



# More Than the ABCs of Market and Performance Awards

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# Agenda

- Trends in performance awards
- Overview of performance awards and metrics
- Tax
- Administration
- Communication
- Disclosures
- Governance considerations



# TRENDS IN PERFORMANCE PLANS

All data excerpted from the NASPP/Deloitte Consulting 2013 Domestic Stock Plan Design Survey

# Prevalence of Long-Term Incentive Vehicles

## Prevalence of LTI Vehicles

81%



Restricted Stock/Units

72%



Performance Shares/Units

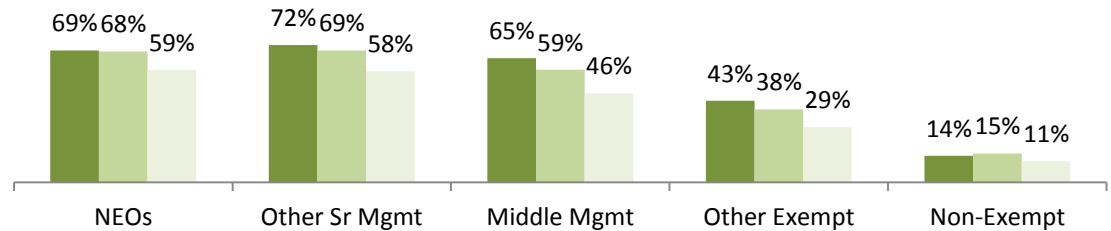
54%



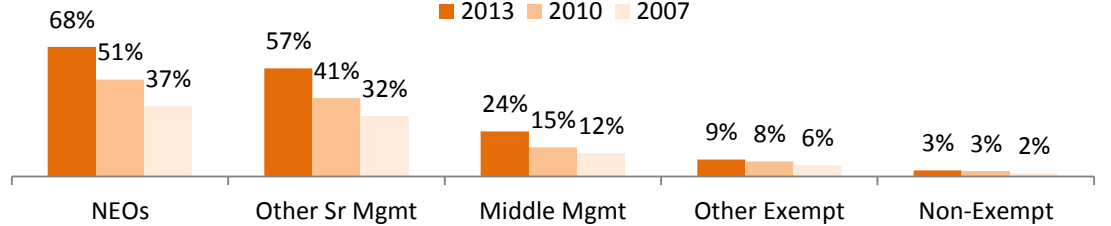
Stock Options/SARs

## Employee Participants

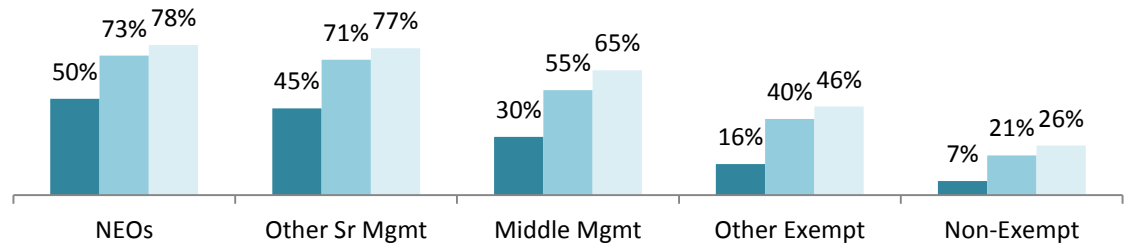
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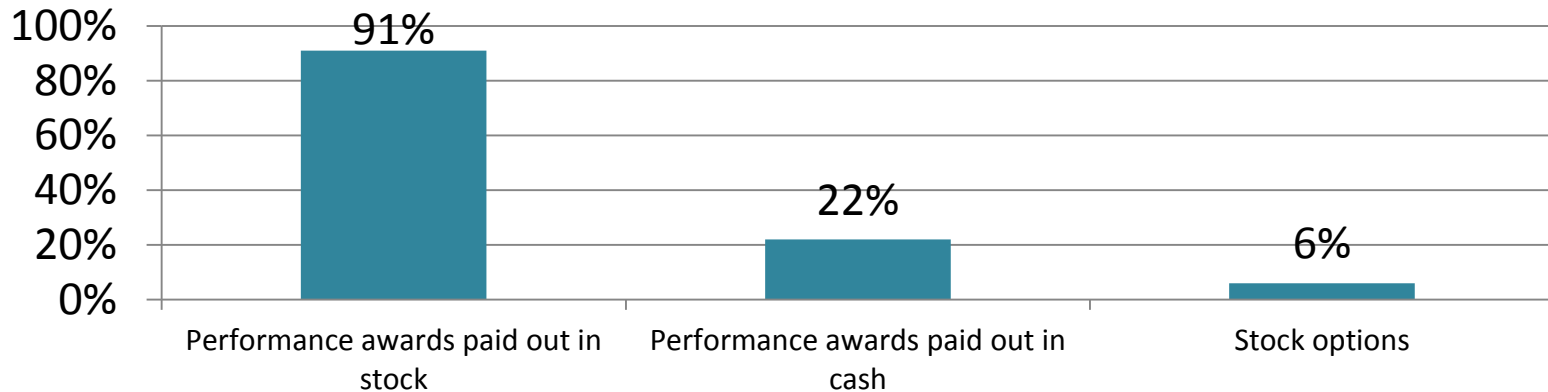
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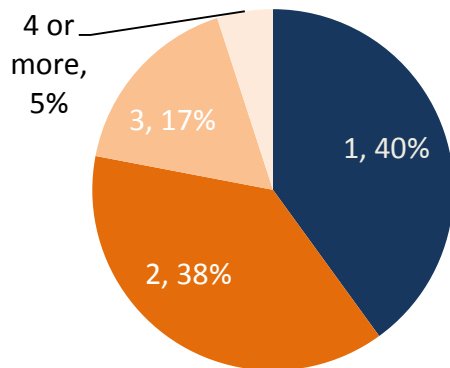


