Dallas NASPP – February 11, 2015

What to Expect in Stock Compensation in 2015

Takis Makridis, President and CEO (takis.makridis@equitymethods.com)
Robert Slaughter, Senior Consultant (robert.slaughter@equitymethods.com)

Introduction to Equity Methods

Founded over ten years ago, Equity Methods has grown to over 40 professionals with experience serving over 500 corporate clients

Equity Methods has supported 27 of the Fortune 100 and serves, on average, 150 companies annually to solve a litany of equity compensation, fair value measurement, and accounting/tax reporting challenges

Across all practice areas, a differentiated client engagement approach is taken that combines intellectual capital with technology-based algorithm design, resulting in superior risk management and automation without sacrificing flexibility and customization Each year, clients trust Equity Methods to develop and post over $25 billion in compensation expense to their financial statements

Professionals have published books used for industry certification and performed over 100 industry webinars/conference presentations

Equity Compensation Valuation Services

- Completed over 1,500 valuation projects all successfully audited by Big 4 accounting firms
- Expertise in solving a variety of valuation problems:
  - Assumption derivation (expected term, volatility, etc) for standard Black-Scholes valuations, including valuation by groups
  - Custom model development for awards containing market conditions, custom payoff schedules, or other esoteric features
  - Forfeiture rate analyses
  - Valuations and support related to modifications: business combinations, repricings/exchanges, etc
  - Warrant valuations
- Company affiliates contributed to drafting of FAS 123R (2004), FAS 123 (1994), and SAB 107 (2005)

Financial Reporting Services

- Full responsibility over generation of all financial statement entries related to equity awards
- Technology-enabled outsourced solution delivering limitless customization to transform equity reporting into a center of excellence
- Dedicated engagement team with backgrounds in technical accounting, process controls design, risk management, and equity compensation
- Breadth of reporting capabilities customizable to each client's specific needs and situation, incl.:
  - Expense amortization
  - Earnings per share
  - Forecasting
  - IFRS 2
  - Mobility reporting
  - Deferred taxes
  - Disclosure
  - Proxy disclosure
  - Int'l recharge billing
  - M&A / modifications

Compensation Design/Modeling

- Rigorous quantitative modeling to understand cost implications of new designs
- On-demand TSR tracking through AwardTraq
- Support in understanding best practices in award design, scope of design features available, and accounting implications of each

Fair Value Measurement

- Business valuations for privately held or private equity portfolio companies
- Valuation of complex securities under ASC 805 and 820 (contingent consideration, convertible debt, contingent liabilities, warrants, etc.)

10 Topics Most EM Clients Are Thinking About

#	Issue	Who Is Affected		
		HR	Finance	Recipients
1	**Hybrid awards** that combine performance and market metrics (TSR)	✓	✓	✓
2	**Fixed vs. flexible value TSR grants** with scenario modeling	✓	✓	✓
3	**Recharging** as a means of capturing tax deductions and repatriating cash		✓	
4	**Pay ratio** – ready or not, here it comes	✓		
5	**Forecasting, budgeting, and management analytics** to support better planning, transparency, and decision-making		✓	
6	**ESPPs** – making a comeback; broad choice of plan designs with different costs and benefits	✓	✓	✓
7	**Participant communication** to drive engagement with participants	✓		✓
8	**Direct tracing** of compensation expense to detailed cost centers and business units within the organizational hierarchy	✓	✓	
9	**Financial reporting process automation** to reduce spreadsheet risk and integrate tax, expense, EPS, and disclosure processes	✓	✓	
10	**FASB revision to ASC 718** could create some major changes to stock compensation accounting and tax withholding	✓	✓	

Overview of 2015 Trends to Discuss

Here's an outline of the 2015 trends we're seeing in equity compensation:

- Advancing Strategy
  - Rethinking the finance function
  - Compliance v. insight
  - Industry trends
- Plan Design Developments
  - Hybrid awards
  - Post-vest holding
  - Realized v. realizable pay
- Financial Reporting Issues
  - Mobility
  - Direct Tracing
  - Recharge
  - Forecasting
  - Spin-outs
- Regulatory/Best Practices Updates
  - FASB updates
  - Pay Ratio
  - New ISS Scorecard
  - Clawbacks

