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EQUITY COMPENSATION ISSUE BRIEF

Bridging Implementation Gaps in Implementing Relative TSR

Relative TSR awards have emerged as a mainstream equity compensation vehicle in an incredibly short period of time. These novel awards offer important benefits, including a strong story to shareholders and meaningful upside opportunities to recipients. Nevertheless, these benefits come at a price: complexity. Complexity, in turn, can result in expectation gaps that leave one or more parties disappointed and frustrated.

This Issue Brief provides a "Top 10" list of common implementation challenges companies encounter with Relative TSR awards. Our content is relevant to compensation committee members, accountants, and regulators, but is especially pertinent to compensation professionals responsible for coordinating strategy with their compensation committee and outside board consultant.

Authors:

Dan Laddin, Compensation Advisory Partners

Takis Makridis, Equity Methods

Introduction

Equity compensation strategies are undergoing considerable transition. Pay-for-performance scrutiny, Say on Pay, the growing influence of corporate governance groups, and ongoing innovation in the science behind incentive design are all paving the way for new share-based compensation strategies to emerge.

Performance-based awards top this list. In one respect, performance-based equity is not new—stock options, a roaring remuneration vehicle in the 90s and still today, link compensation to appreciation of the stock. But stock options can be a limited tool. What if the market collapses, causing *all* companies to lose value? What if the entire industry is hot and growth in the stock has very little to do with an executive's performance and more to do with being in the right industry at the right time? Important questions like these have spawned significant innovation in the design of new equity award structures.

But with innovation comes complexity, and with complexity comes potential confusion, surprise, and frustration. As exciting as performance-based equity can be to senior leaders, the odds are stacked against them having a good experience. More than ever, compensation professionals face considerable risks of failing in their charter to design remuneration vehicles that attract, motivate, and retain top talent. We have specifically seen a number of award implementations achieve lackluster results due to disparate expectations among recipients, shareholders, and company management. The best cure for potential expectation gaps is deliberate planning, analysis, and fact-based decision-making protocols. Even executives, whose wealth hangs in the balance, will generally approach the table in a reasonable manner as long as they perceive the compensation design process as orderly, predictable, and rational.

Our content will be organized as follows: There are certain foundational principles we will share, such as the role of organizations like ISS, the timeline governing granting decisions, and the way in which grant quantities are derived. Then, we will present a "top ten" list of considerations that the compensation committee and the top compensation directors within management should understand and proactively manage.

Fundamentals

Many compensation practitioners will recall the days of stock options prior to the advent of FASB Statement 123R (now called ASC 718), which mandated the expensing of stock options. Prior to ASC 718, the award design process was relatively simple: benchmarking was performed, options were essentially a foregone conclusion (occasionally being complemented by a second vehicle like performance shares or cash), ISS had limited influence, and resolving broken incentives (i.e., underwater options) was relatively straightforward. Today's processes involve far more *competing* priorities.

Compensation leaders need to focus on a number of important foundational principles when approaching the drawing board.

Principle 1: Understand your stakeholders

Compensation leaders have an increasingly tenuous web of stakeholders to satisfy:

- Plan participants, who need to be motivated and retained
- Shareholders, who need to believe that the program yields balanced incentives
- Regulators, who introduced legislation such as Dodd-Frank, but have now largely stepped out of the way
- Corporate governance groups (e.g., ISS), who may wield considerable influence over shareholders
- Finance leaders (e.g., CFO), who will have certain cost expectations and a low tolerance for cost surprises

The needs and concerns of these constituencies are intertwined. Shareholders evaluate research by corporate governance groups, but also want to understand the compensation strategy and its propensity to create competitive advantage in the market for talent. Meanwhile, finance leaders not only fight to avoid budget surprises, but also develop the grant-date award cost calculation—a value that could be quite different from any "back of the envelope[1]" estimates derived earlier in the design process. And, it is the value developed by finance that ultimately finds its way into the proxy summary compensation table. If these values differ from the ones the compensation committee approved, questions, concerns, and problems can quickly arise.

An exhaustive analysis of the needs and interests of each stakeholder group is outside the scope of this paper. Any design process, however, will need to involve considerable triangulation and iteration through the priorities of each stakeholder group.

Principle 2: Performance-based equity comes in multiple flavors

In the 90s, stock options were granted in a homogeneous manner: nearly all options had a 10-year contractual term, were issued at the money, and had ratable vesting over 3 or 4 years. In stark contrast, performance-based equity comes in literally hundreds of distinct flavors and varieties.

Generally speaking, there are two overarching categories of performance equity: awards with performance conditions and awards with market conditions.[2] Although these conditions appear economically indistinct, the accounting rules (ASC 718) treat them very differently. This distinction is important because plan participants typically have strong opinions about "what should be"; to the extent accounting rules produce different outcomes for awards that participants view as similar, those participants may become frustrated or disillusioned with the process. And, insofar as finance leaders are an important stakeholder in the compensation design process, accounting rules can trigger major eleventh-hour surprises. These surprises will produce one of two outcomes: (1) a perception of someone having "dropped the ball," or (2) a pay-for-performance disconnect in the proxy when the target compensation percentile is not achieved. (More on this issue shortly.)

