



Performance Plan-tastic: Handling the Perks and Pitfalls of Performance

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Materials

<http://www.sos-team.com/PDFS/performance.pdf>

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Agenda

- Performance Awards 101
- Design Issues and Considerations
- Accounting and Expense Issues
- Ongoing Administration - Preferred Practices

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Summary of Equity Instrument Types

	Stock Options	Restricted Stock Award	Restricted Stock Unit
What	Right to purchase stock based on vesting	<u>Stock</u> with vesting conditions	<u>Promise</u> to grant stock, with vesting conditions
Cost to Employee	FMV@Grant	\$0 or Par Value	Generally \$0
Shares Issued	Upon Exercise	At time of grant	At time of delivery
Transfer Agent Impact	No shares until Exercise	Book entry at grant, restrictions to prevent sale, coded to avoid dividend payment, No 1099-DIV	No book entry needed , shares issued at vest/delivery
Deferral Allowed?	No	No	Yes
83(b) Election Allowed?	No, unless early exercise	Yes	No
US Taxation	Taxed upon Exercise or Sale	If no 83(b) election filed, taxed at vest ; If 83(b) election filed, taxed at grant	Taxed at delivery
Voting Rights?	No	Yes, generally	No
Dividends	No	Yes	Optional (Dividend Equivalents)
Tax Withholding on Dividends on Unvested Shares	No Dividends	Ordinary income, withholding required	Ordinary income, withholding required
Non-U.S. Taxation	Various	Sometimes taxed at grant	Generally taxed at delivery

Performance Grant Types:

Performance Options (POps)

- Historically more common in Europe

Performance Stock Awards (PSAs)

- RSA with performance criteria

Performance Stock Units (PSUs)

- Currently more common in the US

Not inclusive list

- Many variations and labels

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Performance Awards 101

Perks

Pay for performance
 Investor relations / investor perception – shareholder watchdog groups
 Getting paid in down market if you outperform
 Fewer shares converted to common stock (reduces dilution)
 Potentially qualify as performance-based compensation for exemption from 162(m) cap on tax deductibility for NEOs

Problems

Long-term goals can be challenging to set
 Measuring / Assessing goals is not simple
 Goals cannot be changed or “modification accounting”
 Accounting challenges
 Generally not thought feasible for broad-based plans
 Some systems / providers have limited support

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Implementing a Performance Plan

The Players:

- Compensation Committee
- Compensation/Valuation Consultants
- Executive Management
- General Counsel
- Finance/HR/Stock Administration team

The Process:

- Design Phase
- Accounting Considerations
- Roll-out/On going administration

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Design Issues and Considerations

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Performance Grant Practices: Broad-based or Executive?

Most companies limit to the top 5 to 20 Executives

- Setting goals for non-management employees can be difficult
 - Hard to communicate Corporate goals like EPS or Operating Income
 - Are they really aligned/motivated?

Some companies go deeper, as far as senior directors

- One company issues to top 110, senior directors and above
- Another technology company, just issued performance grants to **18,000** participants...!

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Performance Measures

Two Main “Types”

- Market-based
 - Goal based on share price in some way
 - Stock price
 - Total Shareholder Return (TSR)
 - “Relative TSR” – compared to a peer group
- Performance-based
 - Any performance condition that isn’t a market condition

Various Designs

- All-or-nothing
- Gradations based on level of goal met
- Measurement period can be fixed or undefined
- Catch-up Provision (Earn Prior Tranches)
- Combination of market- and performance-based

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Graduated Payout

Multiple Payout Points

- Depending on to what extent the target is met, awards will pay out more, or fewer shares
- If goal = EPS of \$4.00 per share, when goal partially met (EPS of \$3.50 per share) award would still pay out pre-determined amount
- As long as a minimum threshold is met
- If goal is performance-based, must be reassessed each quarter to determine probable payout so accruals can be performed appropriately

EPS	Payout %
\$3.49 or below	0%
\$3.50 to \$3.99	80%
\$4.00 to \$4.50	100%
\$4.50 and above	120%

Multiple Tranches vs. Cliff Vesting

Many performance shares have cliff vesting at end of one, two, or three years

- Associated with a goal/target

More and more awards have multiple vest tranches - different goal(s) associated with each

- 1st tranche has one-year goal, 2nd two-year goal, etc.
- Design Advantage
 - Facilitates earlier payouts, more like options or RSUs, while providing short- and long-term motivation
- Disadvantages
 - More graduated awards more difficult design and goal setting
 - Makes plan more complex to administer and explain

As Time Goes By...