The Finance Function – Beginning a Transformation

- **The finance/accounting function is at a cross-roads. What is the purpose of the function?**
  - A. To report the news (external financial reporting); or
  - B. To bring analytics and metrics to impact decision-making throughout the organization
- **It's both**
- **But Part A is the traditional view and Part B is hard**
- **And for that reason it often doesn't see the light of day…**
  - "We have analysis people who do that…"
  - "We have system limitations that prevent us from doing that…"

The Transformation within Finance

- "Double Duty," CFO.com, May 2014:
  - "At the end of 2013, only 35% of companies in the Fortune 500 or S&P 500 had a chief operating officer… That's down from 48% in 2000."

- "Building High-Performing Finance Functions," CFO.com Research Report with SAP, December 9, 2014:
  - A controller from a U.S. manufacturer writes that the company's priority should be to "upgrade information systems so as to maximize the time and value of the existing staff, who should be transformed from the current 'data aggregator' into 'effective analysts' adding value to the business."

  - Finally, a CFO from the pharmaceutical industry writes, 'We fight fires really well, but we aren't consistently proactive in identifying issues and addressing them.'

- "The Next Stage in Creating the Value-Added Finance Function," CFO.com Research Report with SAP, October 31, 2014:
  - Finance functions know that they will need to do more than simply churn out the numbers if they are to help business managers avoid information disasters. More and more, business managers will expect finance staff to tell the story behind the numbers.

Stock compensation is just one small piece of the overall finance transformation puzzle—but it's an important component.

EM's stock compensation accounting survey

- How do best-in-class finance functions approach reporting?
- What reports or processes do they use that others might not?
- How do they set priorities?

The survey is still open! (And we invite you to take it.)

What follows are preliminary observations with an eye toward trends we expect to see this year…

Regulatory Updates

FASB Process for Implementing New Guidance

1. Agenda of Topics and Staff Proposal
2. Tentative Decision with Transition Guidance ← Current Status (February 4, 2015)

Step to determine if proposals will become new guidance:

3. Exposure Draft for Public Comment — Summer 2015 (exp.)
4. Evaluate Public Comments — Fall 2015 (exp.)
5. Final Standard

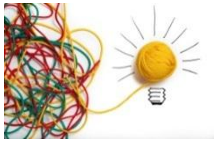
Proposed FASB Updates to ASC 718 – In a Nutshell

The proposed equity compensation changes, from a high level:

Area Affected	High-level Proposal	Transition Method
APIC Pool (As a buffer to P&L)	Remove	Prospective
Realization Requirement (Defer excess benefits in NOL cases)	Remove	Modified retrospective
Forfeiture Rate (Requirement of)	Remove	Modified retrospective
Minimum Statutory Withholding (Liability treatment trigger)	Changed	Modified retrospective
Non-employee Awards (Treatment different than employee awards)	TBD	TBD
Private Companies (Award Valuations)	Simplified	Prospective
Cashflow Designations (Excess tax benefit and tax withholding)	Changed	Retrospective

equitymethods

Pay Ratio – What Is It?



CEO pay / Median employee pay

- Part of Dodd-Frank
- Must disclose ***ratio*** of CEO total compensation to that of the “median” employee
- Median includes: part-time, seasonal, non-US employees

$$\boldsymbol{Pay\ Ratio = \frac{CEO\ Pay}{Median\ Employee\ Pay}}$$

(Disclosed so everybody gets to know…)

Current Status - *PENDING*

- Initial rule proposed by SEC in September 2013; still awaiting final ruling
- Current expectations are for required disclosures for FY 2016 (in 2017 shareholder meeting)

2013
Initially Proposed

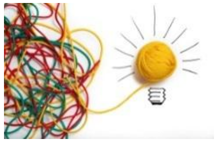
2014
Old Expected Issuance *(bust)*

2015
Expected Issuance

2016
(exp.) First FY of Measurement

2017
(exp.) Disclosed in Annual Meeting

Clawbacks Are Revving up — Be careful to avoid unintended consequences if your provisions are non-vanilla



Clawbacks – Per Sarbanes-Oxley Section 354

- First initiative to codify clawback provisions
- Applies to the CEO & CFO
- Requires return of bonuses and/or incentive or equity compensation, profits on sale of stock
- Look-back is a 12 month period
- Enforceable by the SEC only

Clawbacks – Per Dodd-Frank Section 954

- Applies to both current and former executives
- Requires compensation recovery in an accounting restatement resulting from material non-compliance with financial reporting requirements (no requirement for misconduct)
- 36 month look-back period
- Company responsible for enforcement

Open Questions Until SEC Weighs In

- Will formal SEC rules be principles or rules-based?
- Mechanics of the recovery process and enforceability on “grey” matters?
- How stringent will companies be?

