The Valuation of Non-Vesting Conditions under IFRS 2

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Current Market Practice

Generally, IFRS2 does not require companies to consider the impact of vesting conditions based on non-market performance measures (i.e. ROE, EPS, or many others) in the estimation of fair value for performance awards. This contrasts with market conditions and "non-vesting" conditions, which are considered in the award's fair value estimate.

<table>
<tr><td>Vesting Condition</td><td>Determines both whether the award holder receives the share-based payment and whether the issuing entity receives services in exchange for that share-based payment. Can be service conditions or performance conditions.
<u>Service condition:</u> specified period during which award holder must provide service to earn award - not considered in fair value of award
<u>Performance condition:</u> specified performance targets to be met while service is being provided, can be:
<u>Market condition</u>: earned based on value of issuing entity's equity instruments – considered in fair value of award
<u>Non-market condition</u>: earned based on issuing entity's operations or activities – not considered in fair value of award</td></tr>
<tr><td>Non-Vesting Condition</td><td>Determines whether the award holder receives the share-based payment but not whether the issuing entity receives services in exchange for that share-based payment. Considered in the fair value of the award.</td></tr>
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Additionally, there are some unique situations in which an award that appears to have a performance condition would actually have a "non-vesting" condition, and therefore the condition would need to be considered in the initial grant date valuation. Note that this is an important differentiation compared against ASC Topic 718 and would not be required under ASC Topic 718.

The most common situation in which performance measures become non-vesting conditions is when a performance plan allows for retirement-eligible participants to continue holding their awards upon retirement, subject to the final payout percentage. In this case, the retirement eligible participants would be immediately vested (at least for accounting purposes). In other words, the awards have no service requirement. The issuing entity is no longer receiving services in exchange for the share-based award, so the performance measurement is considered a non-vesting condition.

For the remainder of this piece, we will refer to the simplistic performance share plan below (Example 1), granted when the stock price equals $10:

Example 1: Company ABC grants 1,000 performance shares that will be earned contingent on their earnings per share on the 3rd Anniversary of the grant date with the following schedule:

Earnout	Goal
Target = 100%	$3.00 Cumulative EPS
Threshold = 50%	$2.00 Cumulative EPS
0%	<$2.00 Cumulative EPS

Retirement eligible employees can hold their awards after retirement and earn them on the final measurement date.

The Challenge

The grant date fair value of Example 1 would include two (2) additional considerations (beyond the stock price):

(1) **Probability of Achievement of Cumulative EPS Measurement** – Using Monte Carlo simulation, it will be necessary to project future EPS scenarios for the next 3 years. The model will use a current EPS value, EPS drift (or growth rate, and the volatility, i.e., standard deviation) of future EPS. At the end of the performance period in 3 years, the model will record the cumulative EPS and determine the number of shares earned. Further, it will also be required to estimate a correlation between EPS growth and stock price returns. The future value of the awards (stock price multiplied by payout percentage) will be calculated and discounted to a present value. This represents 1 iteration of a Monte Carlo simulation, and we would generally recommend over 250,000 iterations to minimize statistical error.

(2) **Illiquidity for the 3-year performance period** – The non-forfeitable awards are not liquid until the 3rd anniversary. Comparatively, a normal share of stock is valued as being fully transferable and liquid. Therefore, common models such as the Chaffe or Finnerty models should be applied to estimate the discount for illiquidity to the fair value above.

Under IFRS 2, the fair value of the shares as determined with the discount above will be fixed, and not change based upon the number of actual shares earned by the cumulative EPS measurement. This is distinct from the accounting for awards to non-retirement eligible employees, in which the cumulative EPS measure is not factored into the valuation, and the ultimate expense is reconciled with the number of awards earned.

Net Effect on Fair Value

The two factors summarized above would reduce the fair value of the award in Example 1. The magnitude of each reduction will vary based upon factors like interest rates, volatility levels, EPS measures, and correlation levels. In our example, we have assumed a $1.00 current EPS with a 10% growth rate and volatility of 40%, and a 0.70 correlation with stock price.

Design Characteristic	Range of Discount
(1) Performance Measure Risk	30%-50%
(2) Illiquidity During Performance Period	10%-15%
Net Range of Discount	**40%-65%**

Next Steps

Accurate valuation of equity awards is critical for disclosure of compensation expense in financial statements, and to appropriately measure the return on your compensation dollars. Companies subject to IFRS2 face unique challenges when granting performance awards to retirement-eligible employees and should be aware of the additional analysis required.

If you would like to discuss how we can value and certify your performance shares, please contact us.

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