Wisconsin NASPP
2015 – What's New in Stock Compensation

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The Next 60 Minutes

- **What's new in 2015 in stock compensation?**
- **General focus on stock compensation <u>accounting</u> and <u>plan design</u>**
- **A 'state of the union'-esque presentation is hard, because we can't go in-depth on any one item and still cover the full landscape of emerging topics**
  - Where possible, we include detailed slides that do offer some more in-depth commentary
  - Our contact information is in the back—call us to drill deeper
- **A look at the 2015 EM SBC Survey Results**

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Overview of 2015 Trends to Discuss

We're going to be covering a lot of ground today. Here's an outline of what we want to talk about:

Advancing Strategy
- Rethinking the finance function
- Compliance vs. insight
- Survey: Searching for Best-in-Class

Plan Design Developments
- Hybrid awards
- Post-vest holding
- Communication
- ESPP Resurgence
- Realized v. Realizable pay

Financial Reporting Issues
- Forecasting
- Direct Tracing
- M&A
- Recharge
- Mobility

Regulatory/Best Practices Updates
- FASB updates
- Pay Ratio
- Pay for Performance
- 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 <u>hard</u>**
- **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.

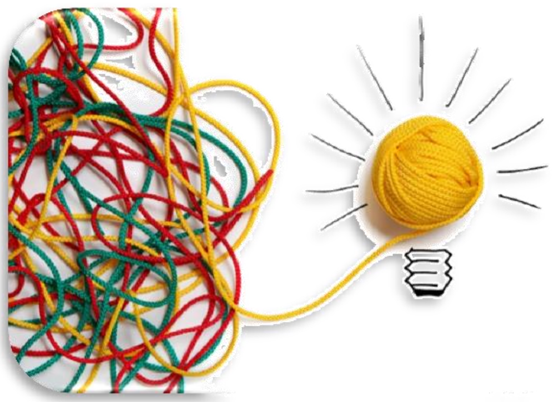
Compliance vs. Insight

Compliance

Be on the lookout for because you need to be

Insight

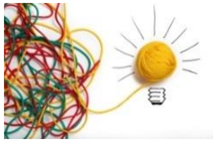
Evaluate in order to broaden impact/value-add



(We'll talk about both…)

Survey Details

Survey Introduction



- **Between December 2014 and March 2015, we administered a survey related to stock compensation accounting and related best practices**
- **With 245 respondents, we will be donating $10/respondent to FMSC, an organization dedicated to eradicating world hunger**

High Level Questions to Answer

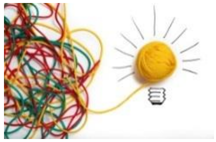
- How do best-in-class finance functions approach reporting?
- What reports or processes do they use that others might not?
- How do they set priorities?

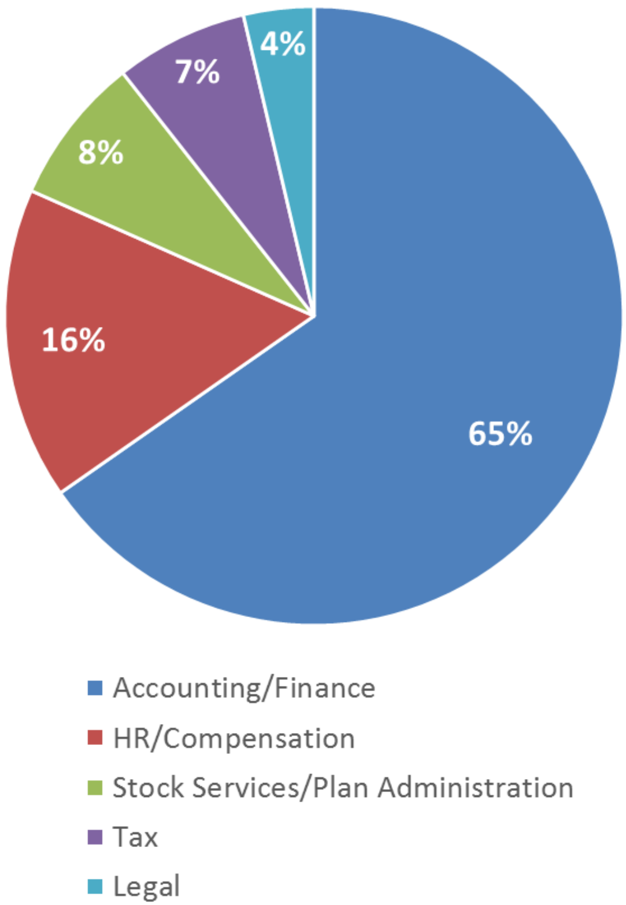
- **Our survey was separated into 7 main sections:**

  Respondent characteristics, granting patterns, budgeting and forecasting, international recharge, direct tracing of expense, IFRS compliance, and tax accounting

- **We learned much more than we set out to learn—we'll provide a summary**

Who Took the Survey?





