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GRIST InDepth: Accounting influences design of performance shares with stock price goals

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In This Article
Summary | Accounting influences choice of performance award measures | Accounting framework for award conditions | Hybrid design concepts | Cash-settled TSR award | Appendix: Detailed accounting treatment of alternative market condition award designs

Summary

Performance share awards conditioned on meeting stock price goals – such as a requirement that a company's shareholder return exceed that of an index – are drawing attention as companies strive to align executive pay with shareholder interests. These awards are conceptually attractive, but their appeal may be dampened by accounting rules that require an earnings charge even if these "market condition" goals are missed. While no perfect solution exists, hybrid award designs that incorporate both stock price and financial goals – for example, earnings per share targets – and cash-settled awards can mitigate the risk of having to recognize cost when goals are missed. However, these awards can have their own accounting drawbacks. This article reviews the accounting rules for stock price and financial goals in performance share awards and discusses the pros and cons of a pure market condition award and three alternatives. The *Appendix* includes detailed accounting illustrations for all four examples.

Accounting influences choice of performance award measures

A performance share award is a promise to issue a set number of shares or make an equivalent cash payment at a future time, with vesting contingent on satisfying specified goals. A critical component of award design is selecting the performance measures. Business strategy, compensation philosophy, pay practices, SEC-required disclosures and shareholder perspectives are among the factors influencing the choice of measures. Accounting considerations also should be a key driver. (For a discussion of tax, disclosure, accounting and other technical issues associated with performance share awards, see GRIST #20080146, April 16, 2010).

Nonaccounting issues. Financial measures, such as earnings per share (EPS) and return on capital, can often be influenced directly by management's actions and, therefore, are frequently used in performance share awards to reward employees for meeting business plan goals. But in some cases, stock price or total shareholder return (TSR) – stock price appreciation plus dividends – may be more attractive than a financial measure and can better align management's interests with those of shareholders. Relative TSR, which compares a company's TSR to a peer group or index, may be particularly appealing to companies – such as those in cyclical industries –that have difficulty forecasting long-term financial projections.

Some view TSR as a flawed measure of management's performance because it is affected by factors, including industry and general market risk, beyond management's control. But relative TSR using a well-chosen peer group can isolate stock price performance attributable to company-specific events.

Performance-share accounting issues. If a performance share award uses a financial goal such as EPS or return on capital – known as "performance conditions" in the accounting standards – total cost is trued up based on the performance outcome. If the goal is not met, any previously recognized accounting charges are reversed. But no true-up is permitted for failure to meet a TSR or other "market condition" goal. The total cost of such an award is locked in on the grant date and recognized regardless of the outcome.

For some companies, the inability to true up total cost when a TSR goal is missed is a significant disadvantage. On the positive side, however, the "no true-up" principle also applies if the TSR outcome exceeds expectations, and the period-to-period expense probably will be more stable and predictable than for an award with a financial goal.

Companies that favor market condition goals but want to mitigate the inability to true up the cost when goals are not achieved may find a hybrid approach that combines stock price-related and financial goals attractive. Another alternative may be a cash-settled award instead of one that pays out in stock.

To help companies explore the accounting impact of alternative approaches, this article delves into the accounting rules for market and performance goals in performance share awards. It also compares the accounting consequences of a pure TSR design, two hybrid designs and a cash-settled alternative.

Accounting framework for award conditions

Under FASB Accounting Standards Codification Topic 718 (which supersedes FAS 123(R)), stock-based compensation awards can have "service," "performance" and "market" conditions that affect vesting, exercisability or other features (GRIST #20110129, June 20, 2011, and #20060166, July 12, 2006). These conditions are defined essentially as follows:

- **Service conditions** depend on an employee providing service to the employer.

- **Performance conditions** depend on achieving a specified performance target defined by reference to (i) the company's own operations (for example, meeting an EPS or return on capital goal) or (ii) the same performance measure of another company or group of companies (for example, exceeding a peer group's average EPS growth).

- **Market conditions** depend on achieving a specified (i) price or amount of appreciation in the company's shares or (ii) level of the company's share price appreciation relative to other securities or an index of securities.

Accounting for service and performance conditions. An equity award (generally, an award settled in shares, not cash) with a service or performance condition receives modified grant-date accounting treatment: The fair value per share is fixed at the grant date and does not change with subsequent changes in stock price, but total cost is trued up based on the actual number of shares that vest. During interim reporting periods, expense is calculated using the number of shares expected to vest based on the company's estimate of the most probable performance outcome.