Best Practices To Implement Today

Design Best Practices

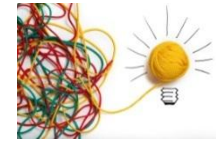
- ✓ Are you willing to enforce the criteria even with high-performers?
- ✓ Do the criteria require excessive discretion?
- ✓ How will the clawback be communicated and tracked?
- ✓ How will compensation be recuperated?
- ✓ Are there state/country law conflicts?

Accounting Best Practices

- ✓ Does any subjectivity cause the ASC 718 grant date to be deferred?
- ✓ How will clawbacks be enacted in the underlying data?
- ✓ Is the clawback an in-substance performance condition?
- ✓ Will outstanding awards be modified?

Plan Design Updates

Post-vest Holding Requirements



Post-vest Holding

- A requirement that shares must be held, even <u>after</u> vesting
- Some benefits, but may prove to be a very contentious issue

Vesting Period → Post-vest Holding

Hey!
What gives?

Some possible explanations…	***Explanation 1****: Easier to enforce <u>with</u>holding requirements*
	Explanation 2*: Easier to enforce clawbacks*
	Explanation 3*: Governance groups (ISS, Glass Lewis) like them*
	Explanation 4*: May result in lower fair value/expense*

Also…

1. Not many companies have adopted, and there aren't yet signs that this will be widespread
2. Not currently expected/appropriate below Section 16 officer level

Modeling To Inform TSR Design

You've heard it before, let's say it again:

- The accounting value on a TSR award will not = stock face value
- For a fixed value granter, this may = participant grant quantity surprises
- For a flexible value granter, this may = CD&A disclosure surprises

Stock Administration and Finance can drive value in one or more ways:

Drive insight and transparency to avoid surprises	Enhance and optimize award design
▪ Run pro forma valuations 1, 2, and 3 months before the grant to gauge where the value is trending	▪ Model the difference between an outperformance and percentile ranking framework
▪ When the value exceeds the face value of the stock by > 10%, unpack the value and proactively explain the drivers of a higher valuation	▪ Model different award features (there's <u>many</u>): payout cap, absolute TSR provision, upside and downside, interpolation, etc.
▪ For any new award design, perform a backtest "as if" the award had been granted every year for the last 7 years	▪ Model multiple comparison groups

Financial Reporting Updates

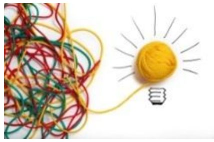
Financial Accounting vs. Management Accounting

Financial Accounting	Management Accounting
✓ Used by external stakeholders	✓ Used by managers
✓ Public	✓ Usually confidential/internal
✓ Historical	✓ Forward looking
✓ Case-based	✓ Model-based (degree of abstraction)
✓ Based on regulatory guidance (GAAP/IFRS)	✓ Based on management needs

Top Issues in 2010	Top Issues Today
Forfeiture rates	2015 ASC 718 revisions
Performance award accounting	Peer volatility for newly public/private firms
Treasury stock method	Control system design
DTA mechanics	Disclosure effectiveness
IFRS	M&A
	Modification accounting

Top Issues in 2010	Top Issues Today
Forecasts of expense (and maybe EPS)	Forecast to actual variance analysis
	Detailed EPS forecasting
	Direct tracing
	Recharging expense
	Executive dashboards
	Mobility management

Fix the Black Box



The Problem

Most finance executives hate stock compensation

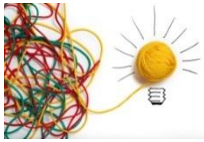
- "I never understand why the numbers move and why our forecasts are always off"
- "Our employees have never captured their Black-Scholes value"
- "Our process is one giant black box"

How do we shatter the black box?

