current practice of treating the monies paid by the employing subsidiary company to the trust to buy the shares as an expense in

individual accounts for tax purposes but not showing the expense in the consolidated accounts (by eliminating the entry in the parent accounts relating to issue of shares at a premium against the trading expense in the subsidiary employer company's accounts) is also arguably wrong i.e. it should be shown as an expense in the consolidated accounts – is it a proper elimination on consolidation where one entry relates to an issue of share capital and the other relates to a trading expense?

We believe it is urgent to draw 1. above to the attention of the Urgent Issues Task Force before companies even voluntarily adopt the practice, in response to current pressure to do so.

Postscript

UITF Abstract 17 says that the profit and loss charge is to be the subject of an opposite credit in the balance sheet (i.e. to include an equivalent amount in reserves (solely so the balance sheet will balance as there is no corresponding entry for the "expense" as it is not an actual outflow of cash)). What is the position on distributable profits? Does the hit to profit and loss reduce them even though the Company itself has not reduced its net assets? Does the balancing adjustment to reserves restore them and how should the credit to reserves be identified – what is it, what is its justification? This is a vital question for companies and one which will begin to be relevant to a number as new economy companies (which have suffered from these charges more than most) move into profitability, look to do a capital reduction to put themselves in a position to pay dividends out of future profits and try to work out just what is their deficit on distributable reserves. It is also of course a judgement which section 262(3) of the Companies Act 1985 lays at the accountants' door.