Accounting for market conditions. In contrast, the total cost of an equity award with a market condition is not trued up to reflect the outcome of the condition – that is, this type of award is subject to *un*modified grant-date accounting. If the award fails to vest because the condition is not achieved, the total cost locked in at the grant date must nevertheless be recognized. On the positive side, if the company outperforms its grant-date projection, no additional cost must be recognized. And because the cost of a market condition award doesn't fluctuate based on changes in either stock price or performance, it facilitates reliable earnings forecasts. (Note: As with all awards governed by Topic 718, the cost *is* adjusted for shares that are forfeited for failure to meet a service condition, such as shares surrendered by employees who leave before the performance period ends.)

A market condition's impact typically is incorporated into the grant-date fair value by using a binomial or Monte Carlo simulation model. Depending on the award design, a market condition may increase or decrease an award's fair value from what it would be if vesting were based solely on a service or a performance condition. Under a common US TSR performance share award design with high upside leverage (up to 200% of target), the fair value is frequently higher than the grant-date stock price.

Accounting for a cash-settlement feature. Companies that favor TSR goals for business reasons but dislike the potential disconnect between accounting cost and actual results may want to consider cash-settled performance shares. Although they are economically equivalent to stock-settled performance awards, these awards are accounted for as liabilities (rather than equity) and are, therefore, subject to variable accounting: The fair value is re-measured at each reporting date using a binomial or Monte Carlo simulation model, with differences recorded as expense (or reversal of expense) until the settlement date, when the cost is trued up. The advantage of this approach is that the total accounting cost will always equal the value of the shares earned. Disadvantages include the variability and unpredictability of the interim expense.

Summary of basic accounting consequences. Determining which design is best in any given circumstance can be challenging. The following chart summarizes the accounting treatment for different types of performance share awards:

Type of award	Initial valuation	Interim expense	Final total expense
Stock-settled – performance condition	Fair value per share fixed at grant	Varies based on estimated number of shares expected to vest (but not changes in stock price)	True up: Grant-date fair value per share times number of shares that actually vest
Stock-settled – market condition	Total fair value fixed at grant using binomial or Monte Carlo simulation model	Fixed based on total grant-date fair value	No true up: Total grant-date fair value
Cash-settled – performance condition	n/a	Varies based on changes in stock price and estimated number of shares expected to vest	Actual value paid out
Cash-settled – market condition	n/a	Varies based on current total fair value (using binomial or Monte Carlo simulation model)	Actual value paid out

Hybrid design concepts

Hybrid awards – combining both stock price-related goals and financial goals – take advantage of the true-up treatment of performance conditions to ameliorate the locked-in treatment of market conditions.

An award with a TSR vesting condition is presented below as a base case, followed by two examples of alternative designs incorporating both TSR and a financial measure. In each case, the award is a performance share under which a specific number of shares will vest if certain predetermined goals are satisfied. The performance period is three years, and the market condition is the company's TSR relative to the TSR of a group of peer companies. More detailed illustrations of the accounting treatment for all three award designs appear in the *Appendix*.

Example 1: Basic market condition award. The number of shares that vest is based solely on the company's TSR relative to the peer companies' TSR.

- Target number of shares: 1,000
- TSR goal: Target shares vest if the company's three-year TSR equals the median TSR of the peer group
- Leverage: 250 to 2,000 shares vest for TSR performance in the 40th to 75th percentiles

Accounting treatment. The cost of the basic award is calculated at the grant date using a binomial or Monte Carlo simulation model and is not trued up to reflect the outcome of the TSR condition.

Regardless of the number of shares that actually vest, the company cannot reduce or increase the cost calculated as of the grant date. Therefore, total accounting cost will seldom reflect the actual number of shares that vest or their value.

Example 2: Additive award – market condition plus performance condition. Half of the award (500 target shares) vests on the basis of the company's relative TSR (same design as the basic award), and the other half (500 target shares) vests on the basis of the company's EPS relative to a preset target. Performance for each half is calculated separately.

Accounting treatment. The two halves are accounted for as if they were two separate awards. The TSR portion is treated the same as the basic award: Total cost is locked in at grant, and no true-up is permitted. The EPS portion receives modified grant-date accounting treatment: Cost per share is fixed at grant, and total cost is trued up based on the number of shares that actually vest.

Example 3: Multiplier – performance condition with market condition multiplier. The number of shares earned is first based on meeting an EPS goal. Those shares are then subject to a multiplier, the value of which is based on the company's relative TSR. The TSR multiplier increases or decreases the number of shares earned under the EPS goal, thus determining the final number of shares that vest.