# Performance Plans - Trends

The majority of performance awards are full value awards that are paid out in stock:



**Awards are subject to two or more metrics at 60% of companies:**





**86% of respondents measure performance at the corporate level only.**

**52% of companies benchmark performance relative to a peer group or index.**

**The majority of respondents report that stock awards (69%) and cash awards (72%) have a three-year performance period.**

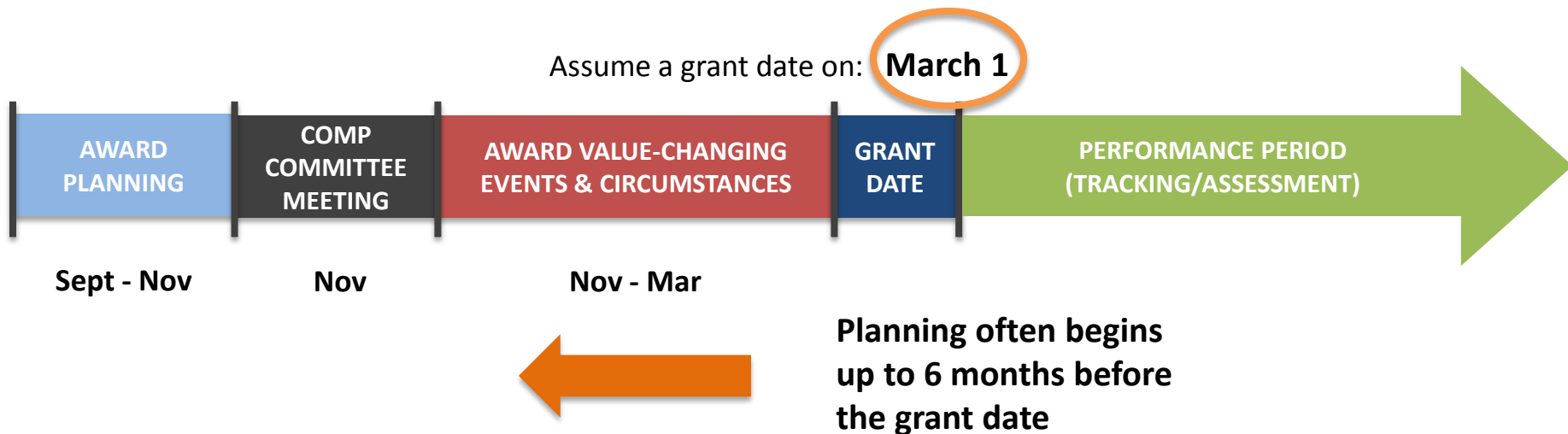
# Award Types – Quick Overview

A quick recap of the main differences between market awards and performance awards

Market Awards	Performance Awards
 <ul style="list-style-type: none"><li>✓ Compares stock performance only (e.g. stock price, or relative return)</li><li>✓ Fair value is complicated (Monte Carlo)</li><li>✓ Better for relative targets</li><li>✓ Easier to forecast long-term</li><li>✓ Static accruals</li></ul>	 <ul style="list-style-type: none"><li>✓ Internal and operational metrics (accounting, strategic, etc.)</li><li>✓ Fair value is simple (stock price)</li><li>✓ Better for absolute targets</li><li>✓ Difficult to forecast long-term</li><li>✓ Variable accruals</li></ul>

# Award Design Process – What To Expect

- Preparation and planning begins far in advance before the actual grant date
- The planning process has many objectives:
  - Evaluate new best practices
  - Create ongoing improvements in incentives and retention
  - Avoid cost over-runs (leading to pay-for-performance surprises) or deflated grant quantities (leading to participant frustration)
  - Energize executives amidst war for talent





# Fixed-Shares Granting and Value Fluctuations

A company decides if they will set grant quantities based on a *fixed shares* approach, or a *fixed value* approach

➤ Each approach comes with difficulty

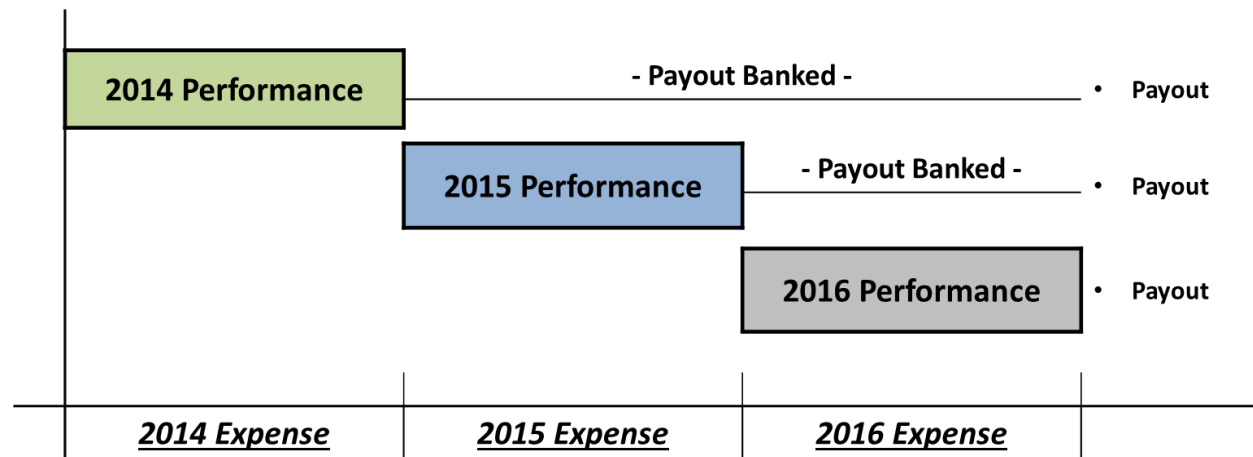
## Take an example

1. 100 fixed shares are planned to be granted at \$10 each = **\$1,000 expense expected**
  2. Stock price then doubles
  3. Grant is made, and comp expense then doubles to **\$2,000 actual expense**
- In a fixed-value world, shares would be reduced to 50, keeping expense constant