Principle 3: Awards can be granted on a fixed-value or fixed-shares basis

Executive compensation departments, with the approval of their board's compensation committee, will generally begin their planning and analysis six months before a formal grant is made. For companies issuing their large annual grants around March, the planning usually kicks off in September of the prior year. Compensation committees and management will develop a preliminary view of the following year's grant by the time they formally meet in November or early December (i.e., four months before the actual grant). In addition to general design terms and pay levels, the compensation committee will also decide whether to issue awards on a fixed-value or fixed-shares basis.

To understand the importance of the fixed-value versus fixed-shares decision, consider the following example: Company A plans to issue its CEO $5 million in performance-based awards, whereas Company B plans to issue its CEO 200,000 performance-based awards. As this planning takes place, the per-unit value in both cases is $25, such that both companies are intending to deliver $5 million in compensation.

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[1] We do not recommend the use of high-level back of the envelope calculations. There are too many variables in most performance-based equity awards that can cause these estimates to be materially incorrect. The best practice is to get a grip on the expected costs as early as possible in order to drive better decision-making.

[2] These are terms defined in FASB Statement 123R or Accounting Standard Codification (ASC) Topic 718. A performance condition is based on the operations of the company or its operations compared to those of a peer. In contrast, a market condition is based on the stock price performance of the company or its stock price performance relative to that of peers.

However, by the time the actual grant comes around many months later, the story might change drastically. Company A might not be issuing 200,000 awards and Company B might not be paying $5 million in compensation. If the actual fair value of the grant spikes to $40 (which is not uncommon), Company A (the fixed-value issuer) will be issuing far fewer awards ($5,000,000 ÷ $40 = 125,000 shares) and Company B (the fixed-shares issuer) will have a more costly grant (200,000 × $40 = $8,000,000) on its P&L. In the first case, the plan participants may be distressed, and in the second case, shareholders may be distressed.

The Ten Things You Need Your Compensation Committee to Understand

This paper is about informing and educating compensation leaders within company management and board compensation committee members on what can cause a performance-based grant to fail from an *implementation* perspective. Implementation is about satisfying the needs of each of the key constituents. Participants need to be energized and motivated; shareholders need to embrace the plan; and finance leaders need to assign a cost to the plan that is compliant with GAAP (ASC 718) and hopefully aligns with all parties' initial expectations.

Honing in on plan participants, our experience suggests executives approach their own compensation planning similar to how they approach other facets of their roles within the firm: they do not like surprises, they appreciate clear and proactive messaging, and they react best to well-packaged, but substance-rich, explanations.

Nevertheless, the compensation committee's planning process is not always staged to leave plan participants with this impression. As quickly as the compensation committee is moving during the planning process, it is essential that certain details not escape their attention. These details comprise our top ten list of considerations below.

Issue 1: Understand the risks associated with a fixed-value granting policy

> *Best Practice: when granting awards on a fixed-value basis, especially TSR awards, be sure to set expectations regarding fluctuations in the shares granted.*

In reality, fixed-value awards are not the problem—the alternative of fixed-share awards is often much worse. Most companies issue awards on a fixed-value basis in order to execute on their target pay percentile. For example, if the goal is to pay at the 50th percentile and this corresponds to an equity grant worth $5 million, then deviating from $5 million undermines the goal of paying at the median of the peer group.

The problem is that award recipients do not think in strict terms of accounting value; they think in terms of shares and the face value of the stock—especially when the underlying unit is a restricted unit. Continuing with our example, the executive may be comfortable with $5 million of pay, thinking that this corresponds to 100,000 units (with a stock price of $50) when, in actuality, it can correspond to far fewer units of a market-based award (given an accounting value in excess of the stock price at grant).

This danger is most prevalent with TSR awards where advanced economic modeling is used to derive the accounting value. The risk is two-fold. First, during the early planning stages, plan participants may be shocked to learn that the accounting value on a TSR award is higher than the stock price (which will result in fewer units being

granted, all else equal). Compensation committees need to be prepared to explain to participants why the accounting value is higher than the stock price on the date of grant.[3]

The second part of this risk concerns changes in the estimated award value between when the award design is initially communicated to participants during the planning phase and when it is formally granted months later. Suppose the participant is made comfortable with a $60/unit value even though the stock price is $50/share. What if the value climbs to $68/unit by the time the formal grant rolls around a couple of months later? This sequence of events can leave an especially bad impression with the executive, as shown by the flow of events in Table 1. This is why it is critical to align the communications process with the design and decision-making process to avoid surprises. Consider the scenario depicted below in Table 1:

	Initial Planning (November)	Initial Communication of Target Award	Waiting Period	Formal Grant (March)
TSR Award Facts	▪ $5 million fixed value ▪ $50 stock price ▪ 100,000 units expected to be granted	▪ $60 TSR unit value ▪ 83,333 units expected to be granted	…	▪ $68 TSR unit value ▪ 73,529 units actually granted
Potential Participant Expectation	*"I'll receive 100,000 units"*	*"Why am I receiving almost 17,000 units less than I expected?"*		*"Why am I missing out on 9,800 more awards?"*

Table 1: Flow of changing participant expectations (fixed-value policy)

The solution to this problem is to get in front of it and manage participant communications proactively. Explain what the possibilities are and what to expect. The case in Table 1 is one of many potential scenarios – circumstances could change in the opposite way, resulting in a positive windfall to the executive. Regardless, participants need to know upfront what to expect so that they aren't soured when something happens that they did not expect. Even in positive windfall cases, it is important to manage expectations so that executives do not expect a repeat situation the next year and do not start viewing equity compensation awards as arbitrarily determined.

Issue 2: Understand the risks associated with a fixed-shares granting policy

The risks associated with a fixed-shares granting policy are the inverse of those presented in the prior subsection. To illustrate, we will recreate Table 1, but this time, implement a fixed-shares framework:

[3] For a detailed analysis, please consult other Issue Alerts published by Equity Methods. In short, the accounting rules (ASC 718) require that all relevant terms and conditions on a market-based award be embedded in the grant-date accounting fair value. Even on awards with a symmetric payoff curve (upside opportunity is equal to the downside opportunity), the fair value will trail higher than the face value of the stock. This is because the awards have optionality—a 150% payout on a more valuable award trumps a 50% payout on a less valuable award.

	Initial Planning (November)	Initial Communication of Target Award	Waiting Period	Formal Grant (March)
TSR Award Facts	▪ $50 stock price ▪ 100,000 units expected to be granted ▪ $5 million *initial* value	▪ $60 TSR unit value ▪ 100,000 units expected to be granted ▪ $6 million *updated* value	…	▪ $68 TSR unit value ▪ 100,000 units expected to be granted ▪ $6.8 million *final* value
Potential Shareholder Expectation	▪ "This corresponds to the median pay in the peer group"	▪ "Now, we've already veered into the 60th percentile"		▪ "How did we end up paying at the 70th percentile?"

Table 2: Flow of changing LTI percentile rankings (fixed-shares policy)

As Table 2 suggests, a fixed-shares policy will create stability for participants, thereby shielding them from the potentially confusing changes in grant quantities between the initial planning meetings and eventual grant date. However, this same benefit can result in compensation reported in the proxy that is substantially different from that targeted during upfront say-on-pay strategizing. Whether this undermines the say-on-pay vote depends on a far broader set of circumstances; nonetheless, a fixed-shares policy will certainly increase the risk of a potential proxy problem. Due to these risks, most companies focus on a fixed-value approach. However, a fixed shares/options approach can be appealing to help address the pervasive question of "I don't understand why I get fewer awards when the stock price goes up." In fact, with relative TSR awards, the unit value can increase even when the stock price goes down (if it went down less than the comparison group).

Issue 3: Be prepared for the same award to have different values at different companies

> *Best Practice: while peer firms may be issuing comparable awards, never expect similar values and results – there are too many different variables at play.*

In some respects, compensation has gone viral, as well-networked and interlocking board members are quick to share experiences and perceived best practices.[4] However, if a certain award design works well at another firm, that same award design may not be appropriate in a different context. The reason is that TSR-based awards usually contain numerous design variables (e.g., peer group used, payout scale, timeframe, capped/uncapped, etc.) and *thousands* of statistical variables. An award that benchmarks company TSR to the TSRs of the S&P 500 constituents has 126,502 distinct input parameters. Consider the following case study involving two peer firms that both decided to issue $8,000,000 in target equity compensation using nearly identical award designs:

S&P 500 Relative TSR Percentile Ranking	Payout Percentage
80th and above	200%
55th	100%
30th	50%
Less than 30th	0%

Company A	Company B
Per-unit per $ value: $1.11 Stock price: $20 Units granted: 360,360	Per-unit per $ value: $1.29 Stock price: $20 Units granted: 310,078

Figure 1: The Same Award at Two Different Companies

[4] We have also made the point that no two award designs are the same. Although interlocking boards give rise to similar design schemes, minor (but important) details usually get changed during the design process due to the sheer number of variables available for manipulation. Additionally, lawyers often draft grant agreements differently for the same high-level award design.

The only departure from reality is the use of an identical stock price of $20 and the target compensation quantity, which preserves anonymity while illustrating how significantly different the results for two companies can be on the same award. The solution is to perform pro forma modeling early in the design process in order to ground all parties' expectations. The risk in this case stems from assuming the unit value will be $1.11 and finding out late in the game that the true award cost is much different.