- Target shares: 1,000
- EPS goal (performance condition): Target shares vest if the company's three-year EPS growth meets a specified goal
- Leverage: 333 to 1,500 shares vest for performance from threshold to maximum
- TSR multiplier (market condition): At the end of three years, the company's TSR is compared to the peer companies' TSR. The relative TSR performance corresponds to a specified multiplier, ranging from 0.67 to 1.33. The multiplier is applied to the number of shares earned under the EPS goal to determine the final total shares that vest.

Accounting treatment. The impact of the TSR multiplier is incorporated into the grant-date fair value using a binomial or Monte Carlo simulation model, resulting in a fixed cost per share. Expense is recognized using modified grant-date accounting for the EPS goal: The number of shares expected to be earned under the EPS goal is estimated and multiplied by the grant-date cost per share produced by the model. Total cost is trued up on the basis of the number of shares earned *under the EPS goal only*. Because the grant-date fair value per share incorporates the estimated impact of the TSR multiplier, no cost true-up to reflect actual TSR results is permitted.

Depending on the outcome of the TSR and EPS conditions, the total cost recognized may or may not be consistent with the actual shares that vest. For example, if the company misses the EPS goal and no shares vest, the total cost will be trued up to zero – consistent with the number of

shares that vest. On the other hand, if the company meets the EPS goal but the TSR multiplier reduces the number of shares that vest, total cost will reflect a larger number of shares than actually vest. Conversely, if the TSR multiplier increases the number of shares that vest, total cost will reflect a smaller number of shares than actually vest.

Depending on how the multiplier is structured – that is, how leveraged it is – the variance between the accounting cost and actual outcome may not be significant. The example uses a multiplier ranging from 0.67 to 1.33. A multiplier of, say, 0.80 to 1.20 could have a smaller impact on the actual number of shares that vest and, therefore, might more closely align with the accounting cost. Conversely, a larger multiplier range – say, 0.50 to 1.50 – might result in a larger variance between the number of shares that vest and the accounting cost.

Cash-settled TSR award

In examples 1 and 2, the TSR component always has a fixed total cost, with a set expense pattern – an attractive feature to some companies because the awards' impact on earnings is predictable. In examples 2 and 3, the amount of expense varies from period to period based on the total number of shares expected to vest under the EPS condition – but the maximum cost is capped at the grant-date stock price times the maximum number of shares that can be earned.

But neither example 2 nor 3 triggers full-blown variable mark-to-market accounting, as is required for cash-settled performance shares or other awards treated as share-based liabilities under Topic 718. A company with a cash-settled performance share award must recognize changes in the fair value of the award as they occur – sometimes resulting in large, unpredictable expense swings from period to period.

Nevertheless, some companies may be willing to tolerate the expense variability of a cash-settled award with TSR or another market condition because the final cost matches the actual amount realized by the employee. For example, a company might want to consider a cash-settled award if a plan has a challenging TSR goal and a low probability of payout. In that case, the company may recognize little or no interim expense, and the final cost is zero if no shares vest.

Example 4: Basic market condition award – cash settled. All of the award parameters are the same as in example 1, but at the end of the performance period, the value of the shares earned is paid in cash, not stock.

Accounting treatment. The award's fair value is calculated quarterly using a binomial or Monte Carlo simulation model. Thus, the cost varies each reporting period based on changes in the company's stock price and those of the peer companies, as well as outcomes projected by the model, which incorporates assumptions about volatility and interest rates. The final cost equals the actual cash paid out.

Appendix: Detailed accounting treatment of alternative market condition award designs

The accounting treatment for four award designs with a relative total shareholder return (TSR) goal (market condition) is presented below, elaborating on the examples described in the article above. The four designs are:

- Example 1: basic market condition award, stock settled
- Example 2: additive award – market condition plus performance condition, stock settled
- Example 3: performance condition with market condition multiplier, stock settled
- Example 4: basic market condition award, cash settled

In each case, the award is a performance share. In the first three examples, a specific number of shares will vest if certain predetermined conditions are satisfied. In the fourth example, the cash value of the shares is paid if the conditions are satisfied. All four examples use the following assumptions:

Grant date	Jan. 1, 2013
Target number of shares	1,000
Maximum number of shares	2,000
Performance period	3 years
Stock price on Jan. 1, 2013	$50
Stock price on Dec. 31, 2015	$60
Dividends paid	none
Actual shares vesting Dec. 31, 2015	1,500
Total value realized by employee	$90,000 ($60 ending stock price x 1,500 shares vesting)

Example 1: Basic market condition award. The number of shares that vest is based solely on the company's TSR relative to the peer companies' TSR.