		Fixed Shares Granting		Fixed Value Granting	
Year	Stock Price	Shares Granted	Comp Expense	Shares Granted	Comp Expense
2015	\$10	100	\$1,000	100	\$1,000
2016	\$15	100	\$1,500	67 ↔	\$1,000
2017	\$20	100	\$2,000	50 ↔	\$1,000

# Multi-year performance condition grants

A popular performance condition program design contains three tranches, with one-year targets that get set at the beginning of each year.

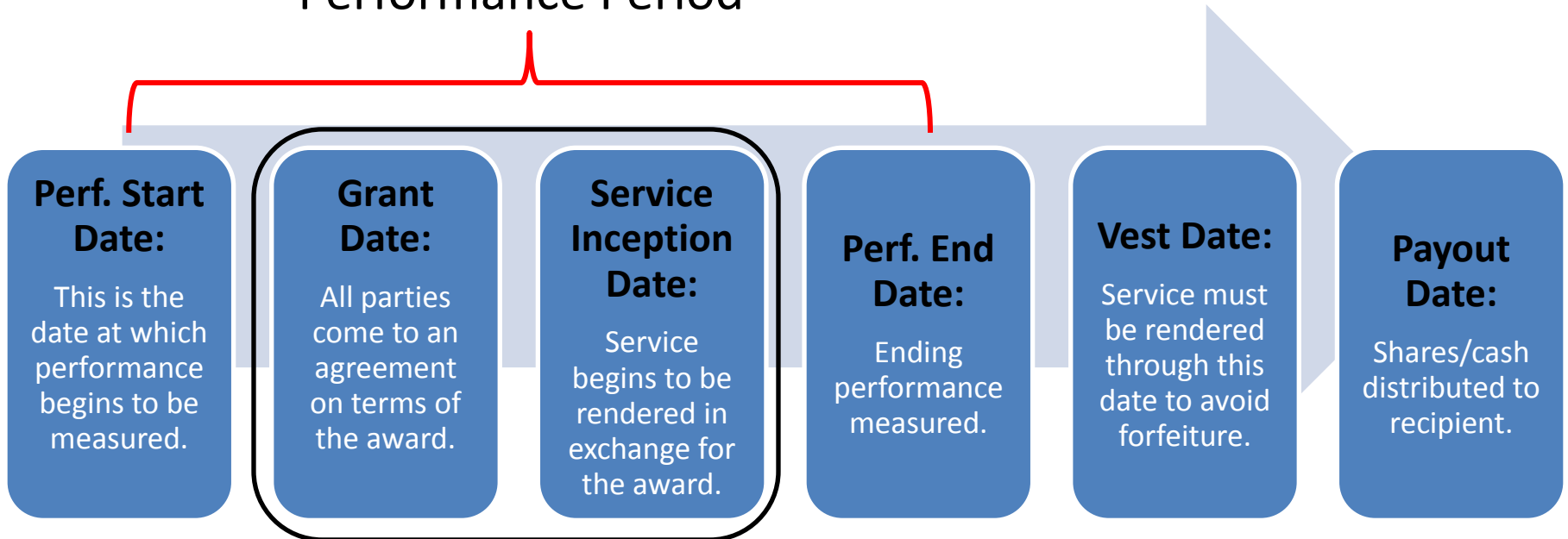


## Long-term v. short-term

- Long-term is generally defined as awards (and targets) for 3 years of performance or greater
- The plan above may be viewed as an STIP masquerading as an LTIP