Time Vesting in Addition to Performance Measurement

- Tranche 1 has goal X
 - Goal X is achieved on 12/31/09
 - Number of shares to payout is set to 150% and fixed
- However, additional “service criteria” applies
 - Vesting is not complete until 12/31/10
 - If the participant terminates before then, shares are forfeited
- Rationales for design
 - Performance + Additional Retention benefit
 - Accrual is performed over a longer period

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Plans with No Chance of Forfeiture

Some performance share plans vest, in part, whether or not even a minimum threshold goal achieved

- Combine best parts of an RSU
 - Always-in-the-money
 - Guaranteed payout
 - Employee retention
- With shareholder-friendly aspects of a performance award

Do they qualify for 162(m) if there is no chance of forfeiture?

- Guaranteed part of grants not considered performance-based for purposes of \$1M cap on tax deductibility under 162(m)
- Only a concern for profitable companies (?) and only for their NEOs

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Goals – Preferred Practices

Choose goals that are reported in the 10K

- Auditable
- Disclosable
- Able to measure against peers (if needed)

Ensure that:

- Definitions of how to measure are precise and clearly documented in advance!
 - True for quarterly assessment as well as final measurement
- If financial goal (like revenue), finance / accounting should be involved in the definition

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Accounting and Expense Issues

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Accounting Treatment: Multiple

Most performance grants require Multiple (fka FIN 28) accrual:

Multiple / Concurrent	Multiple / Consecutive	Straight-line / Cliff
<p>100% 50% 33%</p>	<p>100% 100% 100%</p>	<p>33% 33% 33%</p>
61% of Total Expense accrued in the first year (\$183 of \$300).	Expense accrued evenly over respective service period if performance goals achieved.	Expense accrued evenly over the service period.

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Accounting Treatment Summary

	Performance-based	Market-based
Accrual	Variable based on probable payout	Even accrual over service period
	Pitfalls: ➤ More work ongoing ➤ Expense can be volatile	Perks: ➤ No ongoing work ➤ Expense fixed and known
Reverse Expense if Performance not met?	Yes Perk: Recover expense if goals not met	No Pitfall: No expense recovery if goals not met
Valuation Model	Stock price (RSA/RSU); Black-Scholes (options) Perk: Simpler model	Monte Carlo Pitfall: More work up front

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Variable Accrual (for Performance-based): Unpredictable

Facts:

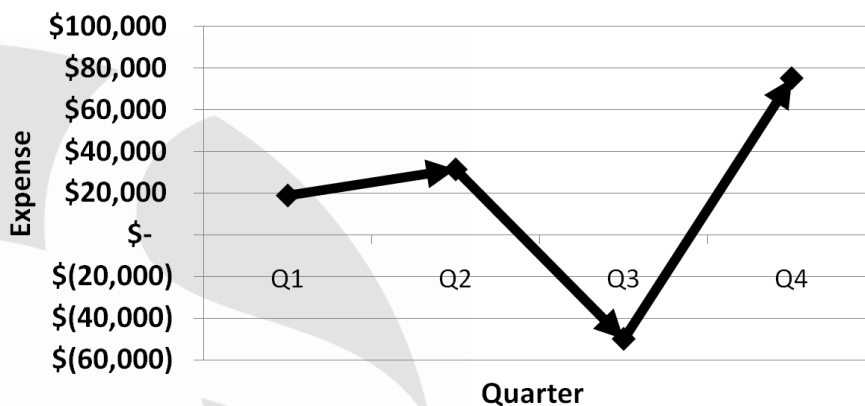
- PSU granted on 1/1/2009 for 10,000 shares, fair value \$5 per share
- Measured & vests on 1/1/2010
- Minimum Payout 0%, Maximum Payout 200%