245 total respondents

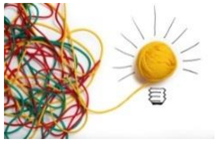
Mix of Titles in Accounting/Finance

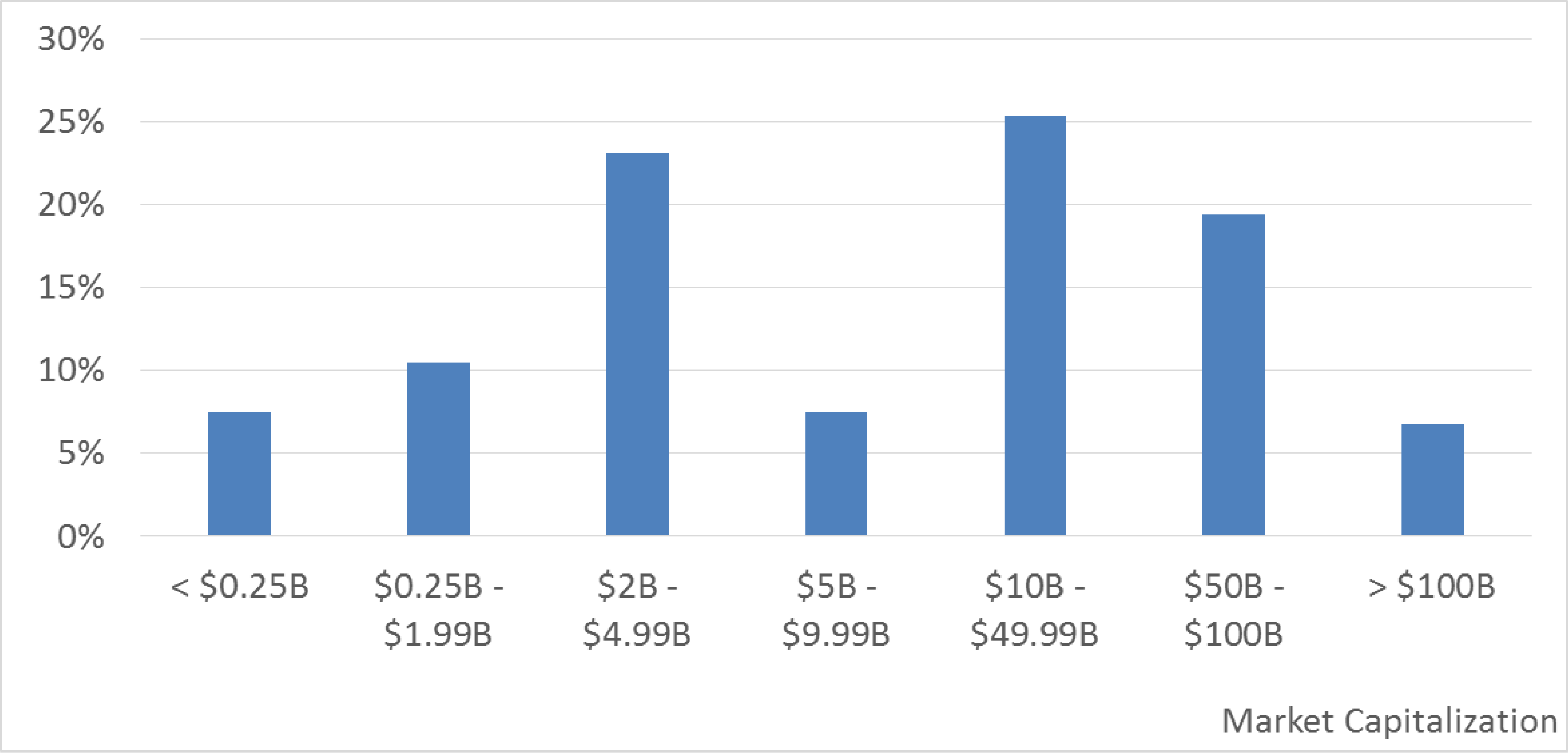
Staff Accountant/Accounting Analyst	10%
Accounting Manager/Senior Accountant	34%
HR Controller/HR Accounting Manager	4%
Manager of SEC/External Reporting	20%
Director of SEC/External Reporting	14%
Assistant Controller	5%
CAO/CFO/Controller	12%

Scope of Involvement

Prepare expense, tax, or related reports	43%
Review final entries and work product	42%
General oversight responsibility but do not directly prepare or review work product	15%

Who Took the Survey?