Suppose Company B had performed modeling early in the process and discovered an expectations discrepancy of $0.18 on the dollar. Company B could inform and prepare the affected parties, or Company B could embark on adjusting some of the award terms with the hope of driving a more favorable cost. Either way, the executives do not encounter a negative surprise at the very last minute.

Issue 4: Be prepared for the same award to have different values at the same company year-over-year

> *Best Practice: do not get anchored to a particular cost; just when you get comfortable with one year's accounting value, the next year's value might deviate materially.*

Just as executives and committee members need to be informed that the same award can have two different values at two different firms, they also need to be educated that the same award can fluctuate in value year-over-year. Consider the following two actual cases:

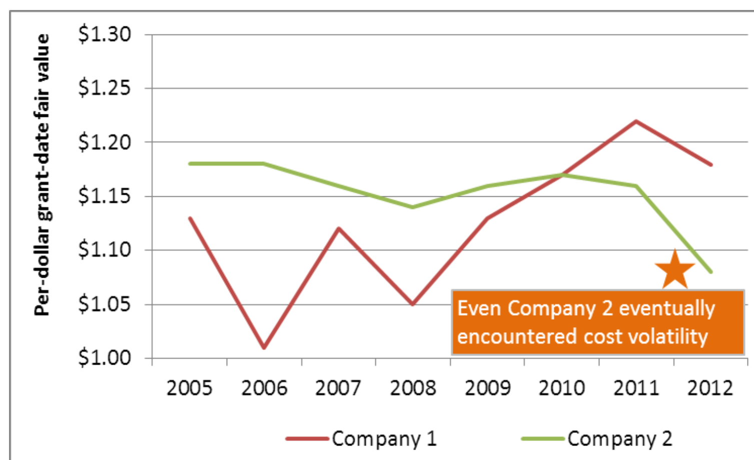

Figure 2: Year-over-Year and Company Comparisons

Company 2 encountered minimal cost volatility from 2005 to 2011. In 2012, they encountered an unexpected and positive windfall as the per-unit cost dropped from $1.16 to $1.08. EM recommends performing a backtesting analysis like the one shown in Figure 2 to any company considering TSR. Even so, had such an analysis been performed as of FY 2011, the sharp decline in FY 2012 could not have been predicted. As such, it is also helpful to perform attribution analysis to assess how each design lever is influencing, *and can influence*, award value.

Equity Methods' Issue Brief *Design Features that Drive the Fair Value of a Relative TSR Award* provides an exhaustive analysis of design levers and their effect on value. Consider just one example: An important lever is the synchronization between the grant date and performance period start date, in which the grant date usually occurs

in March for a calendar year company whereas the performance period starts on January 1st to align with the fiscal year.

Recently, EM helped a Fortune 100 company implement a TSR award for the first time. During the planning phase in October, an analysis was performed as if the three-year performance period began on July 1 and the formal grant date occurred on September 1 (thus mimicking a performance period start date on January 1st and formal grant date two months later). The estimated per-unit, per-dollar cost was $0.93. Fortunately, through attribution analysis, this company was informed that a major driver of the surprisingly low value was a material share price decline between July and September—which may or may not be repeated between January 1st and the actual grant date. When the actual grant occurred in March, the per-unit, per-dollar value was $1.19. Because expectations had been adequately set, this material change in value was much more palatable to all parties.

Issue 5: Carefully communicate differences in market and performance conditions

As we noted above in *Principle 2*, plan participants are at great risk of evaluating two awards that they perceive to be economically similar only to be told the number of shares granted will substantially differ between the two. Since TSR awards usually have a fair value in excess of the face value of the stock, the modeling process usually shows fewer TSR units being granted than a similar award containing only a performance condition. With such a rapid shift toward TSR awards taking place, the stage is set for confusion and frustration.

There is not a particularly appealing explanation to provide to plan participants: the accounting rules (ASC 718) require different treatment of performance and market conditions. This creates a communication challenge. Some companies will focus on clear and proactive explanations to stave off the issue early in the design process. This is particularly challenging when a company uses a combination of market-based and non-market-based metrics (e.g., EPS, ROE, etc.). Some companies choose to use the face value to mitigate the communication challenge, which may lead to a higher accounting charge. If this is the route chosen, finance and the compensation committee should be aware that the expense will differ from the value communicated. If companies choose to use the accounting value, it is similar to Issue 2 explained above. Companies need to take great care in developing a transparent communication strategy outlining the relevant issues and explaining that because of the potential upside value, there is a higher fair value on the award when granted.