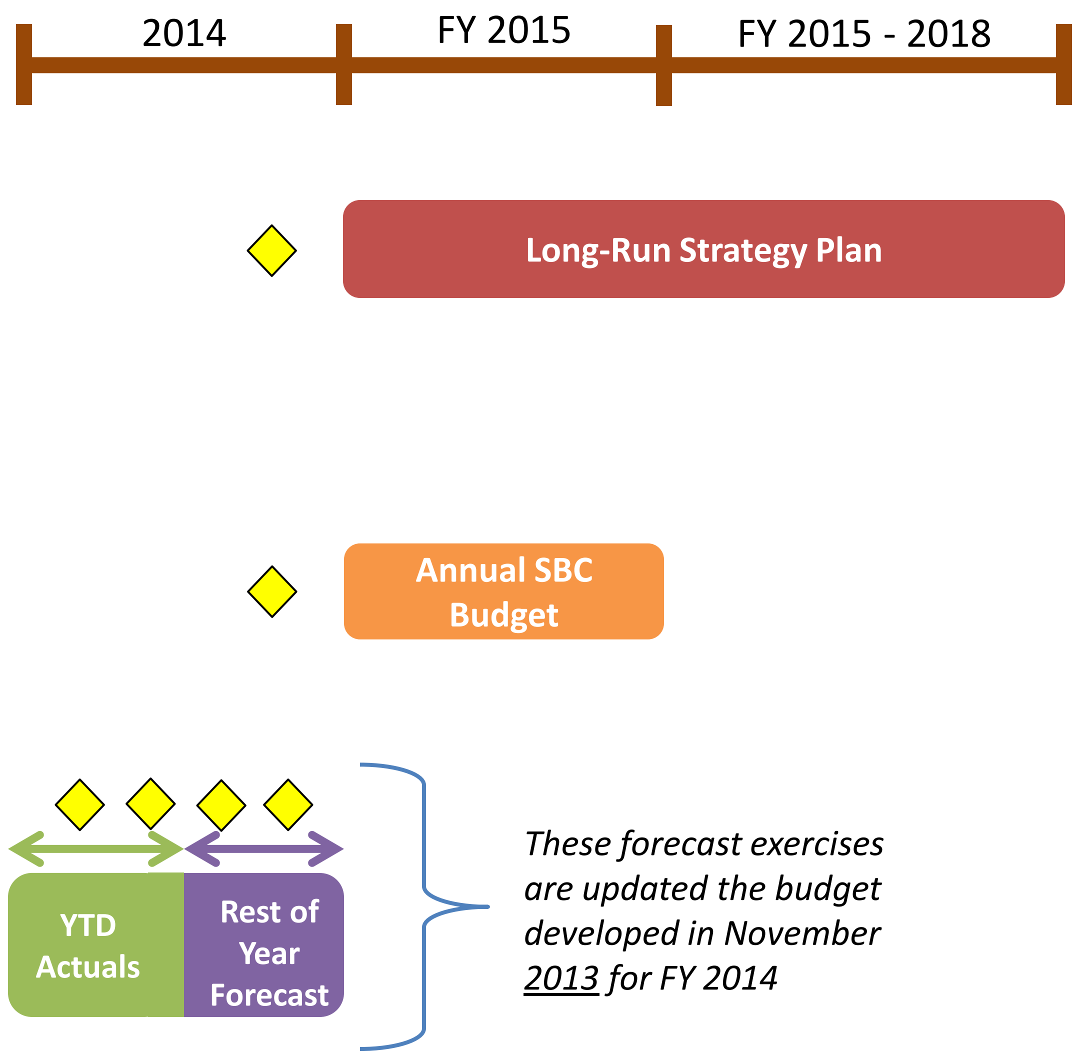
Some Solutions to the Problem

1. Make sure hypothetical awards are incorporated in forecasts, and ideally at the employee level
2. Run multiple scenarios for all inputs with potential variability (e.g., performance multipliers, stock prices)
3. Present forecasts with indicative data (e.g., cost center, legal entity) and in a waterfall format
4. Implement a variance analysis process to explain the drivers behind variances (forfeitures, new awards, etc.)
5. Implement dashboard reports that show roll-ups of expense by grant year, entity, award type, etc.
6. For TSR awards, always model the valuation drivers and the sensitivity of the final value to key award terms

