Technical Compensation Advisors, Inc.

Retirement Eligible Employee and LTI: Accounting and Valuation Considerations

This summary is intended to provide more guidance on the accounting and valuation treatment under ASC718 for equity awards for retirement eligible employees.

Background

Many companies allow for retirement eligible employees to continue to earn equity awards after retirement when meeting defined retirement criteria. Sometimes the retirement criteria are based on an age, or service, or a combined total of age and service. As a reward for their retirement and past service, many companies then allow for the individual to receive the award when it originally would have been earned. Many companies provide this treatment for Restricted Stock Units (RSUs), Performance Share Units (PSUs), and also for employee share options (ESOs). This summary will go through each of these vehicles and the nuanced effect on the accounting and the grant date fair value.

Restricted Stock Units

Example 1: Company ABC grants time based restricted stock with an explicit service period of 3 years. Company ABC allows for retirement eligible employees to continue to vest in the awards after retirement. Employee 1, who is retirement eligible, receives 100 units when the stock price is $10 per share.

Since Employee 1 is retirement eligible and would receive the awards upon retirement, the service condition is considered non-substantive, and the requisite service period is the grant date. The units are effectively vested with no risk of forfeiture and the full amount of compensation expense should be recognized on the grant date. However, the 100 units that were granted have an additional restriction upon them (compared to a fully tradable share), in that they are illiquid for the original service period of 3 years.

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The additional restriction is a mandatory holding period after the requisite service period, which should be considered in the grant date valuation of compensation expense. (In comparison, this grant would be the equivalent of an immediately vested unit with an explicit mandatory holding period of 3 years for the employee). There are tomes of academic and financial literature that provide reasonable estimates to discount for illiquidity in employee shares.

In 2007 at the AICPA Conference, a staff member for the SEC said "*For example, one common term we see in share-based payment arrangements is a restriction that prohibits the transfer or sale of securities. If the security contains such a restriction that continues after the requisite service period, that post-vesting restriction may be factored as a reduction in the value of the security. As a reminder, the staff has*

previously communicated that the discount calculated should be specific to the security, and not derived based on general rules of thumb."

In the example above, an external valuation determines that the illiquid share is worth $9 using a supported and published valuation model. Instead of recognizing $1,000 (100 x $10), Company ABC will recognize $900 (100 x $9) to reflect for the illiquidity during the holding period. The full $900 will be recognized on the grant date (rather than spread over the 3-year explicit service period).

Performance Share Units

Example 2: Company ABC grants Performance Share Units with an explicit service period of 3 years. Further, the earnout at time 3 can range from 0% to 200% dependent on Earnings Per Share goals. Company ABC allows for retirement eligible employees to continue to vest in the awards after retirement. Employee 1, who is retirement eligible, receives 100 units when the stock price is $10 per share

Building upon Example 1 above with Restricted Stock Units, these awards also contain performance conditions under ASC718. The FASB published FASB No. 2014-12, "Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period", which modified ASC718 to add Paragraph 718-10-30-28.

718-10-30-28 In some cases, the terms of an award may provide that a performance target that affects vesting could be achieved after an employee completes the requisite service period. That is, the employee would be eligible to vest in the award regardless of whether the employee is rendering service on the date the performance target is achieved. A performance target that affects vesting and that could be achieved after an employee's requisite service period shall be accounted for as a performance condition. As such, the performance target shall not be reflected in estimating the fair value of the award at the grant date. Compensation cost shall be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service already has been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining 6 unrecognized compensation cost for which requisite service has not yet been rendered shall be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period shall reflect the number of awards that are expected to vest and shall be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. As indicated in the definition of vest, the stated vesting period (which includes the period in which the performance target could be achieved) may differ from the requisite service period.

Therefore, the accounting guidance here states that the full compensation expense should be recognized immediately, based on the probable number of awards that are expected to vest at the end of the performance period, and re-assessed each reporting period until the ultimate determination of earnout at the end of the reporting period.

There is no further guidance in FASB No. 2014-12 on the fair value that should be applied, but refers that the PSUs should be accounted for as a performance condition. Returning to the guidance for performance conditions under ASC718, one should look at Illustrations 5(a) and 5(b) of ASC718:

- Illustration 5(a)-Share Option Award under Which the Number of Options to Be Earned Varies
- Illustration 5(b)-Share Option Award under Which the Exercise Price Varies

Consistent with Illustrations 5(a) and 5(b), Company ABC should determine a fair value under each possible earnout of the performance condition, based on the terms and restrictions of the award in that fact pattern. In Example 2, at each potential earnout of the award (ranging from 0% - 200%), the award is an immediately vested share with a 3-year mandatory holding period. Consistent with Example 1, the award should be discounted for illiquidity during the holding period. The fair value of the award is $9 on the grant date.

Company ABC assesses on the grant date that earnout is probable and that the expected number of awards to be earned out are 100%. Company ABC takes a compensation charge of $900 (100 x $9). Each subsequent reporting period, Company ABC will re-assess the expected number of awards to vest and any changes in the compensation expense will be recognized in the current period with the cumulative effect. If the ultimate earnout is 200%, then the total recognition of compensation cost is $1,800 (200% x 100 x $9). If the ultimate earnout is 0%, then the total recognition of compensation cost is $0 (0% x 100 x $9).

Employee Share Options

Example 3: Company ABC grants employee stock options with an explicit service period of 3 years. Company ABC allows for retirement eligible employees to continue to vest in the awards after retirement. Employee 1, who is retirement eligible, receives 100 employee share options with a $10 strike price when the stock price is $10 per share. The fair value determined using a Black-Scholes pricing model yields a fair value of $4.00 per option granted.

Consistent with Example 1, the awards do not have a substantive vesting condition, and therefore compensation expense for the employee share options should be recognized immediately. However, the difference being with employee share options is that options are not exercisable during the holding period, and there should not be any change in exercise behavior or expected life subsequent to the normal vesting date. Therefore, we generally would not anticipate an increase or decrease in the fair value of an option, especially if the valuation is determined with the Black-Scholes pricing model. Therefore, there is no need for a distinct valuation for employee stock options.

Next Steps

Very few organizations recognize that the accounting treatment for "retirement eligible" employees creates an "implied" mandatory holding period. The implied holding period creates restrictions after the requisite service period that may be discounted for illiquidity. Further, substantive financial research has been done on how to measure illiquidity based on empirical data found in private placement transactions, and multiple models have been published by academics.

If a significant portion of your equity eligible population is retirement eligible, then it would be worthwhile to consider this in the grant date valuation. Note that the grant-date fair value calculated in accordance with ASC 718 is required to be disclosed for named executive officers in the Summary Compensation Table (SCT), without any adjustments reflecting service-based forfeiture estimates. As

of this writing, there is no proxy disclosure guidance that specifically addresses discounts for illiquidity. Accordingly, we believe that unless there is future guidance form the SEC that would prohibit applying this discount, there might be an opportunity to reflect this discounted value in the SCT and the Grants of Plan-Based Awards Table. However, keep in mind that there might be different values disclosed for different named executives based on their respective retirement eligibility status. These differences would appear to be illogical since awards with more severe restrictions (i.e., forfeitable) would have a higher value than those with less severe restrictions (i.e., mandatory holding, but not forfeitable). We encourage companies to discuss this issue with their legal advisors before applying this discount in the proxy.