Issue 6: Do not underestimate participant communications

> *Best Practice: as attractive and exciting as you consider the award, plan carefully for how you will communicate and explain the new design to participants.*

Change is difficult. The complexity of performance-based awards relative to stock options and time-based restricted stock creates an ideal environment for conflict, skepticism, and confusion. The considerations presented in this paper all represent speed bumps that can cause a plan participant to trip and become frustrated.

One of the best ways to get in front of this problem is through backtesting—the process of calculating how the proposed award design would have paid out had it been granted for the last 5+ years. Some adjustments will need to be made, since the current comparison group may not have existed five years ago exactly as it does today (e.g., delistings and M&A). The results of backtesting can help inform a talk-track. One possibility is that the backtesting results are appealing, in which case this should strongly inform the messaging (along with adequate caveating that the future may not repeat the past). Participants often do not realize how TSR awards, in their purest form, are geared toward creating leveraged upside that disproportionally rewards outperformance.

On the other hand, backtesting may suggest that the award would not have fared well in prior years, in which case the compensation committee's messaging should focus on governance pressures and the fact that the entire industry is shifting toward similar award designs. However, if this is the case, it should be considered holistically in light of the company's compensation strategy and retention efforts.

We also strongly recommend developing crisp award brochures that explain the award terms in "plain English" and also include FAQs. Frequently asked questions might include:

- Why am I getting more or less shares under this TSR program than I did last year when I was granted time-based restricted stock?
- How was the comparison group selected?
- Is it possible for our stock to rise but for me to receive a lower payout?

Finally, begin thinking about how you will update plan participants on the award's progress during the performance period—something we call *performance tracking*. Different companies take different positions on this topic. Some will leverage an online portal EM provides that offers real-time updates on performance-to-date and the corresponding hypothetical payout. Others like to control access to this information, but might still distribute quarterly updates to the plan participants. Either way, an ongoing tracking and communication strategy *after* the grant can be just as important as what is done before the grant. It is, otherwise, very challenging for a participant to track how the company is doing on a relative basis, especially when a large comparison group exists.

Issue 7: Understand and socialize the total cost of implementation (TCI)

> *Best Practice: although the implementation tail should never wag the strategy dog, carefully consider the total costs associated with implementing a new award.*

With all the enhanced flexibility afforded by award design levers comes a very real risk that implementing performance-based equity awards will be significantly more costly than any prior awards issued.

Compensation and accounting leaders within management need to be cautious when discussing this topic with the compensation committee. On the one hand, committee members are usually interested in implementation challenges; on the other hand, committee members understand the importance of getting compensation right and do not want small obstacles to interfere with this. In our experience, the best practice is to provide a neutral and objective accounting of the holistic costs associated with the new award. Focus on conveying that the goal is not to unwind the compensation strategy, but rather, inform all parties of the costs involved in effectively implementing the idea on the table.

Strong implementation follow-through is important and touches on the various potential cost drivers:

- Plan administration
- Financial reporting
- Performance measurement and certification
- Participant support and communication

In some cases, there is a specific award feature that is driving the costs associated with implementation. In these cases, the compensation committee is often interested in hearing what that driver is and whether there is a simple

way to replace it with something that does not cause problems but preserves the core set of award incentives. In other cases, there is not such low-hanging fruit, and the goal should be to set expectations as to the budget and time lag needed to coordinate the implementation.

Issue 8: Do not expect TSR awards to automatically address all say-on-pay risks

Most compensation professionals are relatively familiar with the role ISS and Glass Lewis play in impacting say-on-pay votes. Large firms like General Electric even had eleventh hour award modifications to insert performance provisions into their awards in order to secure a positive vote recommendation from ISS.

While ISS and Glass Lewis tend to view TSR-based awards favorably, each company should consider its own actual shareholder base. Many institutions are not biased towards TSR-based awards and actually encourage companies to select metrics that best drive line-of-sight—which could be more localized targets like EPS or cash flow. In these cases, the expectation is simply that the metrics selected are tightly correlated with shareholder value creation.

ISS and Glass Lewis tend to favor relative TSR awards because, on the surface, they align with shareholders; however, many design variables need to be tested to make sure these awards are actually shareholder-friendly, including:

- Have we picked the right reference group?
- Is the payout scale appropriate?
- Is there excessive upside?

Designing a clear and persuasive proxy story, in addition to best practices in engaging with investors ahead of the proxy, is outside the scope of this paper. Companies should plan to allocate considerable time and effort to these essential shareholder engagement responsibilities.

Issue 9: Nitty-gritty award details matter

> *Best Practice: always take time to review and approve the finer details of the award, because these details can significantly affect the ultimate payout.*

As tempting as it is to focus on higher-level design considerations, such as target pay percentiles, performance metrics, and anticipated shareholder reactions, details matter more than ever. Performance-based awards have many more nuanced terms and conditions affecting the payout and vesting that need to be carefully vetted. A few examples include the manner in which peer firm changes are handled over the performance period, treatment of dividends, the formulaic specification of TSR, and the mathematics behind a relative performance ranking. For additional detail on "nitty-gritty" design details, see Appendix B: Specific Award Details Needing Consideration.