Example 1: Award calibration		
TSR relative to peer group (percentile)	**% of target number of shares vesting**	**Number of shares**
75th	200%	2,000
50th (target)	100%	1,000
40th	25%	250

Accounting treatment. Fair value at grant date (Jan. 1, 2013) per target share is calculated to be $52, using a Monte Carlo simulation model, for a total cost of $52,000. This cost is not adjusted for the outcome of the stock price goal.

Total cost is spread equally over the three-year performance period: $17,333 per year. Regardless of the actual outcome of the TSR goal, this amount must be recognized (net of any service-based forfeitures).

Example 1: Accounting treatment

Reporting date	% to recognize through year-end (a)	Total expense to recognize through year-end (b) = (a) x $52 x 1,000	Current-year expense (c) = (b) – prior year (b)
12/31/13	33%	$17,333	$17,333
12/31/14	67%	$34,666	$17,333
12/31/15	100%	**$52,000**	$17,334

Example 2: Additive award – market condition plus performance condition. Half of the award (500 target shares) vests on the basis of the company's relative TSR (same design as the basic award), and the other half (500 target shares) vests on the basis of the company's EPS relative to a preset target. Performance for each half is calculated separately, and neither half is dependent on the outcome of the other.

Example 2: Award calibration

TSR			EPS		
TSR relative to peer group (percentile)	**% of target number of shares vesting**	**Number of shares**	**EPS growth**	**% of target no. of shares vesting**	**Number of shares**
75th	200%	1,000	Maximum	200%	1,000
50th (Target)	100%	500	Target	100%	500
40th	25%	125	Threshold	25%	125

Actual shares vesting: 750 for TSR + 750 for EPS = 1,500

Accounting treatment. The two halves are accounted for as two separate awards. For the TSR portion, the accounting treatment is the same as for the basic award. Fair value at grant date (Jan. 1, 2013) per target share is calculated to be $52, using a Monte Carlo simulation model, for a total cost of $26,000, or $8,667 per year. This cost is not adjusted for the outcome of the stock price goal.

For the EPS portion, the cost per share also is fixed at grant, equal to the $50 stock price, but the total cost is trued up for the actual number of shares that vest. Interim expense is based on the

estimated number of shares expected to vest, using the company's assessment of the most probable outcome for the EPS goal at each reporting date.

Example 2: Accounting treatment

	EPS					Total	
	Co. estimate of shares expected to vest	Estimated total cost	% to recognize through year-end	Total expense to recognize through year-end	Current-year expense (EPS)	Current-year expense	
						TSR	EPS + TSR
Reporting date	(a)	(b) = (a) x $50	(c)	(d) = (b) x (c)	(e) = (d) – last-yr (d)	(f) = 0.5 x value in Ex. 1(c)	(g) = (e) + (f)
12/31/2013	500	$25,000	33%	$8,333	$8,333	$8,667	$17,000
12/31/2014	1,000	$50,000	67%	$33,333	$25,000	$8,667	$33,667
12/31/2015	750 (actual)	$37,500	100%	**$37,500**	$4,167	$8,666	$12,833

Total cost: $26,000 for TSR + $37,500 for EPS = $63,500

Example 3: Multiplier – performance condition with market condition multiplier. The number of shares earned is first based on meeting an EPS goal. Those shares are then subject to a multiplier, the value of which is based on the company's relative TSR. The TSR multiplier increases or decreases the number of shares earned under the EPS goal, thus determining the final number of shares that vest.

Example 3: Award calibration

EPS			TSR	
EPS growth	% of target no. of shares earned	No. of shares	TSR relative to peer group (percentile)	Multiplier applied to shares earned under EPS goal
Maximum	150%	1,500	75th	1.333
Target	100%	1,000	50th	1.0
Threshold	33%	333	25th	0.67

In this example, the award is calibrated so the maximum number of shares that can vest remains at 2,000, the same as in examples 1 and 2: 1,500 shares earned for the EPS goal x 1.333 TSR multiplier = 2,000.

For simplicity, this example assumes performance outcomes that differ from examples 1 and 2 to obtain the same total number of shares that vest. The final outcome is assumed to be 1,200 shares for EPS x 1.25 multiplier for TSR = 1,500 shares vesting.