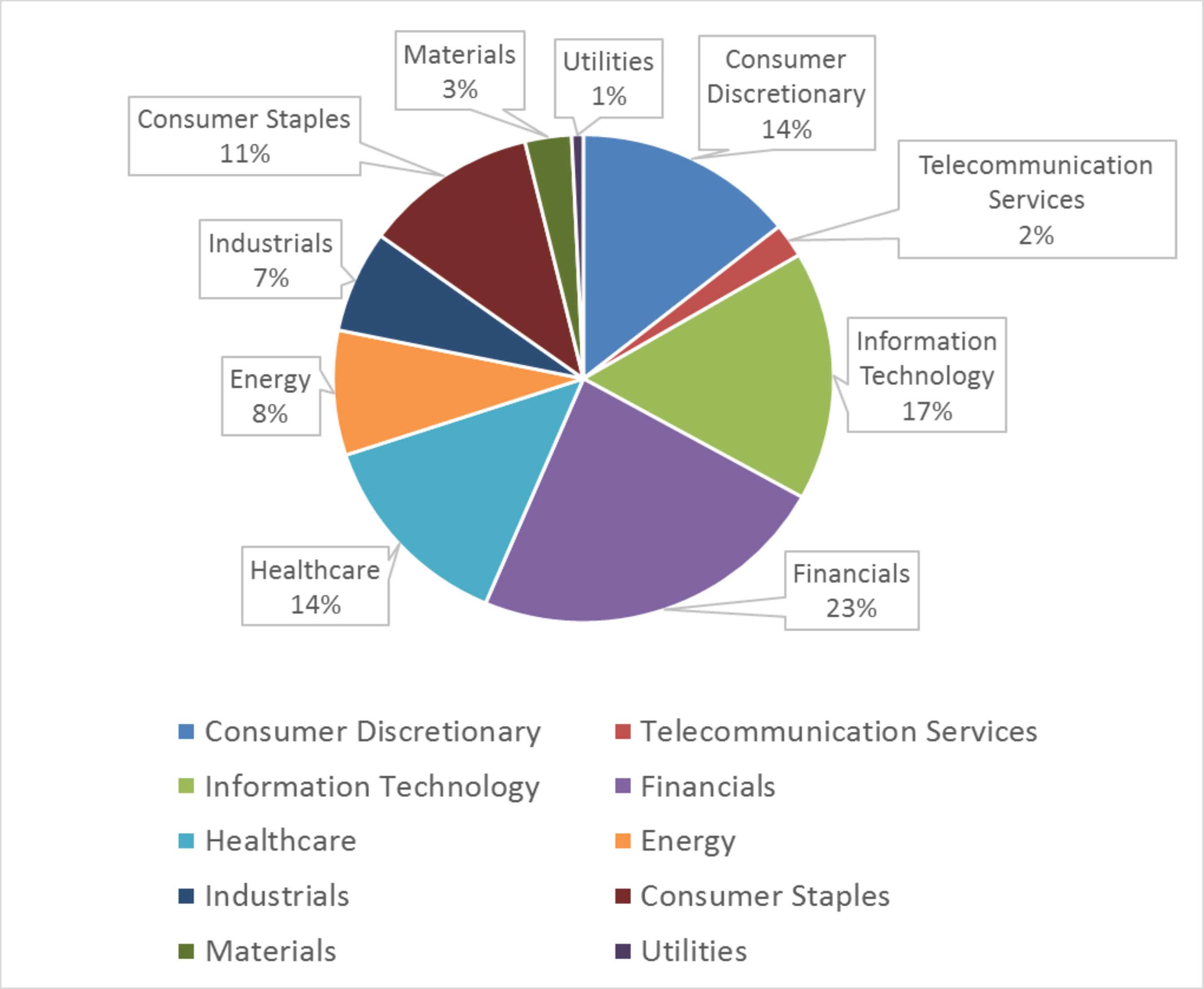




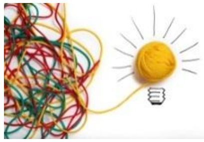
Public Companies: 97%

Private Companies: 3%

Who Took the Survey?



In Search of Best-In-Class…



Pool of respondents

Results-Based Analysis

- Organizations with relative outperformance in the market
- Organizations with large plans (> 1,500 participants)

Characteristics-Based Analysis

- Organizations with a strength in analytics and/or controls
- Organizations with strong reporting to senior management and the BOD

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)

3 Exposure Draft for Public Comment

Summer 2015 (exp.)

4 Evaluate Public Comments

Fall 2015 (exp.)