Whereas the compensation committee may not spend as much time on these items, a checklist of decisions should be presented to the committee with the pros/cons/risks for sign-off. The alternative is that the approved design is silent on key award details, which may result in one of two common problems. First, the lawyers responsible for formalizing grant agreements may also overlook the details, in which case employees sign grant agreements that are silent on key issues. Alternatively, the lawyers might imbue intended meaning into the award agreements, which could create different problems—either a meaning different from what the design team intended or flaws in the specification of advanced financial variables.

We have witnessed *countless* debacles in this area. Many are very recent, but one memorable case involves a financial services firm issuing a relative TSR award in 2007 based on 20 comparison firms. The award failed to specify what took place in the case of firms delisting. Five of the twenty firms delisted due to the financial collapse during 2008. Depending on treatment of delisted firms, the issuing company would either be ranked at the median or the 75th percentile—a significant difference.

We have also witnessed a few cases in which the grant agreement very explicitly characterized the award as measuring *total shareholder return*, but then proceeded to (erroneously) specify TSR as being equal to capital gains on the stock (i.e., it omitted consideration of dividends). For a high dividend-paying company, this was extremely problematic.

The best practice is for members of company management to propose specific terms and obtain the compensation committee's approval so that there are neither omissions in the formal grant agreement nor unintended assigned meanings to what are complex financial variables.

Issue 10: Embrace design flexibility to solve potential problems

> *Best Practice: facilitate an iterative process in which alternative design specifications are considered that can address initial concerns and reactions.*

When issuing plain-vanilla stock options, there were very few award levers to contemplate that could inform the design process. However, when issuing performance-based equity—especially relative TSR—the compensation committee should understand the sheer number of design levers that are available to fix potential award problems.[5] This underscores the importance of making the design planning and analysis process iterative and scenario-based. Committee members might be overwhelmed if they are given dozens of slight design variations, but will appreciate a short list of possibilities with associated pros and cons. The process should start early to leave room for iteration. Assembling pro forma cost estimates, performing backtesting, and conducting an attribution/sensitivity analysis are ways of holistically evaluating design alternatives and facilitating fact-based decision-making.

[5] For more context, please see Equity Methods' Issue Alert *Design Features that Drive the Fair Value of a Relative TSR Award*.

A simplified example of forcing the process to be iterative follows:

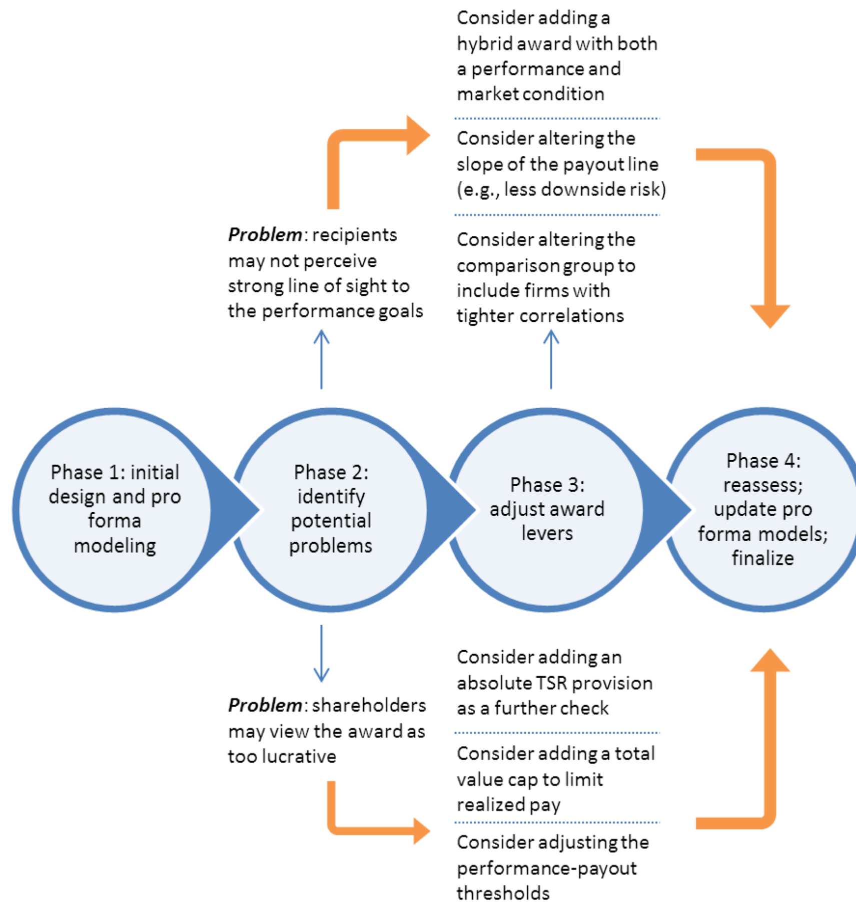

Figure 3: Iterative Design Process with Scenario Analysis

Figure 3 provides a few examples of some of the issues that can be considered during an iterative process that may otherwise be overlooked in a one-step process. For example, a growing number of companies are considering multi-condition awards (e.g., a relative TSR metric combined with an absolute TSR threshold); however, this decision can have significant cost implications on the award and may not be appropriate in many contexts.