# Performance Measurement Dates Overview

## Performance Period

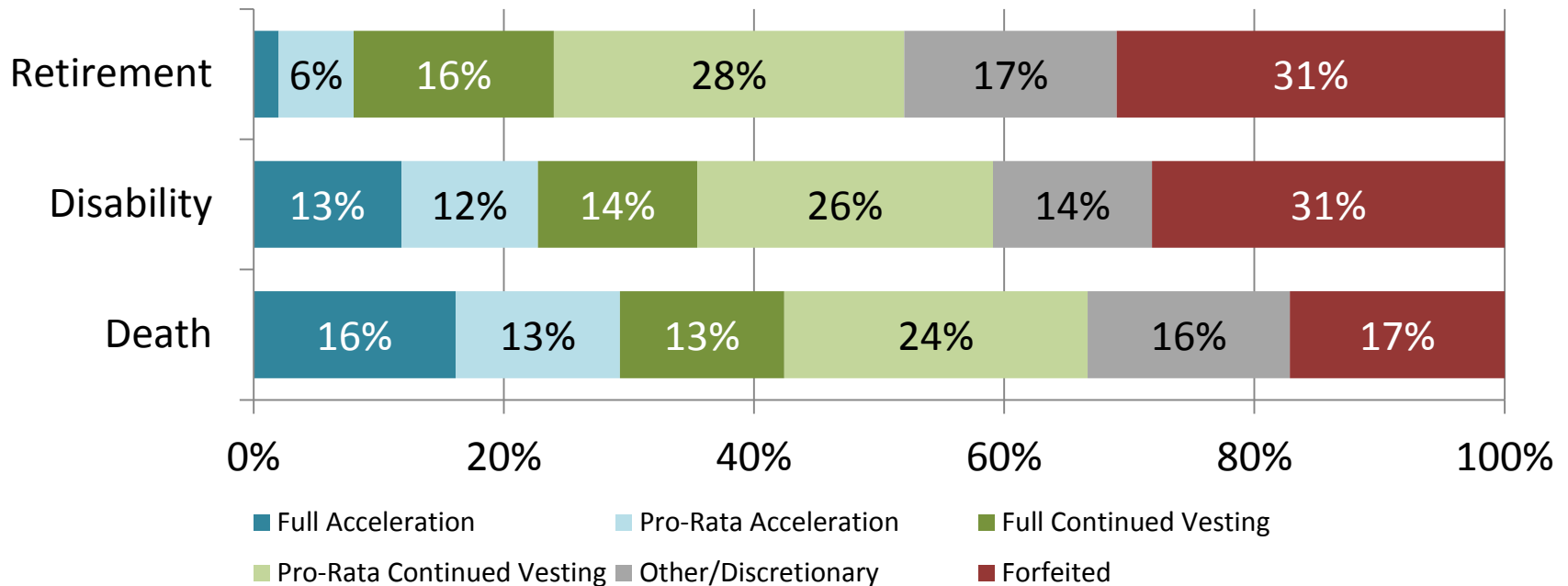


**Note:**

*Some of these dates occur concurrently, but they should be independently specified*

## Requisite Service Period

# Performance Plans – Termination Provisions



59% of respondents provide that awards can be assumed/substituted upon a change in control.

Where vesting will be accelerated upon a CIC, 48% of respondents pay awards out at target and 33% pay awards out based on performance as of the CIC date.

# TSR peer group selection – An overview

## Peer Group Considerations by Type

Category	Peer Group Source	Considerations
Index	1 Broad market index (e.g. S&P 500)	<ul style="list-style-type: none"><li>• To compare relative performance of index <b>constituents</b> or index <b>level</b></li><li>• Closed and semi-closed lists<ul style="list-style-type: none"><li>• Drops from index—do we still measure against them?</li><li>• Entries into index—should they replace an initial peer?</li></ul></li><li>• <b>Beware:</b> the larger your peer group, the larger the administration burden</li></ul>
	2 Specialty market index	
Competitors	3 Competitors or close comparable firms	<ul style="list-style-type: none"><li>• Absolute or relative ranking?</li><li>• M&amp;A outside of peer group</li><li>• M&amp;A <i>within</i> peer group</li><li>• Bankruptcy</li><li>• Spin-off or industry exit by peer</li></ul>

# Choosing Performance Metrics

For TSR awards the decision is between an absolute TSR award, a relative TSR award, or a combination of the two

## Absolute Return

- Stock price appreciation v. TSR (difference=dividends)
- Payout determination
  - Price vested or scaled payout
- Measurement windows
  - Point to point
  - Trailing average or window?

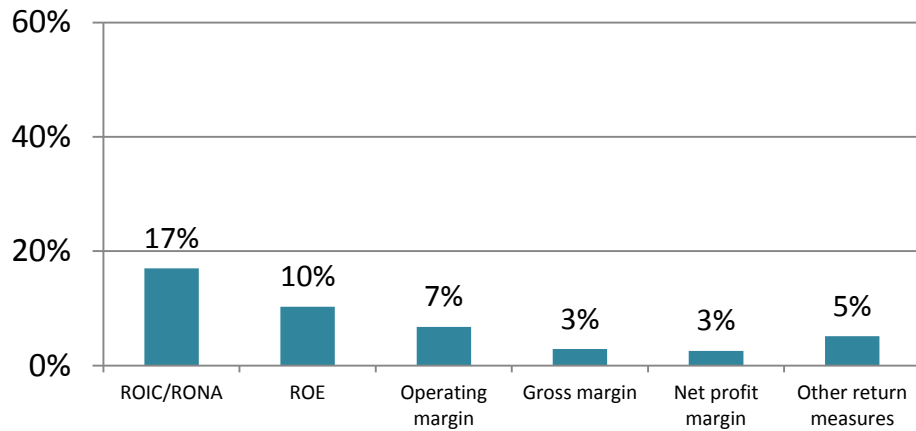
## Relative TSR

- Payout schedule
- Choose peer list and/or index
- Measurement term and windows
  - Point to point / window to window
- How to measure performance ranking? Absolute rank or percentile rank?
- Do you add an absolute threshold? (E.g. payout capped at 100% if TSR is negative)