5 Final Standard

Step to determine if proposals will become new guidance

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

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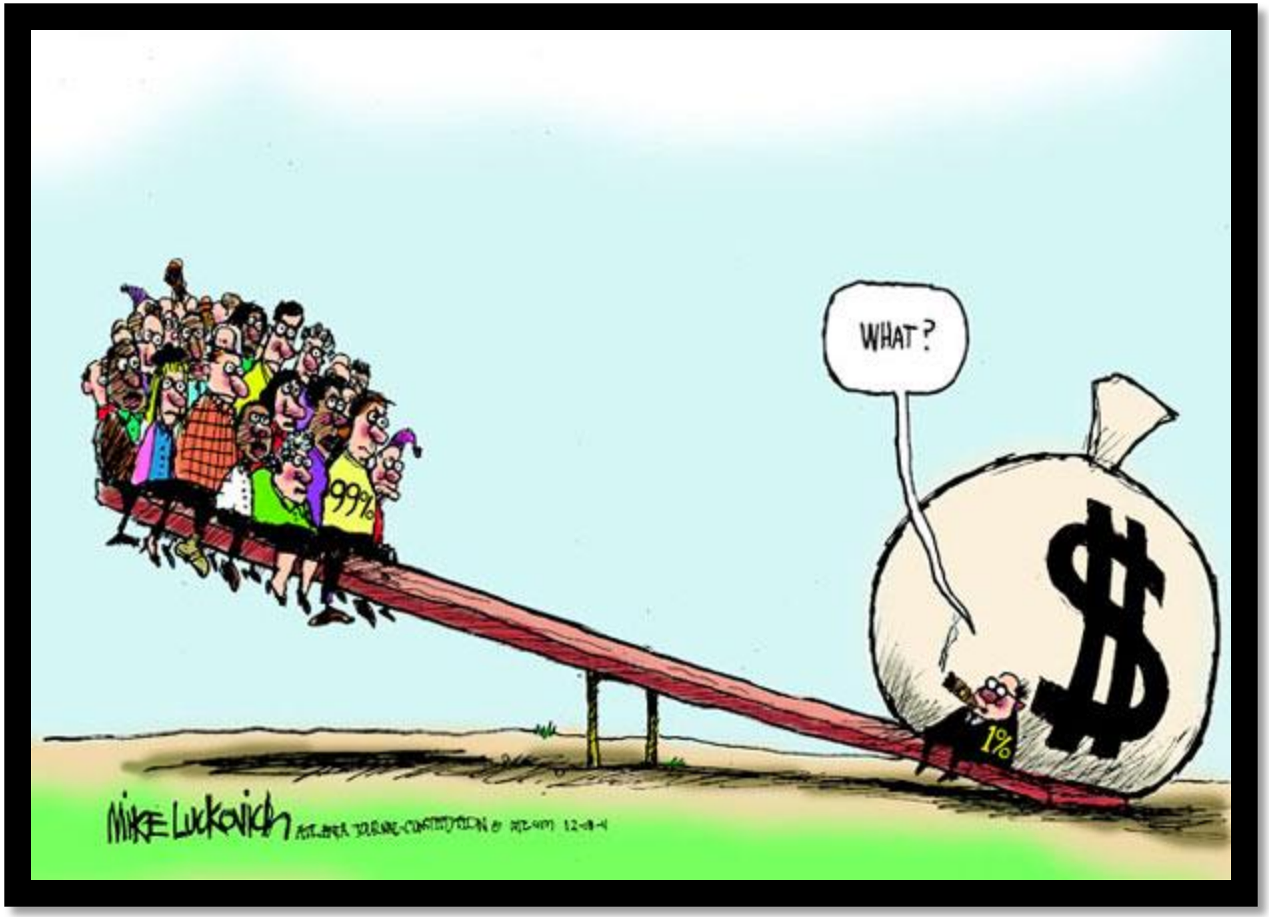
Pay Ratio



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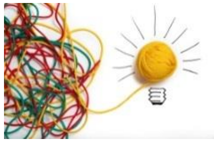
Pay Ratio – What Is It?