Quick Forecasting Tips



When forecast is prepared



3 or 5 Year Strategy Plan

- Long-run waterfall forecast used an input in long-run planning exercises
- Granularity in out years is annual or quarterly

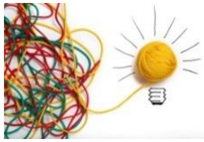
Annual Budget

- Occurs as part of budgeting process for following year (e.g., September/October)
- Usually only one year in length, but monthly granularity to facilitate detailed budget-to-actual variance decomposition

Recurring Forecasts

- Occurs multiple times during a fiscal year
- Gauge variances against formalized budget
- "Re-budget" to incorporate new information and sense of trending FY expense

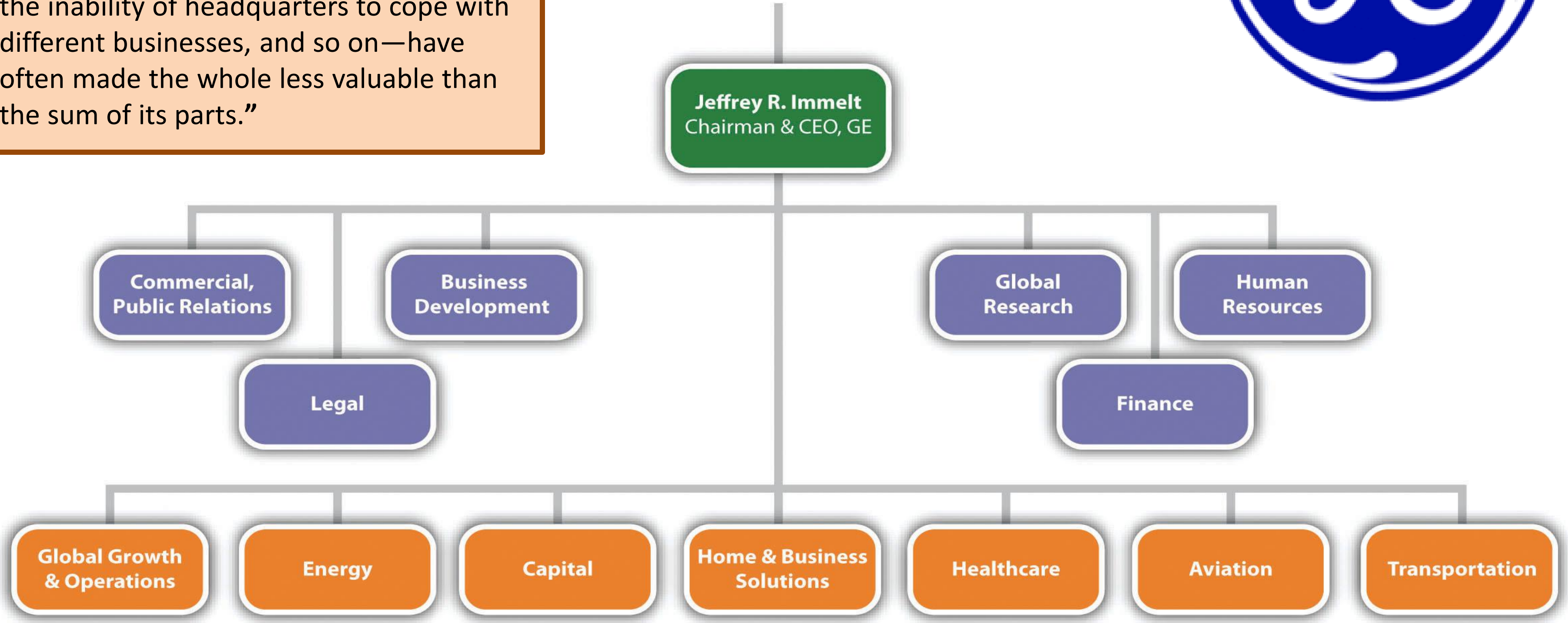
A Problem for Every Large Organization



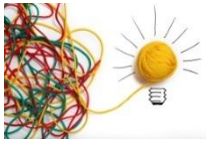
<u>"Why Conglomerates Thrive," HBR, December 2013</u>

"The divisional structure was supposed to improve the parent's ability to deal with diversification. But the problems associated with the structure—extra layers of senior executives, opaque accounting, the inability of headquarters to cope with different businesses, and so on—have often made the whole less valuable than the sum of its parts."