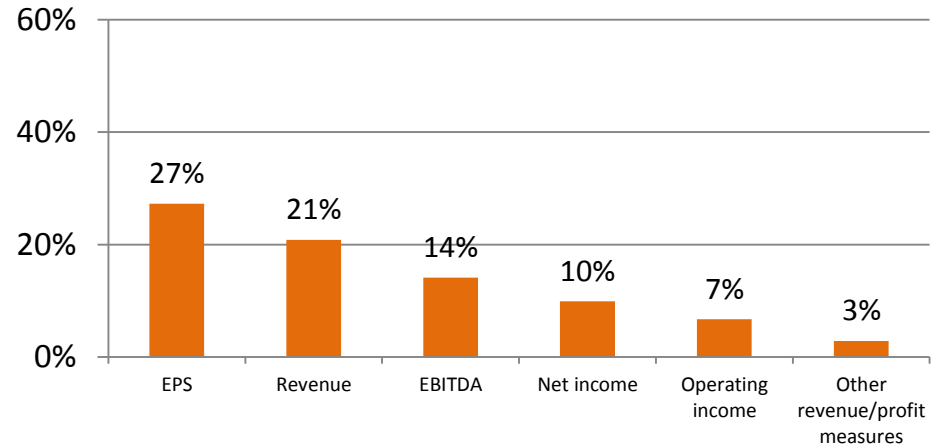


# Performance Plans - Performance Metrics

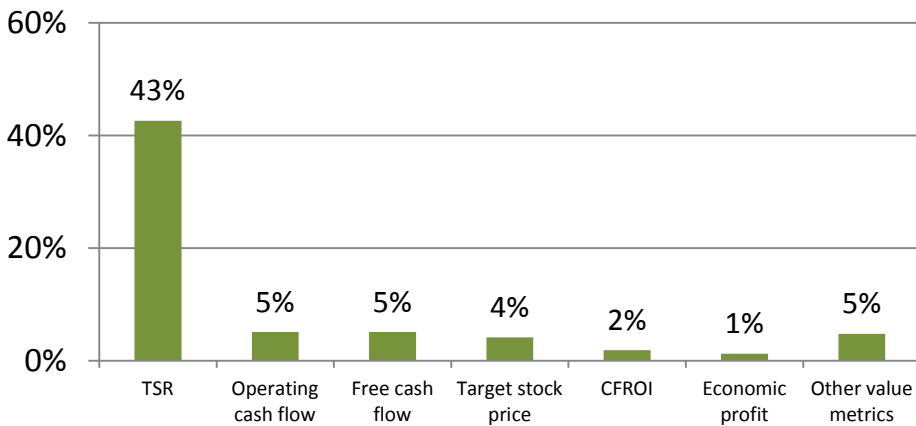
## Return/Margin Metrics – 38%



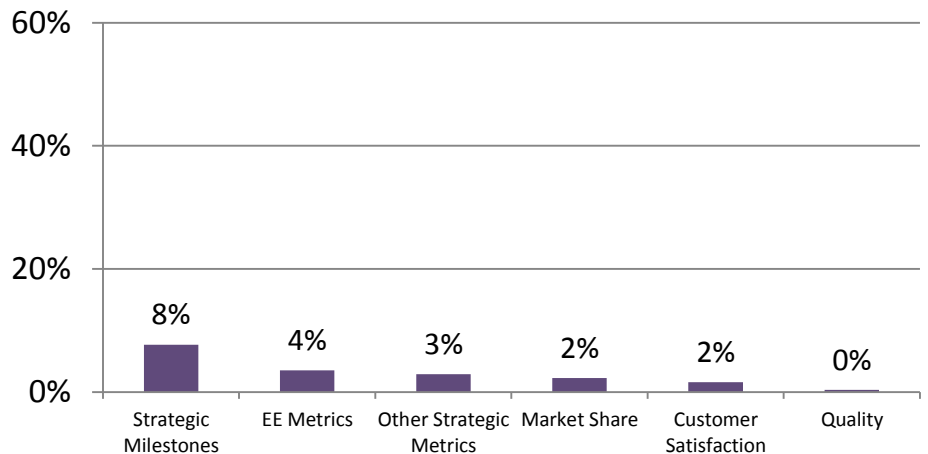
## Revenue/Profit Metrics – 60%



## Value Metrics – 58%



## Strategic Metrics – 14%

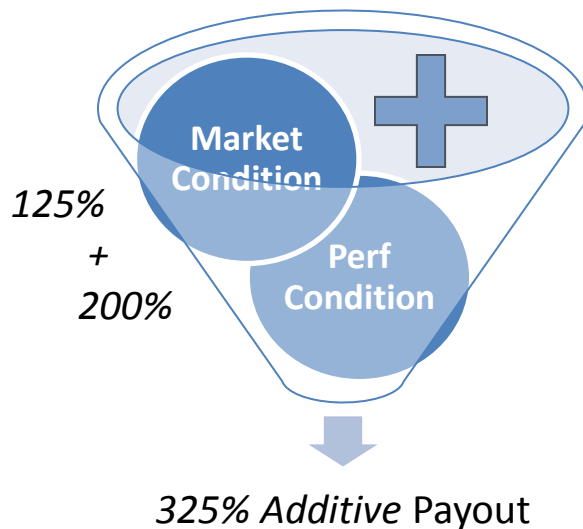


# Hybrid Awards: Performance & Market

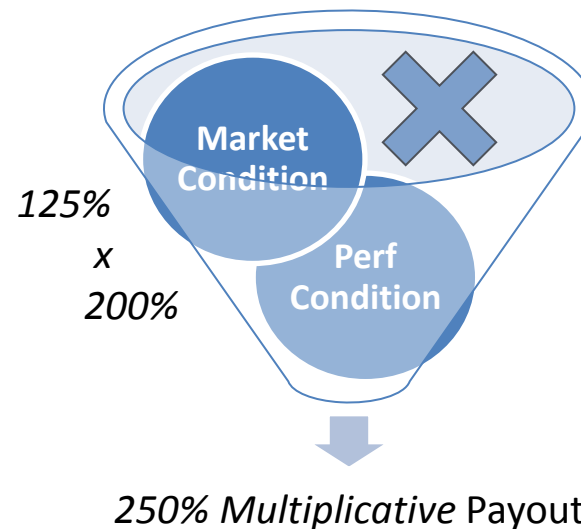
## Hybrid awards

- A hybrid award that is gaining traction in the market: the performance *and* market award
- The payout is combined, and often you must hit multiple targets to receive payout
- These types of hybrid can lead to complicated downstream implications, depending on design

### Additive Payout



### Multiplicative Payout



# TAXATION

# Taxation

- In most cases, performance awards are subject to tax at vest or payout
  - Performance options are taxed upon exercise
  - Where payout is deferred more than two and half months after the end of the year in which vesting occurs, FICA is due in year of vest
  - Performance restricted stock subject to tax at vest, even if not paid out

# Taxation – Key Considerations



- Key considerations for tax purposes:
  - When do all forfeiture restrictions lapse?
  - How long after this date will the awards be paid out?
  - For units, does constructive receipt occur upon payout or when shares are available to executives in their brokerage accounts?

