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Equity incentives: News from Capital Strategies on share-based rewards

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Analysing the impact of the Accounting Standards Board's share option proposals

Last week we reported on the ASB's proposals that share option gains be charged to the profit ad loss account of the grantor company. This newsletter considers its proposals in a little more detail.

The ASB proposes that a charge to profit and loss account should be recorded for each year over the period between date of grant and the date when the option becomes exercisable (vesting date), based on the fair value of the option in each year of the vesting period. Normally, an option pricing model (Black Scholes being the most commonly used) should be used to work out the fair value.

This may be best illustrated by an example! We attach an illustration. If you would prefer a hard copy, please contact sarah.anderson@capitalstrategies.co.uk.

To obtain a rough guide to the proposal's impact on your own company, you could run a similar calculation based on previously granted options that have become exerciseable. As a very approximate rule of thumb, we suggest that an option be valued at 20% of the market price of a share (this is likely to be higher than 20% in companies with a volatile share price, but less than 20% where share price is relatively stable).

For highly valued companies making extensive use of share options, this approach could deliver some potentially alarming results. For example, one company we have analysed with a £7 billion market capitalisation would, if it granted options over 1% of its share capital, potentially suffer a charge to its profit and loss account in the year of grant of £4.6 million, reducing pre-tax profits by approximately 17%. If the new proposals do come into effect, many such companies may fix the P&L charge at the outset by financing a trust to acquire shares needed in the future to satisfy share options.

There is an argument that investors are already sufficiently aware of the dilutive impact of share options that the greater transparency resulting from the ASB's proposals will not have a material impact on company valuations. There is also a potential silver lining to the proposal, which is that the Inland Revenue may frequently allow a corporation tax deduction for any profit and loss account charged – never previously available.

However, it remains to be seen whether these factors will be of consolation to Finance Directors who will be reluctant to concede any further assaults on headline profits resulting from awards of share-based incentives.

The ASB invites comments on its proposals. A copy of its Discussion Paper on Share Based Payment is available at a cost of £15.00 from ASB Publications, tel 01908 230344.

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If you want to find out more about using share schemes generally to incentivise your employees, contact Robert Postlethwaite on (+44) (0) 207 256 8000 or email him on

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