Closing Thoughts

This Issue Brief is intended for a wide variety of audiences, ranging from compensation managers to compensation committee members. The compensation planning and design process has evolved to become collaborative between management and the compensation committee. Both parties have access to critical information that is needed to facilitate a smooth and effective roll-out of whatever design is ultimately selected.

Our goal in developing this Issue Brief has been to educate parties who are both directly and tangentially involved in the design process as to the implementation “speed bumps” that can make the difference between success and frustration. Appendix A includes a one-page checklist of the top ten considerations presented here. We understand the difficulty in presenting nuanced topics to busy compensation committee members. Nonetheless, as in many contexts, success has as much to do with the messaging as the message. Our experience is that those responsible for making compensation decisions are interested in getting it right, but they need to receive information in an organized and orderly fashion so that they know what to do with the information.

We recommend that you leverage content in this Issue Brief to continue further educating internal stakeholders on the risks associated with performance-based equity, especially if TSR awards are under consideration. In most cases, the benefits of shifting to performance equity far exceed the costs, so the message should not be one of despair. Instead, we believe it is essential to emphasize the importance of being coordinated, methodical, and proactive in planning compensation so that all parties understand the final decisions and receive thoughtful communications from start to finish.

We invite you to contact either of the authors with questions or your experiences in dealing with these topics.

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Appendix A: Top Ten Implementation Challenges Tear Sheet

The following matrix is a brief summary of the items discussed in this Issue Brief. We recommend using this as a checklist during the design process. For a standalone copy of the matrix, please contact either of the authors, who can provide this checklist on a single page that can be used or repackaged.

#	Issue	Important Considerations	Enter Your Notes / Strategy Here…
1	Understand the risks associated with a fixed-value granting policy	▪ Model upfront how much values can change and the probabilities ▪ Perform sensitivity updates at least 3 weeks prior to the grant ▪ Set expectations with participants regarding potential unit changes	
2	Understand the risks associated with a fixed-shares granting policy	▪ Understand how much of a value change is needed to trigger a pay-for-performance disconnect ▪ Set expectations with participants regarding potential unit changes	
3	Be prepared for the same award to have different values at different companies	▪ Ensure committee members are not basing their expectations on experiences at other companies ▪ Obtain a formal estimate of accounting value	
4	Be prepared for the same award to have different values year-over-year	▪ Perform attribution analysis to determine how historical factors affected historical costs (and how these can change) ▪ Set expectations with participants regarding potential unit changes	
5	Carefully communicate differences in market and performance conditions	▪ Set expectations with participants that accounting rules may result in different grant quantities for similar awards	
6	Do not underestimate participant communications	▪ Develop a detailed FAQ document ▪ Develop a process or procure technology for ongoing performance tracking; consider making available to plan participants	
7	Understand and socialize the total cost of implementation	▪ Consult stakeholders in accounting, stock administration, and legal ▪ Evaluate design refinements that can reduce costs without changing incentives ▪ Present a conservative estimate of total upfront and ongoing costs to secure budget and support for implementation	
8	Do not expect TSR awards to automatically address all say-on-pay risks	▪ Evaluate investor base and their views on award design/strategy ▪ Conduct investor outreach and pre-socialize the proxy story ▪ Ensure peer group selection includes comparable companies ▪ Evaluate overall pay opportunity relative to historical performance	
9	Nitty-gritty award details matter	▪ Engage legal/accounting professionals to flush out essential terms ▪ Socialize formal grant agreement for potential omissions	
10	Embrace design flexibility to solve potential problems	▪ Implement iterative process that considers multiple design levers ▪ Consider use of multiple conditions, total value caps, and other levers	

Appendix B: Specific Award Details Needing Consideration

The following list provides insight into some of the "nitty-gritty" award details that are often neglected during the design process, but which can bear significantly on the final award payout. Thinking through these items is important for a number of reasons. First, these issues will come up during the final performance measurement certification, so it is only prudent to consider them upfront before competing expectations can be formed. Second, companies may face litigation risk if they take a position on any one of these items that differs from what an executive could reasonably come to expect from the terms in the grant agreement. Clarity benefits all parties.