# Taxation - Withholding

- Two unknowns make tax compliance more challenging:
  - FMV
  - Amount/timing
- Most common tax payment methods
  - Share withholding
  - Sell-to-cover
  - Cash
- \$100,000 next-day deposit rule



# Taxation – Best Practices

- Grant units, not performance restricted stock
- Delay payout at least a week or two after board certifies performance
  - Imposing an additional service period is shareholder friendly and can help with tax compliance
- If possible, avoid payouts:
  - On December 31
  - On record date
  - During black-out periods
- Require share withholding
  - Where executives can elect to pay cash, default to share withholding if payment isn't received within one day of payout date
  - Consider requiring executives to hold net shares received for a period of time so they aren't immediately selling
    - Shareholder friendly and provides time to make any adjustments necessary if tax calculations are off

# Taxation – Section 162(m)

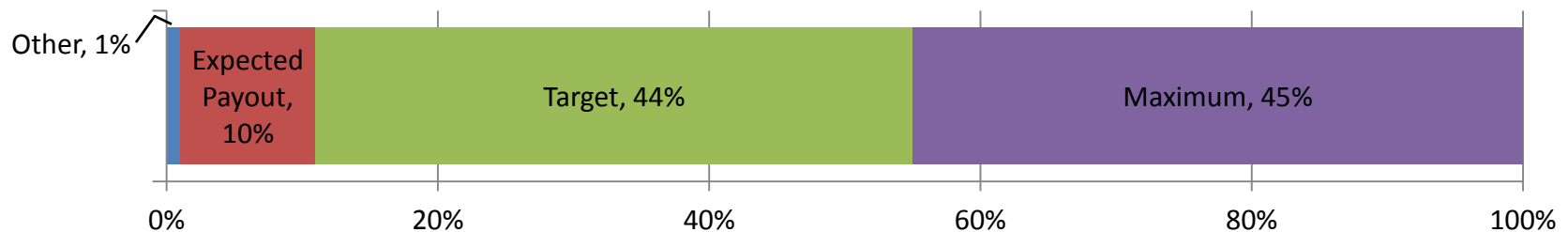
- Performance goals must be specified in advance and board must certify that performance has been achieved
  - Achievement of goals cannot be preordained
  - Goals must be communicated to executives
- Goals must be objective
  - Negative discretion is permissible
- Plan must be approved by shareholders every five years
  - Exception if plan specifies performance goals that awards are subject to
- Awards must be approved by committee of two or more outside directors
- Awards cannot pay out upon retirement, termination without cause, or termination for good reason
- Plan must specify the maximum compensation payable per employee over a specified time period
  - Dividends/equivalents paid on awards count against this maximum

# ADMINISTRATION

# Administration – Share Counting

- How many shares should be counted against the plan?
  - Awards can pay out a range of shares
  - Counting the maximum payout against the plan can result in fewer shares available for other purposes
  - Counting at less than the maximum could result in a shortfall should awards pay out higher than anticipated

**How do you count performance awards that have been granted but not yet paid out against the plan reserve?**



# Administration – Stress Testing

- Holistic review of potential award outcome in multiple circumstances
  - Company: What revenue/earnings/growth would be realized if goals necessary to achieve the specified payout are achieved?
  - Shareholders: How much wealth would be created for shareholders?
  - Executives:
    - What would be the award payout to executives?
    - How much additional wealth would be created through other variable compensation?
      - Other equity awards, bonus programs, etc.
    - How does wealth creation for executives compare to shareholders

# Administration - Controls

- Accurate grant calculations are critical
  - Rounding
  - Accurate salaries and targets
  - Different stocks
  - Currencies
- Accurate payout calculations are critical
  - Right share price used
  - Dividends computed correctly
  - Performance multipliers correct
  - Where shares are sold quickly, mistakes could necessitate broken trades
- Performance awards typically granted to a highly visible population



# Administration - Communication

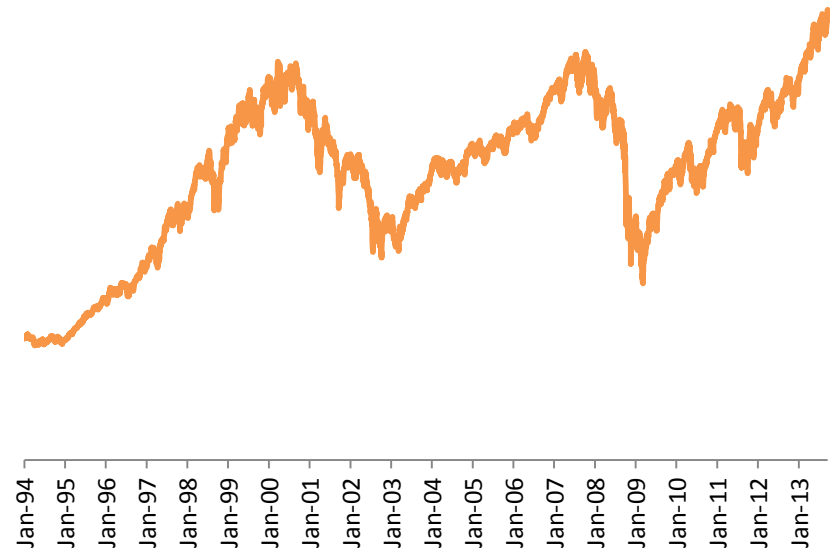
- Complexity inherent in awards makes education challenging
- Key educational program components
  - Performance goals
  - Payout structure
  - Progress reports
  - Payout process
  - Taxable income/withholding
  - Confirmation of payout