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

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

(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

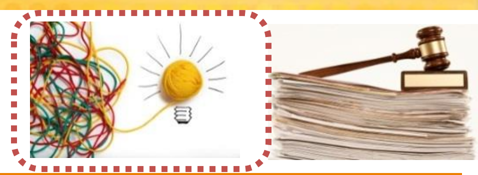
2014
Old Expected Issuance *(bust)*

2015
Expected Issuance

2016
(exp.) First FY of Measurement

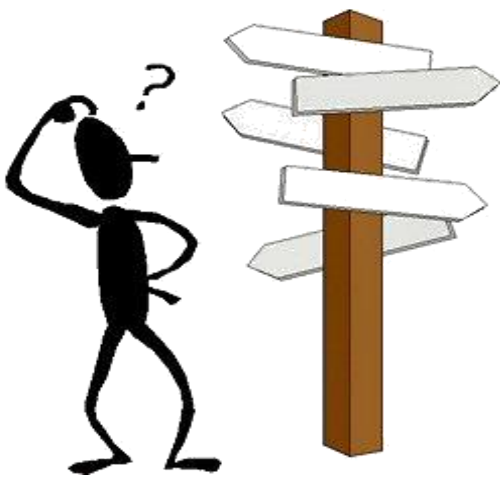
2017
(exp.) Disclosed in Annual Meeting

Pay Ratio – Initial Considerations



Major data complexity is expected

- Both finding and computing pay for the median employee will likely be complex tasks
    - Salary bonus, stock, options, non-equity incentive plan comp, changes in pension value and NQDC earnings, other comp (including perqs), foreign exchange difficulties…etc.)
- These inputs will come from many different systems/sources



Which way to go?

- Calculation discretion will be allowed
- Some ways to think about the task
    - Compliance?
    - Impression management?
    - Proxy best practices?
- We recommend a proactive approach to get out in front of the issue

Pay for Performance

On April 29, the SEC released proposed Pay for Performance rules

- Rules would require clear disclosure of the relationship between executive compensation *actually paid* and company financial performance

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 229, 240, 249

Release No. 34-74835; File No. S7-07-15

RIN 3235-AL00

PAY VERSUS PERFORMANCE

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

Currently we are in a 60-day comment period

- Final guidance could be released in Fall 2015
- Could be effective as early as 2016

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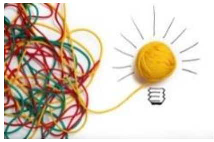
Plan Design Updates

As award designs grow in complexity, HR and Accounting stand to benefit from collaboration. Areas of opportunity: (1) pre-grant modeling, and (2) catching potential nasty surprises



Question:
Please describe any surprises that have occurred when granting. Please select all that apply.

Type of Surprise (select all that apply)	All	TSR Award Granters
Fewer (or more) units were granted than expected because the accounting value was higher (or lower) than planned	8%	23%
Grant values disclosed in the Summary Compensation Table in the proxy were higher (or lower) than initially targeted	4%	23%
Participants did not understand or ascribe adequate value to their grants	24%	69%
Little to no surprise	46%	38%

EM Comment:
- TSR granters face the highest risks of confusion / surprise.
- Pre-grant modeling upfront helps identify potential cost surprises and/or sensible design refinements.
- Post-grant communication helps drive understanding with participants and overall engagement.

Internal HR leaders are more regularly playing 'quarterback' on award design decisions… With this comes risk and opportunity

Question:
For each compensation activity, please select who PRIMARILY carries it out.

- *High-level pay strategy i) Internal compensation group ii) External compensation consultant*
- *Award design process i) Internal compensation group ii) External compensation consultant*

Process Owner	High-level pay strategy	Award design process
Internal compensation function	76%	86%
External (BOD) compensation consultant	24%	14%

Risk

Without external scapegoat, surprises cause blame & friction

+

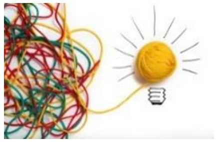
Opportunity

Detailed modeling can provide solid insights

Solutions:

1. Backtest new award designs before implementing
2. Evaluate at least 3 variations on an existing design for potential optimization
3. Run pro forma cost estimates 3 months prior to grant
4. With TSR, identify drivers of fair value premium/discount
5. Consult with accounting re: adverse implications

COMMUNICATION: The next 'frontier' with performance-based awards. How do we understand their value? Why are they MUCH more than a lottery ticket?



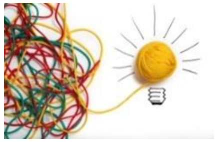
Question:
How do you communicate and explain your performance-based awards (check all that apply)?

Communication Lever	%
Formal grant agreement	100%
Brochure	26%
Webcast	11%
Video with animation	14%
Performance tracking (e.g., AwardTraq)	6%
Townhall with executive speakers	11%

EM Comment:

- In our experience, there is not a one-size-fits-all answer – communication decisions should be made in the context of the corporate culture.
- But, more communication is better than less. We like to see communication pre-grant to those "in the know," multiple mediums used at grant, and post-grant tracking to keep the award salient.