Award Term	Question	Considerations / Discussion
Peer Group	Is the peer group open or closed?	When comparing against an industry index (e.g., S&P 500), it is important to distinguish whether peers who enter the index during the performance period are added to the peer group (open peer list) or excluded from the peer group (closed list).
	How are delisted and bankrupt peers handled?	If a company is delisted from a stock exchange or goes bankrupt, is that company removed from the peer group, or is included and placed at the bottom with a -100% return?
Dividend Protection	Period of accumulation	A specific definition of the period over which dividends accumulate for the recipient should be developed.
	Scalability with payout	It should be clearly outlined how accumulated dividends are scaled (if at all) by the payout multiplier on the award.
	Participating security treatment	Are accumulated dividends forfeited in the event the underlying unit/award is forfeited?
Payout Calculation	Cash versus Shares	A decision must be made as to whether the instrument is paid in cash (liability) or shares (equity).
	Discretion of payout vehicle	If discretion regarding the payout mechanism (cash versus shares), the party with the discretion (employer or employee) is very important.
Return Calculation	Definition of "total shareholder return" (TSR)	Contrary to perception, there are numerous alternative specifications, some better than others, of TSR. In particular, dividend reinvestment assumptions can vary or be open to interpretation. A clear specification and equation of the TSR financial variable is needed.
	What prices are used to measure returns over the performance period?	There are many possible definitions of the fair market value (FMV) of a stock price on a given day, and potentially multiple stock exchanges trading the security. Clear specification of these variables is needed.
	Treatment of missing prices	Specification is needed on how to handle a missing security price because there was a day where no trading occurred.
	Definition of percentile ranking (if applicable)	An equation of the definition of percentile rank must be provided to avoid confusion from differing interpretations.
	Share prices used for starting and ending stock price measurement	The average price at the front-end and back-end of the TSR measurement window should be specified, including whether it is based on trading days or calendar days.
Service Period	Are the service period and performance measurement period the same?	A performance period that starts before the service period is most common, but can create unexpected swings in value. A service period that extends past the performance period can cause complications with dividend accumulations.

For additional detail on these important award terms and provisions, please contact either of the authors.

About the Authors

Dan Laddin
Partner
Compensation Advisory Partners
Tel: 212-921-9359
Email: Daniel.laddin@capartners.com

Dan Laddin is a founding Partner of Compensation Advisory Partners, LLC (CAP) in New York. Dan has approximately 20 years of experience. He works with boards and management consulting in all areas of executive compensation, including annual and long-term incentive design, performance measurement, target-setting, regulatory/compliance as well as outside director compensation programs.

He has experience working with both private and public companies across industries with a focus in energy, consumer products/services, media and manufacturing. Dan has worked with his clients on a wide range of projects, including designing incentive compensation strategies and programs. He also works closely with committees to ensure strong governance of their executive compensation programs and that programs drive performance and are aligned with shareholders.

Dan has authored several articles, including 2011 Non-Employee Director Compensation Pay Practices (CAPflash 2012),recent articles on Best Practices in Executive Compensation and the Dodd-Frank legislation for WorldatWork's workspan publication, and target-setting in the recently released book *Pay for Results – Aligning Executive Compensation with Business Performance*. In addition, Dan has given speeches and workshops at several compensation organizations.

Dan received his MBA from the University of Chicago Booth School of Business and graduated magna cum laude from the University of Albany with a BS in Accounting. He is also a member of the Beta Gamma Sigma honor society.

Takis Makridis
President and CEO
Equity Methods, LLC
Tel: 480-428-1203
Email: takis.makridis@equitymethods.com

Takis Makridis is the President and CEO of Equity Methods, LLC. Takis has considerable experience in working with finance and HR executives to address their equity compensation accounting, valuation, and financial reporting needs, and he remains critically engaged with thought-leaders from consulting firms, public accounting, and academia in addressing emerging issues. Equity Methods has served over 500 companies, including 26 of the Fortune 100, since its inception over 10 years ago. The 30+ professionals at Equity Methods assist clients in the valuation, design, and financial reporting of equity compensation awards, fair value measurement of complex securities subject to FAS 157 and FAS 141R, and business valuation for 409a purposes. Equity Methods delivers value and helps clients manage risk by fusing deep domain expertise with algorithm-based solutions.

Takis is a nationally recognized speaker at industry conferences across the country and frequently leads executive briefing sessions and firm webinars to enhance knowledge sharing among client firms and disseminate best practices throughout the industry. Takis is the author of *Advanced Topics in Equity Compensation Accounting* and coauthor (with Barbara Baksa) of *Accounting for Equity Compensation* (third – fifth edition), both published by the National Center for Employee Ownership, which have been required texts for the Certified Equity Professional (CEP) designation. Takis is also an advisory board member of the Certified Equity Professional Institute and the Department of Finance at the WP Carey School of Business at Arizona State University. Takis has published articles in various technical and business publications and has been cited in media publications such as the *New York Times* and *Compliance Week*. Takis holds a B.S. in Economics and Finance from Arizona State University and an M.B.A. from Oxford University.