Accounting treatment. Fair value at grant date (Jan. 1, 2013) per target share is calculated to be $52, using a Monte Carlo simulation model. (For simplicity, we have assumed the Monte Carlo value of the TSR feature is the same as in examples 1 and 2. In fact, it is likely to differ because the leverage of the TSR multiplier in this example differs from the TSR leverage in the first two examples.)

The impact of the TSR multiplier is reflected in the grant-date fair value of $52, different from the $50 grant-date stock price which would be the fair value if there was no TSR component. No further adjustment is made to the accounting cost for the estimated or actual outcome of the TSR multiplier. But the total cost is trued up for the actual number of shares that vest based on the EPS goal. Interim expense is based on the estimated number of shares expected to vest under the EPS goal, using the company's assessment of the most probable outcome for that goal at each reporting date.

Example 3: Accounting treatment

Reporting date	Co. estimate of shares expected to vest (EPS goal only)	Estimated total cost	% to recognize through year-end	Total expense to recognize through year-end	Current-year expense
	(a)	(b) = (a) x $52	(c)	(d) = (b) x (c)	(e) = (d) – prior-year (d)
12/31/2013	500	$26,000	33%	$8,667	$8,667
12/31/2014	1,000	$52,000	67%	$34,667	$26,000
12/31/2015	1,200	$62,400	100%	**$62,400**	$27,733

Total accounting cost = $62,400, which is based only on the 1,200 shares earned under the EPS goal. The impact of the TSR multiplier, which increases the actual number of shares vesting to 1,500, was already factored into the grant-date fair value per share.

Note that the company's relative TSR performance could have resulted in a multiplier that reduced the number of shares vesting, instead of increasing them. For example, if the company's relative TSR resulted in a multiplier of 0.67 instead of 1.25, the actual number of shares vesting would have been 800 (1,200 x 0.67), but the total accounting cost would still be $62,400, based on the 1,200 shares earned under the EPS goal.

Example 4: Basic market condition award – cash settled. All of the award parameters are the same as in Example 1, but at the end of the performance period, the value of the shares earned is paid in cash, not stock.

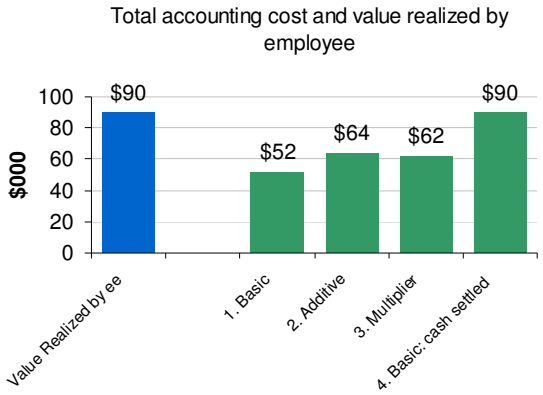
Accounting treatment. The fair value of the award is calculated quarterly using a binomial or Monte Carlo simulation model. (For simplicity, however, the exhibit below shows annual calculations.) Thus, the cost varies each reporting period based on changes in the company's

stock price and those of the peer companies, as well as outcomes projected by the model, which incorporates assumptions about volatility and interest rates. The final cost equals the actual cash paid out.

Example 4: Accounting treatment				
Reporting date	**Total fair value on reporting date (from model)**	**% to recognize through year-end**	**Total expense to recognize through year-end**	**Current-year expense**
	(a)	(b)	(c) =(a) x (b)	(d) = (c) – prior year (c)
12/31/2013	$51,000	33%	$17,000	$17,000
12/31/2014	$112,000	67%	$74,667	$57,667
12/31/2015	$90,000	100%	**$90,000**	$15,333

Summary: Comparison of value realized and accounting cost. In the first three examples, the employee receives vested shares with a value of $90,000 ($60 ending stock price x 1,500 shares vesting). In the fourth example, the employee receives cash with a value of $90,000. Total accounting costs are as follows:

Example	**Total accounting cost**
1. Basic	$52,000
2. Additive	$63,500
3. Multiplier	$62,400
4. Basic: cash settled	$90,000



In addition, in all cases except example 1, year-to-year expense varies. In examples 2 and 3, expense varies because the cost of the EPS component is based on the number of shares expected to be and actually earned. But the maximum cost is known on the grant date: grant-date fair value per share times the maximum number of shares that can be earned.

In contrast, in example 4 the variability is more significant – and uncapped, since it depends on the results of the Monte Carlo simulation or binomial model, which are based on changes in the company's stock price and those of the peer companies, as well as outcomes projected by the model.

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