

Changes to global accounting standards for employee plans are coming: underestimate them at your peril

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As many companies are aware, unprecedented changes to the Australian Accounting Standards come into effect for the accounting period commencing 1 January 2005. In particular, the changes to AASB 2 will dramatically change the face of equity-based employee plans. Adopted from the International Financial Reporting Standard (IFRS 2) in direct response to issues surrounding the Enron-style abuse of share and option plans, these changes will present a variety of challenges to companies in terms of equity plan accounting, valuation and design, including:

- profit and loss impact
- cash flow and tax implications
- connection to company strategy and business imperatives
- investor expectations
- program efficiency — correlation of 'cost' to perceived value, and
- the need for simplicity/transparency.

Particularly for those companies administering their employee share plans in-house, the importance of seeking specialist industry advice and planning for the impact of these impending changes cannot be overstated. Companies will be required for the first time to record expenses related to issuing shares or options to employees, which will affect their bottom line and potentially run into millions of dollars.

To provide a context for the new AASB 2 changes, it is important to understand the recent trends in equity-based employee plan offers.

Recent trends

In recent times we have seen a definite trend toward broad-based employee plans, with a significant increase in the number of companies making gift offers to employees in Australia following the introduction of the Division 13A taxation legislation. This allows employers to claim the gift offers as a tax deduction, with no effect on their profit and loss.

Major Australian companies such as Virgin Blue Holdings and Pacific Brands have recently led the way in this area, implementing gift share offers of AUD\$1000 worth of shares per employee, that resulted in a take-up rate in excess of 90 per cent for both companies. This figure is consistent with the general take-up rate of these types of gift offers and achieves the objective of having the majority of the company's employees as shareholders.

In addition, a recent review of S&P/ASX 200 listed companies revealed other key trends including:

- salary sacrifice for shares features predominantly in exempt and deferred plan types
- some salary sacrifice plans also incorporate a price discount or matching component from the company
- gift shares under exempt plans are increasingly being linked to company performance
- equity plans remain popular, with executive plans in 86 per cent of companies and employee plans in 81 per cent, and
- performance shares/rights plans are on the increase.

Bracing for impact

It is vital for companies to fully understand the magnitude and potential impact of the AASB 2 changes, that are expected to provide greater opportunities for salary sacrifice plans, and feature an increase in price discounts or matching employer contributions linked to performance. There is also a prevailing perception that companies will be forced to become more discerning with the allocation of shares, and ultimately offer these shares in a more effective manner.

How will companies adjust to profit and loss expensing?

To cater for the profit and loss expensing requirements within the new regulatory

environment, companies will need to review their current plan design, accounting treatment and valuation methods including:

- whether to scale back gift/free share offers
- linking performance with the offer of gift shares
- offering a performance grant, with contributory 'top-up', and
- offering full salary sacrifice purchased shares.

For example, co-contribution and salary sacrifice plans could be considered part of employee remuneration packages, and subsequently represent part of the employee cost for profit and loss recording purposes. The company contribution could also be linked to the achievement of performance hurdles.

The anticipated move towards co-contribution schemes will also place greater emphasis on design and communication requirements. For example, to reduce risk, companies may consider purchasing shares monthly rather than annually, which aligns with payroll deductions. In addition, as employees contribute their own salary, it is essential the benefits be clearly communicated to them on a regular basis. This will be made possible through further enhancements to electronic communications and online access to holding information.

An example of the advancements made in this area is the availability of an online trading/sales facility, that becomes increasingly crucial when we consider the evergreen nature of plan design. Specifically, shares become available to employees on a monthly basis at the conclusion of the three-year vesting period under monthly purchased tax exempt-style plans, enabling them to manage their holding in a similar manner to a savings account.

Increased administration requirements

Perhaps the largest logistical issues companies will face under the new regulatory regime will be those relating to increased administration and reporting requirements associated with salary sacrifice and co-contribution plans, under which monthly deductions and purchases are made. The AASB 2 changes will also require new accounting entries supported by accurate reports and valuation methods.

In addition to the AASB 2 changes, the recent introduction of the *Financial Services Reform Act* (FSRA) also affects companies' share plans in terms of administration, communication and compliance requirements, including the management and licensing of employee trusts.

Specialist expertise and capacity required

As a result of the increased administrative burden, in-house management of employee plans will become increasingly unviable. Companies will need to employ industry specialists to help them

successfully navigate these latest regulatory changes, ideally under an outsource solution that will ensure alignment between:

- disclosure of cost in financial statements
- economic cost to entity
- the communicated value to recipients, and
- compliance with the FSRA.

As the IFRS 2 reforms will have a global impact on employee plans, companies will need to appoint service providers with the ability to manage the more complex administrative requirements through their:

- technical expertise and global capability
- common global approach for plan services, including offer management, ongoing administration and sale/exercise facilities
- proactive industry advisory role on such issues
- ability to effectively communicate the terms and value of plans to employees
- customised solutions to meet specific corporate/HR remuneration objectives of each company, and
- a robust valuation technique to assist companies:
 - understand the impact of the equity plan and proposed awards on financial statements
 - contrast the costs of different design features, and
 - identify the impact of different performance hurdles on value.

Conclusion

If not taken seriously, the AASB 2 and IFRS 2 changes could potentially damage the bottom line of companies. However, if aided by the correct advice and outsourced service solutions, these companies will be able to:

- reduce the bottom line impact of AASB 2 by considering plan design alternatives
- successfully deal with the new administrative requirements
- continue to reap the significant benefits of high participation in equity-based employee plans, and
- avoid the growing compliance risk associated with self-management in the post-Enron environment.



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