Accruals:

Qtr	% Service Period Completed	Estimated Payout	Calculation	Current Period Expense
1st	25%	150%	$(\$50,000 \text{ fair value} * .25 \text{ of service period} * 150\%)$	\$18,750
2nd	50%	200%	$(\$50,000 \text{ fair value} * .5 \text{ of service period} * 200\%) - \$18,750 \text{ prior expense}$	\$31,250
3rd	75%	0%	$(\$50,000 \text{ fair value} * .75 \text{ of service period} * 0\%) - \$31,250 \text{ prior expense}$	(\$50,000)
4th	100%	150% (pay out made)	$(\$50,000 \text{ fair value} * 150\% \text{ of service period} * 0\%) - \0 prior expense	\$ 75,000

Variable Accrual: Unpredictable

Variable Accrual of Performance Shares



Performance-based Grants Diluted EPS

Treat as contingently issuable common shares

Apply FAS 128 criteria for contingent shares

- Determine the number of shares that would be issuable if balance sheet date was the end of the contingency period

Determine if the instrument is dilutive

Apply the treasury stock method

If performance/market condition has not been satisfied during period:

- Shares are not considered issuable for diluted EPS
- However, compensation cost related to those awards is included in earnings if it is probable that the performance condition will ultimately be satisfied

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Ongoing Administration - Preferred Practices

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Tracking Goals

Need to understand and assign responsibility for performance tracking and maintenance

- Finance team/HR Compensation/VP of Division
- Generally tracked outside of Stock Plan System

Track and update software or outsourced provider for Financial Reporting:

- Plan Reserves or shares available
- Estimated payout and percentages

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Communicating Goals

Keep the language simple and understandable

- If participants don't understand goals, how do goals motivate behavior?
- Avoid participants lawsuits triggered by misunderstanding the goal

Other Communication Considerations

- Display goals on website, in grant agreement, somewhere participants can reference

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Other Preferred Practices

Keep it Simple

- Keep goals simple
- Keep structure of grants as straight-forward as possible

Earn the Ear of the Designers

- Ask them to let you participate in design discussions
- Propose solutions, not just problems, give them choices

Step-by-Step Process for Vesting/Measurement

- Make sure you have a step-by- step process flow for how approval/taxes/section 16 filing will work
- Think it through and write it down!

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Administrative Nuances

Avoid too high a maximum for performance-based awards

- Increases variability in accounting

How do you count shares against your plan?

- Most issuers are counting maximum shares
 - Prevents running out of shares and having to prorate payouts or ask shareholders for approval of more shares
- Don't want to run out of plan shares because a performance target was unexpectedly met

Continue vesting during leaves of absence

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Dividends on Performance Shares

Reclassifying Expense for Shares not Earned

- Cash dividends paid, shares forfeited
- Reclassification of expense required, often not done

Dividend calculations can be problematic

- If dividends paid on payable date...
- What do you calculate dividends on? 100%?
- What if you pay out less, or more?
 - Recalculate all prior dividends?
 - Problematic, especially for dividends on dividends

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Countdown to Assessment

As end of each quarter nears, start communicating with those responsible for assessment of "probability" of attainment of goals early

- Quarter end is hectic for everyone
- Make sure you've made assessment requirement visible to team
- Avoid last-minute rush to get assessment completed

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And even MORE... Preferred Practices

Talk to your vendor about what they can support and HOW to best support it

- These plans are new and vary widely
- Systems cannot support it all,
- Document manual processes
- Propose slightly revised plan to compensation committee based on what you and your vendor can do

Continue Your Input to Vendor

- Regarding ongoing issues as they design new functionality
- Participate on an advisory board for performance grants

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