# Performance tracking

- Performance tracking is a critical part of award management post-grant
- Difficulty in performance tracking is directly proportional to complexity of award and size of peer group

## Two users of performance tracking:

- Award recipients
  - ✓ Keeping recipients apprised of performance in an efficient, user-friendly manner
  - ✓ Updates should be succinct and easy to understand
- Accounting/finance
  - ✓ ASC 260 requirements
  - ✓ Accrual adjustments



# Disclosures and Filings

- Section 83(b)
- Insider filings: Form 4 or SEDI
  - Changes in share ownership (of which share-based grants to insiders fall under)
  - Must be filed within 48 hours of ownership change (5 days in Canada)
    - Performance awards (and relative awards) are filed after the performance period
    - Market awards that are not based on relative return (e.g. price-vested awards) are filed after the grant date



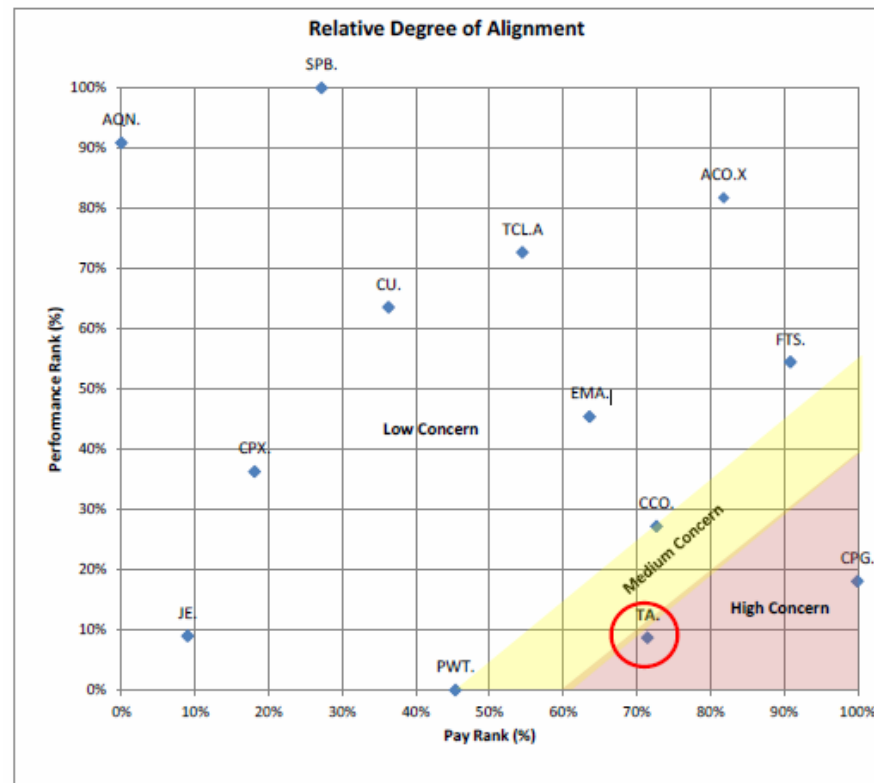
# Shareholder and Governance Considerations

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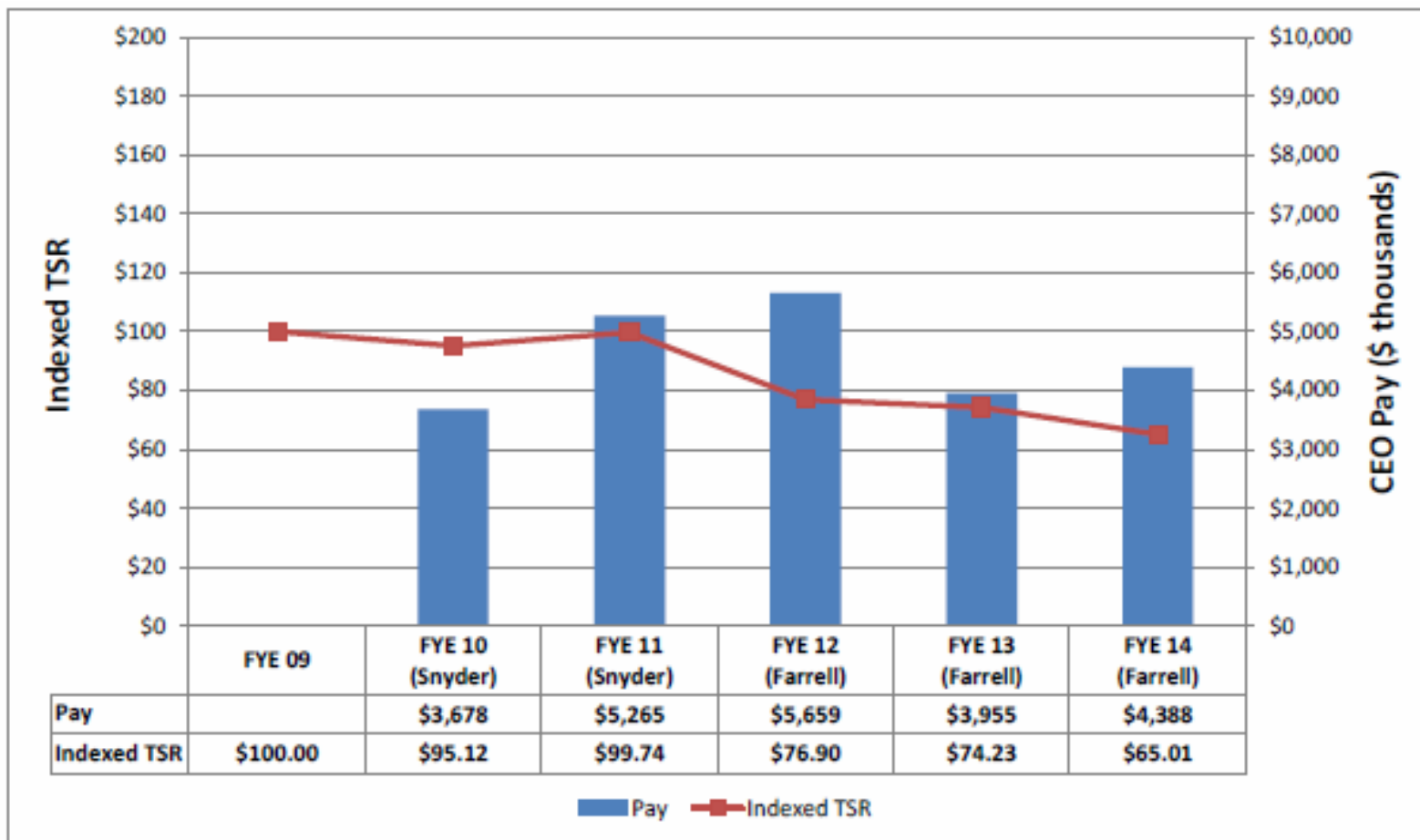
- ISS, Glass-Lewis and others analyze proxies and make recommendations to shareholders on such things as say on pay, director voting, resolutions.
- Let's look at ISS and pay for performance
- 3 key tests used to determine a degree of concern