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

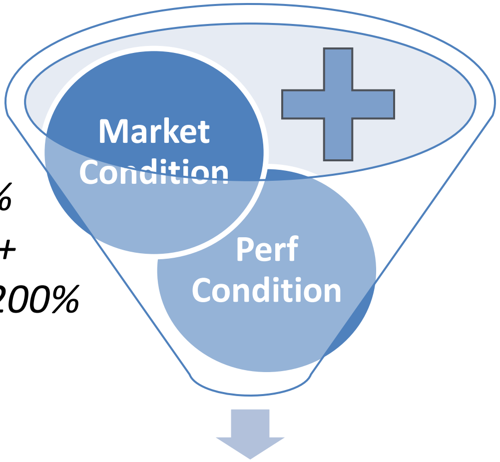
Additive Payout

- Simpler accounting; may involve system constraints

125%

+

200%



325% Additive Payout

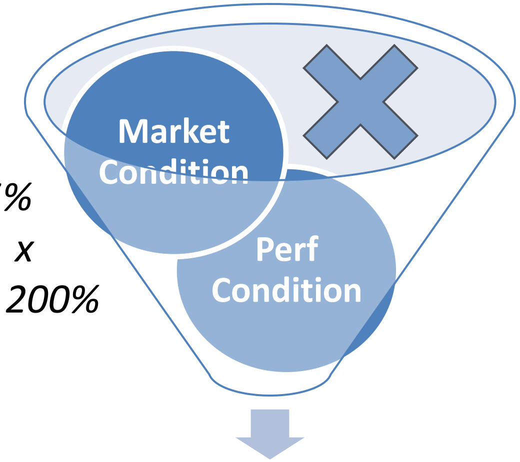
Multiplicative Payout

- Beware! If there is a payout cap, it can lead to complicated fair value implications

125%

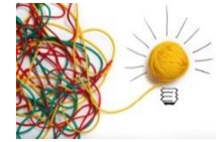
x

200%



250% Multiplicative Payout

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

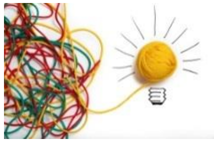
With post-vest holding restrictions, there are important handoffs to manage

Pros	Cons
Simplifies monitoring and enforcement of ownership guidelines	Limited market adoption to date = potential for competitive disconnects between companies
Simplifies enforcement of clawback provisions	May worsen an executive's already poorly diversified wealth concentration
Positive signal to proxy advisory firms (e.g., ISS, Glass Lewis)	Aggressive valuation could draw SEC scrutiny
Valuation discount allows reduction to total expense or increase in # awards granted	Ambiguous shareholder story if valuation discount is plowed back into more shares (which is dilutive)
Absent an aggressive valuation approach, available techniques are relatively straightforward	Share withholding difficulty and tracking of different withholding timings
Improved proxy story to tell	

There are important handoffs between Compensation, Stock Administration, Finance, and outside vendors – if going down this road, plan carefully!

Financial Reporting Updates

How Do You Use Stock Compensation Budgets and Forecasts?



#	Ways of Utilizing Forecasts	All	Respondents with Strength in Analytics
1	Estimate external reporting expense for senior management	80%	78%
2	Estimate dilutive impact of equity for senior management	59%	75%
3	Track share counts, overhang, and burn ratio	53%	61%
4	Reduce uncertainty associated with plan design changes	15%	22%
5	Establish performance goals and expectations for business unit managers	26%	47%
6	Model impact of retirement and termination activity	15%	28%
7	Measure actual or expected impact of recharge agreements	7%	17%
8	Estimate future settlements for tax	19%	33%

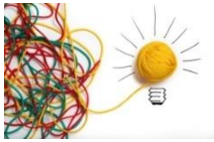
Question:

Is forecasting worth the effort?

High performing companies spend more time on forecasting and planning

Performance Quartile	≥ 4 Distinct Ways Using Forecasts
Lowest	20%
#2	15%
#3	18%
Top	32%

Direct Tracing – Weighing Benefits and Costs



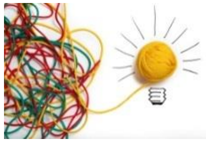
Direct tracing isn't easy: what factors should impact your decision?

