A Plethora of Performance Plans

Performance plans have been getting attention ever since Topic 718 (nee 123R) "leveled the playing field" for their accounting treatment starting in 2006. However, it seems that SOSers can't pick up the phone these days without getting another question about performance plans. How do they work? How do you enter them into my software? How do you account for them?

This article will review some of the basics of performance shares and will also delve a little into some of the "more unique" features of and questions about these plans we've been seeing of late.

(This article, to avoid becoming a book, will focus on restricted stock and restricted stock units with performance criteria, which are currently the most common type of performance vehicle for US-based corporations. If you're interested in performance stock options, drop us a line, we're happy to answer questions or write a follow-up article.)

Where and why we started...accounting...

While I promised my editor not to make this yet another article on accounting, we can't really talk about performance shares without a little accounting review. As alluded to above, Topic 718 removed the unpredictable variable accounting treatment for performance awards that had long made them anathema to CFOs and comp committees around the country. Performance grants are now valued on grant date, much like employee stock options, restricted stock and RSU grants, which makes the expense much more predictable (sometimes absolutely fixed) and therefore much more palatable and now popular. (Though I'd argue the playing field is still not quite "level", for performance-based awards but we'll get to that shortly.)

However, there is one significant difference the way you accrue for these grants remains, nearly regardless of the type of goal: accrual is generally done tranche-by-tranche (sometimes called FIN 28 or accelerated accrual). If you have two vesting tranches one with a one-year service period and one with a two-year service period, you start accruing for both tranches on the grant date and accrue over one year for the first tranche and two years for the second tranche, which means that the majority of the expense for the grant is recognized in the first year. Straight-line accrual is not a choice as it is with other types of vehicles. Though, as with everything about performance grants, there are exceptions to this rule, some of which we will discuss later.

Two main "types": Market-based and Not...

While there are limitless variations on the theme of performance awards, there are two basic types of metrics (or "goals") associated with these grants that classify these awards for accounting purposes. The first type is a market-based metric; basically any metric reliant on share price, including TSR and/or relative TSR goals. The second type is a performance-based metric which is the catch-all for almost any goal not related to or dependent on share price, including revenue, EBITDA, EPS, etc.

Market-based awards are valued using a complicated option-pricing model, such as a Monte Carlo simulation. Generally outside valuation consultants are engaged to build these models based on the specific attributes of the awards. The good news is that once the valuation is complete, the work is done. No adjustments are made to expense from that point on. The expense is accrued over the service period. (Service periods can be a complicated topic for performance awards as well, but I will not delve into them here.) Even if the goal is never achieved, the expense is not reversed. The probability that the goal will not be achieved is "baked into" the valuation model, so the grant-date fair value already reflects the possibility of forfeiture due to targets being missed. Some companies have balked at this treatment. "You mean we have to expense it even if the employee gets no benefit?" But we at SOS are quick to point out the similarities to a regular employee stock option. Seen any options expire underwater lately? Same thing...keep the expense, no employee benefit realized...Terry Adamson of Radford Valuation Services says "I call this the 'glass is half-empty' argument, but note that the 'glass is half-full argument' says that even if we outperform and pay out at greater than target (i.e. 200%), then no additional expense accruals are necessary. Ultimately, it creates very fixed and level expense."

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Performance-based awards are valued using the market value on the grant date, just like regular restricted stock and restricted stock units. Nice and simple, right? Not so fast! each quarter you accrue based on the probable payout at that time. So if you originally estimated that you'd pay out 200% of the base shares, let's say 20,000 shares, you'd accrue for 20,000 shares for the first few quarters. Then something goes terribly wrong and beginning in the 1st quarter of the grant's two-year life, you believe that no shares will be paid out, you'd reverse all the expense previously booked for the award and stop booking expense until your expectations change. The reverse is also true. You might start out booking expense for 10,000 shares and suddenly your employees begin to knock the proverbial ball out of the proverbial park and you're now headed for 200% payout. You'd perform a cumulative catch-up for the new estimate in the quarter in which the estimated payout changes. This is where I argue that the unpredictability of performance shares is not truly gone, therefore the playing field is still slightly slanted. However, the silver lining is that you do know, at the outset, the maximum amount of expense that will be required. I'm sure that helps your CFO get to sleep at night. Okay, I'm done with accounting, I promise... Okay, I'm done with accounting, I promise...

On to some of the types of designs we've seen:

Shades of gray

Many of the plans we have seen have multiple payout points, meaning that depending on to what extent the target is met, the awards will pay out more, or fewer shares. So if the goal were to achieve EPS of $4 per shares, if goal were partially met, perhaps EPS of $3.50 per share, the award would still pay out a pre-determined amount, as long as a minimum threshold is met. A very simplified design might look something like this:

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

If the goal is performance-based, this type of award must be reassessed each quarter to determine the probable payout so that accruals can be performed appropriately.

