Liability Awards and their Consequences

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Agenda

• Liability award overview: classification and pros/cons
• Liability award accounting support: systems and spreadsheets
• Other complexities and accounting considerations under mark-to-market accounting
• Q&A and case studies
Arent case studies earlier in the agenda?

Palermo, Michael, 03/23/14
Overview: Classification

• Award classification:
  – Equity Awards – Settlement requires issuance of stock
  – Liability Awards – Settlement requires the issuance of cash, which is an asset transferred to the recipient, hence a liability to the issuer.
Classification pt. 2

• Equity awards can become a liability under contingent cash settlements if probable of occurring (e.g. change in control)

• ASC 718 classification remains in effect until expiration or modification.
Common liability awards

- Cash-settled stock appreciate rights
- Cash-settled stock units, including those linked to performance conditions
- Equity and liability award split
  - Employee election
  - Company policy determination
Liability Award Pros and Cons

• Pros
  – Non-dilutive
  – No excess tax benefit/deficiency

• Cons
  – Variable accounting
  – Expense volatility
  – Company needs enough cash to settle obligations
LIABILITY AWARD SUPPORT
Systemization

• Link awards to pricing tables for end of period and settlement prices

• Possibly be able to track multiple pricing tables
  – Company stock price
  – Option pricing models for SARs
  – Other fair values for TSRs, etc.
Systemization pt. 2

- Elect equity/liability treatment at multiple levels (grant plan, award)
- Mark expense to end of period prices
- Mark through settlement at settlement price
- Different vesting tranches end up having different fair values
Systemization pt. 3

• Modify treatment from equity to liability and vice versa
• Reclassify accrued expense balance for treatment modification
• Not all equity compensation software handles all issues, so spreadsheet support may be required.
Spreadsheet Support: PNC

• Standard spreadsheet "templates" were created in-house and are used quarterly for various accounting impacts.

• Separate templates are used for (a) plain-vanilla cash-payable RSU, (b) performance conditioned cash-payable RSUs, (c) liability classified stock-payable performance RSUs and (d) bifurcated performance awards [e.g. awards that pay out in stock up to 100% target, and pay out in cash for any amount above 100% target].
Spreadsheet Support: PNC pt. 2

- Spreadsheets are "automated" where possible so that only variable data input fields (for stock price, and impacts for performance, retirement acceleration, forfeiture cancellation) need changed, and the spreadsheet calculates the expense acceleration or reversal, and quarterly M2M adjustment.
- As the population of employees receiving these awards are relatively small (compared to the population who receive plain vanilla equity awards), spreadsheet use is not overly cumbersome or inefficient.
Spreadsheet Support: PNC pt. 3

• Due to inherent risks, our spreadsheets may receive review by internal audit, external audit, accounting policy, SOX and/or risk management offices.

• All spreadsheet formulas, inputs, and outputs go through a multi-tier review process prior to recording accounting entry impacts.
Spreadsheet Support QCOM

- Customized spreadsheet "templates" were created and design was based on type of liability awards.
- Amortization schedule per award set up horizontally; each period end has its own column (added to the right)
- Separate tabs for system booked expense, quarter end prices for M2M, %vested
- Forfeitures are added to the schedule as they occur and any adjustments are made on the period they occurred
Spreadsheet Support QCOM p.2

- Automation has increased and improved as we’ve learned from previous, more manual versions
- Linked journal entry to record changes in liability, equity, expense amortization
- True-ups are booked for post close adjustments
- Minimum two levels of review, involves multiple people from different groups
Spreadsheet Support QCOM p.3

- One of our constantly reviewed Quarterly Reporting Schedules
- Always get selected for SOX control testing
- Checklist became model template for other key processes
- Yearly assessment is done to make sure we capture all relevant activity and to prepare for next round of grants
COMPLEXITIES, FORECASTING, EPS, TAX, AND IFRS 2
Mark-to-Market Complexities

• Equity-based awards with M2M treatment
  – Service inception precedes grant
  – Performance criteria not determined until end of performance period
  – Non-employee, non-director awards
Forecasting

• A small swing in stock price could result in a large swing in expense
• Stress tests can be used to forecast potential volatility
  – For example, the variability between the stock price going down 10% vs. up 10%
• Variance analysis to actual
• No dilution
• …unless there is a possibility that awards could settle in shares
• In this case, the shares should be included in dilution calculations as this is more conservative.
Tax

• DTA is remeasured along with expense
• Intrinsic value at exercise release = pre-tax DTA
• Typically no windfall or shortfall will exist
• Unless tax deduction based off price on sale and DTA based off closing price
IFRS 2

• If no service is required, expense and liability recognized on grant
• If cash-settlement is based on an election, then the accounting depends on the party that makes the election:
IFRS 2 pt. 2

• Entity: Wholly accounted for as equity or liability depending on present obligation to settle in cash.

• Counterparty: Treated as a compound award with both liability and equity treatment.
IFRS 2 pt. 3

- Liability treatment of net-settled awards
- Under IFRS, awards that allow payment of taxes via share withholding are subject to liability accounting
- In theory this treatment is only required for the portion of the award that is "cash-settled" (the shares due for taxes)
• Employer Taxes Liability Accrued (Mark-to-Market)

• Under IFRS, as with other liabilities the taxes that must be paid by the employer must be anticipated and a liability accrued for them.
• Who is granting? If a subsidiary is granting the rights to equity of its parent, then the subsidiary accounts for this transaction as a liability
Q&A and Case Studies

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