General Electric's Organizational Chart February 2011



Direct Tracing – Weighing Benefits and Costs



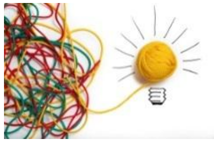
Direct tracing isn't easy: what factors should impact your decision?

1. Is equity compensation a material or important part of compensation in your organization?
2. Does corporate struggle in allocating resources across the business?
3. Are business units held accountable for financial results?
4. Is it difficult to plan equity grant sizes across the organization?
5. Do business unit managers/controllers argue with corporate over cost allocations?

Potential Benefits
Accurate performance measurement at the business unit level of interest – "direct tracing"
Prompt business units to directly pay for the cost of equity granted to their employees
Comparative analysis to understand lumpiness of equity granting and expense across organization
Facilitate better ad hoc / what-if analysis regarding potential termination/divestiture activity
Recharging will become much easier once the broader push-down infrastructure is in place

Costs To Anticipate
Tracking mobility between divisions and cost centers
Changes to organizational hierarchy and manner of restatement needed (prospective/retrospective)
Changes in communication protocols w/ divisions/LEs
Mapping costs to appropriate hierarchy location given HRIS system shortcomings
General data problems (usually for int'l employees)
Need for journal entry automation

Employee Mobility (corporate side)



Country to Country

- Global working environment
- Expats
- Permanent relocations/movement
- Impact recharge agreements
- Difficult to get data in a timely manner
- Difficult to maintain time series of movement

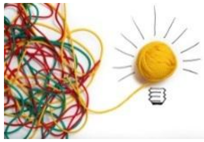
Will impact:

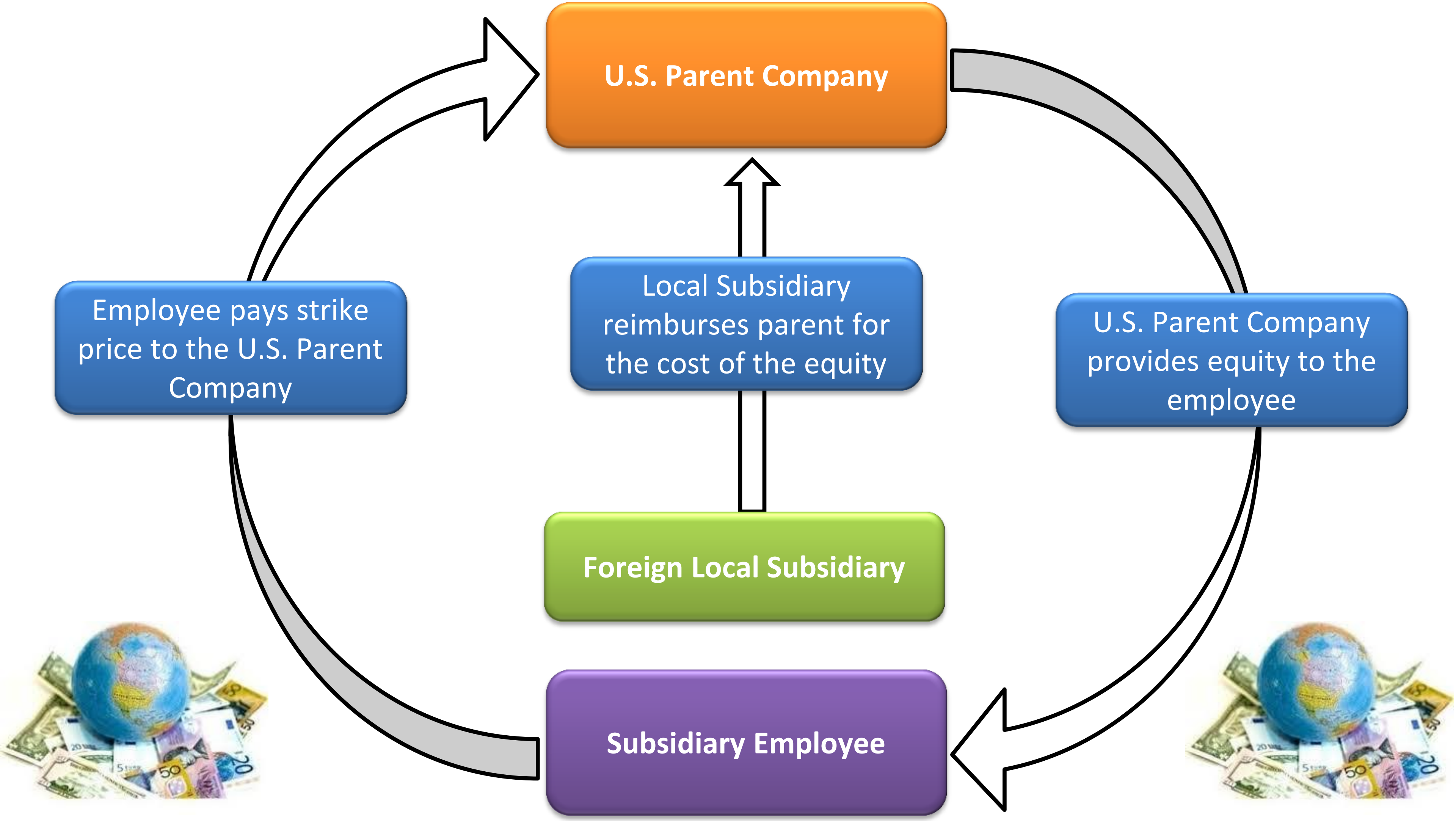
- ***Deferred tax assets***
- ***APIC Pool***
- ***Recharging***
- ***IFRS statutory reporting***

