

TIME TO THINK:

VALUING SHARE-BASED INCENTIVES

The design of a share-based incentive can have a significant impact on its accounting cost. This Time to Think reviews the modelling techniques available and summarises the main drivers of the cost.

The Ellason team is experienced in supporting companies with valuation opinions for share-based payments in accordance with IFRS2 – please contact us if you would like to discuss further.

1. What are companies required to report?

Under the IFRS2 accounting standard, companies are required to value and account for any share-based payments in their financial accounts. A suitable valuation model must be used to assess the 'fair' value of these share-based payments.

The choice of which valuation model to use will depend upon the characteristics of the incentive award and the nature of any underlying vesting conditions. Of particular importance is whether the award is subject to any 'market-based' performance conditions.

2. What is a 'market-based' performance condition?

IFRS2 defines a market-based condition as one where the vesting, and/or exercisability, of an award is dependent on share price. Common examples include share options, and performance shares that vest on achievement of share price or total shareholder return (TSR) targets.

Other vesting conditions are generally defined as a 'non-market' and include hurdles or targets relating to P&L or balance sheet measures (e.g. revenue, profitability, return on capital measures, etc.).

Of course, many incentive awards combine both market-based and non-market conditions, and this must be reflected in the overall valuation.

3. How does the accounting valuation differ between market-based and non-market performance conditions?

Non-market performance conditions are *not* captured in the fair value calculation, and the accounting charge relating to awards with such measures is 'true-up' at each interim reporting date, i.e. taking into account the then-expected vesting outcome.

For incentive awards, the vesting of which is determined only by non-market conditions, the grant-date fair value is simply the share price on that date (discounted for expected dividends if these do not accrue to participants). The total accounting expense taken in respect of awards with non-market conditions is then ultimately the number of shares actually vesting multiplied by the grant-date share price.

Conversely, market-based performance conditions must be taken into account in calculating the grant-date fair value of awards. This fair value is then fixed and so, unlike with non-market conditions, there is no subsequent true-up at future reporting

dates, regardless of the extent to which the performance condition is actually achieved (note: there is a true-up to reflect award lapses through participants leaving, but this is not covered in this TTT). The total accounting expense can therefore be both higher or lower than the value realised by participants. For example, if a TSR-based award lapses due to weak TSR performance, an accounting expense will have been accrued even though the value vesting to participants is nil.

4. Which valuation models can be used?

There are a range of models used for the purposes of valuing share-based payments, and the choice of which is most appropriate will depend on a number of factors – most notably the incentive vehicle and performance conditions.

The Black-Scholes model is a simple and widely-used technique, and is typically associated with valuing simple time-vesting share options. Black-Scholes can also be used for more esoteric options such as 'premium-priced' options (where the exercise price is set a higher level than the prevailing share price) or 'binary' options (where the payout is dependent on a share price level being achieved but where the payout is fixed). Black-Scholes can also be used for valuing some Value Creation Plans, linked to achieving specific share price hurdles.

However, the Black Scholes model cannot reflect market-based performance conditions such as absolute TSR hurdles or relative TSR ranking. For these more complex incentives, an alternative technique such as a Monte Carlo simulation (MCS) is required. An MCS allows customised plan design features to be incorporated in the

valuation, and involves simulating future share prices for a company and its peers, which can then be used to estimate vesting outcomes. The MCS model relies on a number of input assumptions and involves running a large number of simulations to produce a single fair value outcome.

5. What are the key drivers of values?

The most significant driver of value is the probability that the performance conditions are achieved. This will depend on (i) 'embedded' performance at the time of grant, and (ii) the volatility of performance.

The influence of embedded performance can be material where the grant date is significantly later than the start of the performance period. The influence of volatility can be material for smaller companies, newly-listed companies or those subject to speculative trading, and can be difficult to determine if there is limited available data on which to base a reasonable assumption.

Contact us for more information

Accounting for share-based payments is a technical area and this note only scratches the surface of the considerations required in undertaking a valuation.

Ellason has experience in providing clients with independent valuation opinions in relation to a wide range of incentive designs at competitive rates. We can assist in the valuations for incentives granted by listed and private companies, and for a variety of performance conditions and award structures.

Please do get in touch with us if you would like to discuss.