# Shareholder and Governance Considerations

- Relative pay versus relative performance is a key metric in evaluating pay practices

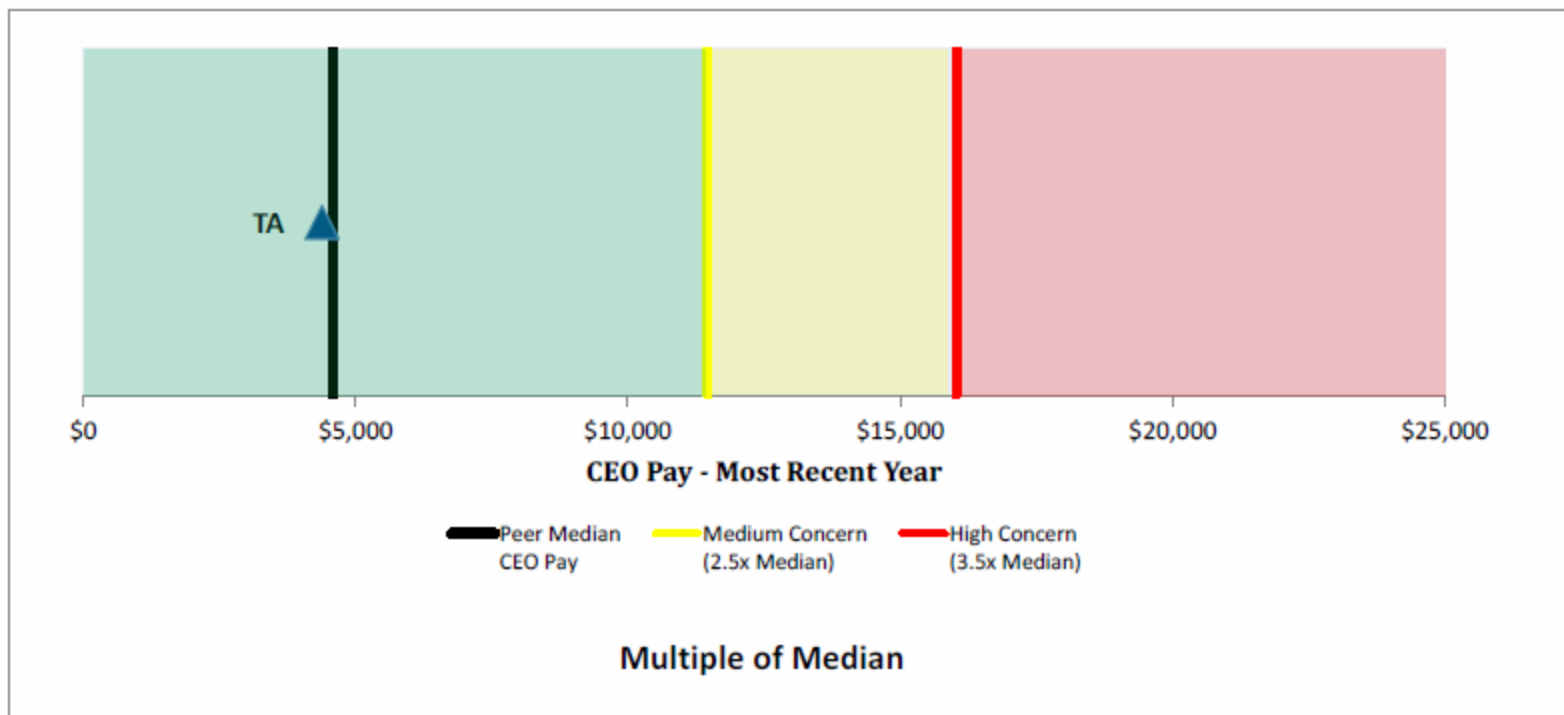


# Shareholder and Governance Considerations





# Shareholder and Governance Considerations





# Shareholder and Governance Considerations

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- High concern on any one test will lead to “No” say on pay recommendation. You can present to ISS and get them to consider qualitative factors
- Consider how your performance awards will be viewed
  - Relative TSR market awards can mechanically help maintain a good balance



Questions?

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