Cost Center

- Mobility can be in the form of ratifications or splitting of a current division
- Impacts what cost center expense gets booked to
- Similar challenges in country to country – maintain time series

Recharging Stock Compensation





M&A Activity Remains Strong

	Acquisitions	Spin-Offs
Main Issues / Treatment	▪ Often, buyer elects to assume target's awards to provide continuity and avoid depleting their own share pool ▪ Pre-close modifications can introduce additional complexity – Treatment depends on who is driving ▪ Plan data conversion carefully ▪ Major valuation/accounting issues	▪ Two methods for splitting awards: – Shareholder approach: employees gain awards in both entities – Employment approach: employees only gain equity in firm they join (spinnor or spinnee). ▪ Expect considerable data challenges ▪ Major valuation/accounting issues ▪ Treatment varies by expense, EPS, Disclosure, DTA and APIC Pool
Relevant Accounting Guidance	▪ Authoritative guidance: – Primary: ASC 805 – Secondary: ASC 718, 740, 260 ▪ Non-authoritative guidance: minimal	▪ Authoritative guidance: – Primary: ASC 718, 740, 260 ▪ Non-authoritative guidance: <u>extensive</u> reliance on industry best practices

Questions and Speaker Information

Speaker Information

Takis Makridis
Equity Methods, LLC
480-428-1203
takis.makridis@equitymethods.com

Takis Makridis is the President and CEO of Equity Methods. 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.

Takis is a nationally recognized speaker at industry conferences across the country and supports Equity Methods' broad thought leadership efforts 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 also 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.

Robert Slaughter
Equity Methods, LLC
480-428-3308
robert.slaughter@equitymethods.com

Robert brings a background in mathematics, financial analysis and analytical problem solving to his role at Equity Methods. As a Senior Consultant in the Valuation Services Practice, Robert has led hundreds of equity valuation projects. In addition to playing a lead role on complex engagements, Robert also has a supervisory role on many projects, in which he reviews internal work, collaborates with associates on methodology issues, and represents the engagement results to clients' senior management and external auditors. Robert has also made many contributions in the areas of process redesign, strategic marketing, and thought leadership. Prior to joining Equity Methods team in 2010, Robert performed market research at Taser International involving inferential and regression-based analysis. Robert holds a B.S. in Economics and Mathematics from Arizona State University. He is a SAS Certified Base Programmer and is working toward obtaining the Advanced Programmer Certification.