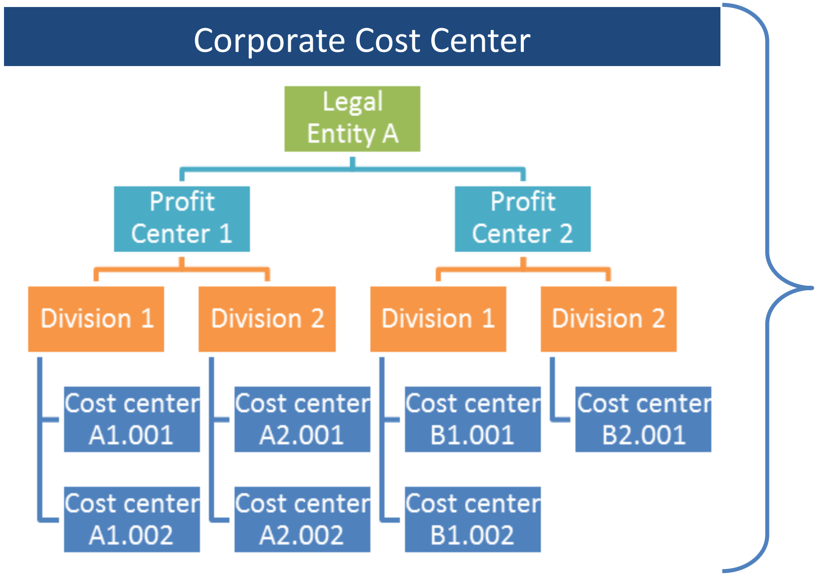
1. Is equity compensation a material or important part of compensation in your organization?
2. Does corporate struggle in allocating resources across the business?
3. Are business units held accountable for financial results?
4. Is it difficult to plan equity grant sizes across the organization?
5.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

Where is SBC expense being booked?





Booking Level	All	Analytics Strength
One corporate cost center	15%	14%
Each legal entity	14%	17%
Each profit center / business unit	13%	17%
Each cost center	32%	38%
Financial statement segments	13%	7%
Multiple P&L line items only	13%	7%
Other	6%	7%

WHY DO YOU DIRECT TRACE?

It allows us to more accurately measure standalone business unit or cost center performance separately	79%
It allows us to capitalize portions of our stock compensation expense	18%
It simplifies recharging procedures	13%
It helps us make future award design or awards allocation decisions	14%

EM Comment:
Small trend toward more granular booking (business unit / cost center level) among firms with an analytics strength

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

M&A, one-off deals with executives, and efforts to restore broken incentives all give rise to award MODIFICATIONS. Be ready: the accounting is tricky and there's often not much time to prepare.

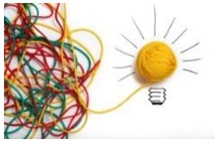
- 86% of our survey respondents reported at least one modification
- But of the 18 different varieties of modifications, very few reported having more than 3
- Implication: prior experience may not prepare you for what lies ahead!
- Check out Equity Methods' white paper on modification accounting (available on request)

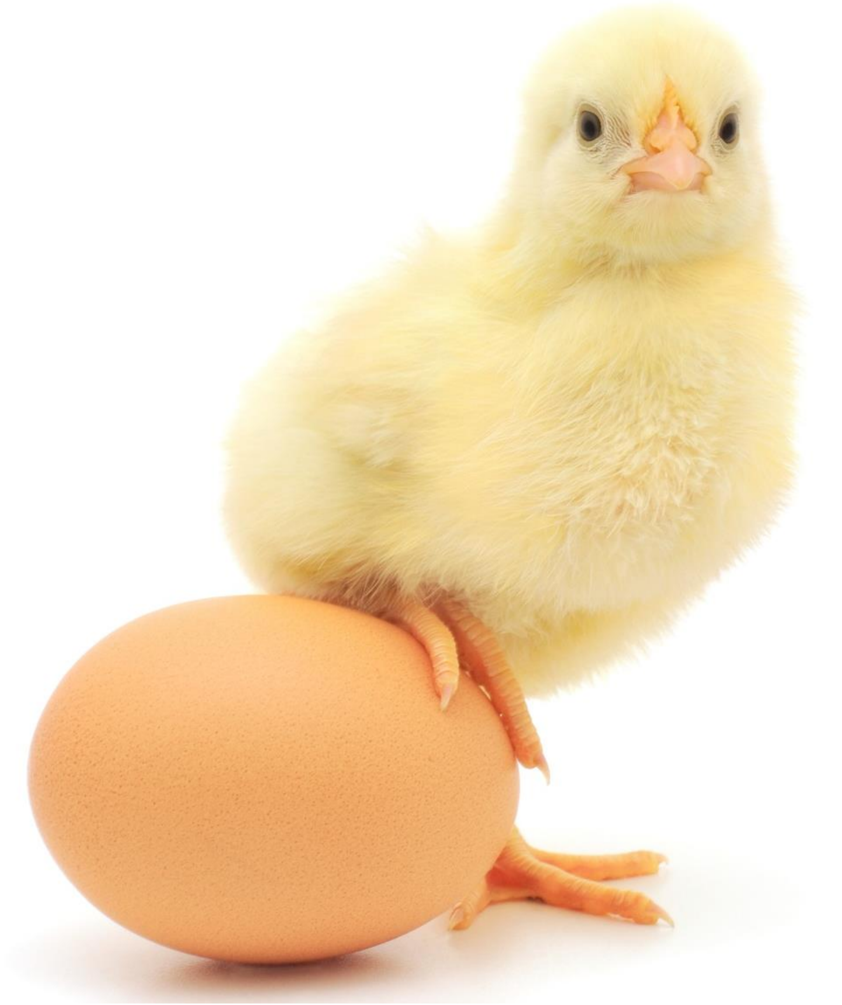
#	Modification Type	%
1	Increasing performance targets	8%
2	Decreasing performance targets	5%
3	Modifying market conditions	5%
4	Changing performance conditions to market	8%
5	Changing market conditions to performance	5%
6	Extending the post-termination exercise window	12%
7	Allowing vesting to continue post-termination	30%
8	Accelerating vesting	59%
9	Cancellation without consideration	3%

