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EITF Issue 13-D Explained

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On March 13, 2014, in response to a persistent issue regarding the recognition of expense for performance awards, the Financial Accounting Standard Board's ("FASB") Emerging Issues Task Force ("EITF") determined that a performance target which can be achieved after an employee provides the requisite service, is a performance condition that affects the vesting of the awards (not a condition that can affect the grant date fair value of the awards). Therefore, compensation cost should be recognized if it is probable that the performance condition will be achieved. This EITF ruling narrows the scope of acceptable accounting practices, only allowing the use of the performance condition approach.

Background

The question to the Task Force revolved around the definition of a performance condition. FAS literature defines a **performance condition** as:

A condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that related to both of the following:

1. *An employee's rendering service for a specified (either explicitly or implicitly) period of time; and*
2. *Achieving a specified performance target that is defined solely by reference to the employer's own operations (or activities).*

The definition of a performance condition does not specify that the employee must be rendering service when the performance target is achieved (i.e., there is no explicit requirement that the service period be at least as long as the measurement period of the performance target).

Generally, awards with performance targets require the recipient to render service until the performance target is met, but there are cases where that is not true. Examples where the performance condition may be achieved after completion of the requisite service period include attaining a specified profitability metric, retirement or selling shares

in an initial public offering (IPO). As such, different practices have arisen when the performance condition can be met after the requisite service period has been obtained. These practices include:

1. Treat as a Performance Condition;
2. Treat as a Non-Vesting Condition; or
3. Classify as a liability (rarely used and not discussed further in this alert).

Implications

There are two main implications of this question:

1. **Performance Condition:**

    Measurement of the grant-date fair value — assumptions about the achievement of the performance target **are not** included in the grant date fair value

    Timing of the compensation cost — compensation cost is recognized when the achievement of the performance target is considered probable. This may never occur or it may occur long after the requisite service period has ended and the recipient is no longer employed by the company.

2. **Non-Vesting Condition:**

    Measurement of the grant-date fair value — assumptions about the achievement of the performance target **are** included in the grant date fair value.

    Timing of the compensation cost — compensation cost is recognized over the requisite service period, regardless of the actual performance outcome.

Example

Consider a Performance Award for a retirement-eligible employee (100 awards), such that, upon retirement, the employee will earn the performance award at the final multiplier in the future. The final multiplier can be zero, 1x or 2x. The performance metric is EPS and the stock price is $10 on the date of grant. For accounting purposes, there is no risk of forfeiture and no requisite service period. Therefore, the full accounting P&L charge of $1,000 (100 awards x $10) needs to be taken immediately on the date of grant. The following outlines the treatment under the two common approaches that have been utilized.

1. **Treatment as a Performance Condition** — Expense the full $1,000 upfront, but take a cumulative credit/charge reflecting the changing expectation of the performance multiplier. If, at a later time, it becomes expected that the EPS metric will payout at 2x, then take an additional $1,000 charge (so a total of $2,000 gets expensed). If at a later time, it becomes expected that the EPS metric will not payout (zero multiplier), then all the expense is reversed out.

2. **Treatment as a Non-Vesting Condition** — The probability of achieving the target is something that should be included in the initial grant date valuation. Therefore, the company will need a valuation which will adjust the $10 grant date price by the probability of hitting the EPS metric. For this example, assume the probabilities of possible EPS performance yielded a fair value of $8. As a result, the company would expense $800 as of the grant date (100 awards x $8). Then at the end of the performance period, regardless of payout level, there is no true-up based on the actual number of shares delivered. Note that the probability of hitting internal metrics would need to be determined, which introduces increased complexity (and non-standardized assumptions) to an already complex process.

By virtue of the EITF deciding to treat performance awards where payouts can be achieved after an employee provides the requisite service as a **performance condition** under US GAAP, companies can now avoid the more complex process of treating awards as a non-vesting condition. However, the EITF decision is at odds with tentative guidance from IFRS, which recommended using the non-vesting approach. This means global inconsistencies remain in the system, and clients should stay tuned for potential revisions in the future.

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