#	Modification Type	%
10	Assuming awards in an acquisition	14%
11	Award conversion during a spinout	5%
12	Employee becoming a consultant	8%
13	Option exchange / repricing	5%
14	Incorporating retirement-eligibility provisions	10%
15	Incorporating clawback provisions	5%
16	Incorporating antidilution provisions	0%
17	Changing classification from liability to equity	3%
18	Changing classification from equity to liability	5%

Wrap-Up

Correlation or Causation? Does it Matter?



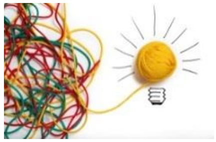


Organizations with a strength in analytics and strong upward reporting to senior management and the Board, on average, outperform in the market.

	% with Analytics Strength	% with Strong Upward Reporting
Top 5-year return quartile	39%	64%
Bottom 5-year return quartile	23%	13%

In the end, we don't really care whether a strength in analytics and strong upward reporting *cause* stock outperformance. What we've found is that these organizational qualities are worthwhile in and of themselves.

What We Learned About 'Best-In-Class'



What we initially thought	What we actually learned
▪ Efficiency ▪ Minimal resources ▪ 1-day reporting cycles ▪ Controls/automation	▪ IMPACT ▪ Broad internal reach ▪ Heavily relied upon ▪ Controls/automation <u>and</u> flexibility

<u>What it looks like:</u>

- *The quiet life…*
- *Out of sight, out of mind*
- *Finance – a "well-respected support center"*

<u>What it looks like:</u>

- *Constant improvement – processes AND capabilities*
- *High internal collaboration*
- *Much reporting consumed by many internal parties*
- *Finance – a "deeply-critical source of business insight"*

Questions and Speaker Information

Speaker Information

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Nathan O'Connor is Managing Director and Valuation Services Practice Leader at Equity Methods, an equity compensation valuation and financial reporting consultancy in Scottsdale, Arizona. He is also Adjunct Lecturer of Finance in the Eller College of Management at the University of Arizona. In his role as the national valuation practice leader, Nathan oversees all client delivery, operations, and R&D in support of valuation engagements with more than 200 public companies. Nathan also works closely with Equity Methods' Financial Reporting Group, and is responsible for formulating the firm's policy positions on all technical topics related to equity compensation valuation. Nathan is a nationally recognized speaker at industry events and frequently leads instructional webinars on industry best practices and recent trends in equity compensation valuation. As an expert in the valuation of equity compensation instruments, he has directly consulted senior executives at several Fortune 50 companies and more than 100 public companies of all sizes on the compliance requirements of ASC Topic 718. Prior to joining Equity Methods, Nathan trained in the doctoral program in finance at the University of Arizona, where he actively participated in consulting and research projects. He previously served on the boards of the Las Vegas and Phoenix Chapters of the NASPP.

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Collin McClellan, Valuation Consultant, brings a distinct background in finance and economics to the Equity Methods Valuation Services Group. Collin leads equity compensation valuation engagements for the firm's clients and assists other consultants on custom valuation engagements related to ASC 718 compliance. He utilizes his broad understanding of finance and economics to address the unique compensation challenges faced by his clients. Collin began his career at Wells Fargo Bank where he developed technical skills and worked to expand the business of the bank. Prior to joining Equity Methods, Collin completed an M.S. in International Business from the University of Economics in Prague, Czech Republic and an M.S. in International Management from the University Jean Moulin III in Lyon, France. While in Europe, he collaborated with international finance professionals in research and academic competitions in the areas of investment banking, retail banking, and investment solutions. Collin also holds a B.S. in Finance from Arizona State University, where he was an active member of the Sigma Phi Lambda Honors Fraternity. He is a SAS Certified Base Programmer and is working toward obtaining the Advanced Programmer Certification.