All your eggs in one basket

However, some plans we've seen of late have an "all or nothing" design. The payout is 0% or 100%. If the goal is achieved, total shares are paid, if not, no shares are paid. While these are easier to administer on some levels, Terry points out "In my opinion, this is hard to rationalize as cliff payouts create risk, and incents to manipulate numbers or focus on short-term goals rather than long-term goals." But Brett Harsen, of Radford Consulting, counters: "One rationale for these kinds of plans is that the metric used may lend itself to a single cliff-vest event. For example, you often see 100% '"on/off' switches in plans using product milestones. For example - the first time 1,000 units ship you vest... If you don't do it by X date they expire. Another reason is that it simplifies admin and communication of the plan. Finally, some companies may have trouble setting reasonable goals and simply can't graduate a payout curve any further."

Multiple Tranches

While many performance shares do have cliff vesting at the end of one, two, or three years associated with a single target, more and more awards these days seem to have multiple vest tranches and a different goal associated with each. The first tranche has a one-year goal, the second a two-year goal and so on. The design advantage year is facilitating earlier payouts, more like options or RSUs, while providing short- and long-term motivation. However, as Brett points out: "The more graduated the awards are, the more difficult design and goal setting (as you have to set more goals) and it makes the plan more complex to administer and explain to participants."

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

Just recently we ran across a performance share plan that would vest, in part, whether or not even a minimum threshold goal was achieved. The idea was to combine the best parts of an RSU (always-in-the-money, guaranteed payout, employee retention) with the shareholder-friendly aspects of a performance award. However, the wrinkle here is that the guaranteed part of these grants will not be considered performance-based for the purposes of exclusion from the $1M cap on tax deductibility under 162(m). For the large chip company in question, that apparently wasn't a concern. However, for others it is likely to be a bigger issue. Keep in mind that this is only a concern for profitable companies and only for their NEOs.

What's in a name?

One of my personal pet peeves about performance shares are the crazy, creative, crafty names that companies have a way of coming up with OSUs are a recent favorite standing for "Outperformance Share Units", or MSUs for Market Stock Units, or PBRSUs for Performance-based Restricted Stock Units or simply PA's for Performance Awards or PU's for Performance Units. But really, coining and using your own terms for these sorts of grants is likely to cause more confusion than anything else. What are they? How do they work? Which tax treatment do they receive? If you use one of the more "industry-standard" terms such as PSA or PSU, those questions can be easily answered, for both your shareholders and your participants.

2nd Chance Shares

At least a couple of plans we've seen recently included a feature that allows shares to be earned even after the initial service period is over. For example the first tranche has a one-year target and service period, but even if the goal was not achieved within the one-year period, the employees could still earn the shares as long as the goal was achieved before the grant expired three years after the grant date. This type of design has the advantage of continuing to motivate employees even after an initial target is missed and is relatively simple to administer and account for. The expense can still be accrued over the one-year service period unless there is no likelihood of attaining the goal over that period. And administratively you would simply not release the shares until the goal is achieved. Some softwares and systems will now support this type of design with relative ease. We've seen this referred to as a "clawback" or "catch up" provision, but we have coined the term 2nd Second Chance Shares for this feature, which we think expresses the design more effectively.

Brett says out that most of the plans he's seen with these designs give you a chance to recoup only a portion of the original shares if the original target date is not met, though that is not consistent with what I've seen of late.

Time after time...

Another twist we've encountered is the application of time-based vesting being layered on top of the performance goal. The target is achieved within a year but the employee must remain employed for an additional year or two in order to finally earn the shares. Terry explains that "With multiple vesting criteria that all are required to be achieved ("and" conditions), then the requisite service period represents the longer of the explicit service period, the derived service period, and the implicit service period."

Keeping to the straight-and narrow

As I mentioned above, generally these plans are accounted for using FIN 28 or "accelerated" accrual. The exception to this rule applies when the setting of the goal cannot be completed until a subsequent tranche has vested. In that case the "service inception" date of the subsequent tranche cannot begin until the previous service period is complete. For example, goals for certain internal performance metrics (i.e. EPS or other) are easier to set after each prior year when you have more knowledge about the prior year performance. Therefore you end up with a version of straight-line accrual rather than the accelerated approach. However, many systems cannot support this approach for performance awards. There are workarounds to attain this end, but these awards are definitely trickier to administer for the present.

Beware of Good Leavers

Watch out for designs that pay out shares to terminating or retiring employees despite the fact that the performance goal was not or will not be achieved. Not only are you giving a better deal to employees that are leaving than to those remaining on board, but these types of provisions also cause issues under 162(m).

Relatives are fun...Relative goals that is...

Relative goals seem to be on the uptake as well and they make a lot of sense to many of us. If the market is down but your company is outperforming its peers, shouldn't your employees still be rewarded? And if your company's market value is up, but that's not due to any excellence on your part but simply because every company's stock is gaining due to some new wave of irrational exuberance, should the employees profit from that? Relative goals put all this in perspective.

"There are not many relative plans based on operational metrics. They are almost always based on TSR/stock price. Further, Relative TSR is infinitely transparent to shareholders and plan participants alike. They remove subjectivity in determining performance against plan because they are formulaic. If you use revenue on the other hand, the Board often has to make subjective calls about removing extraordinary items or how to adjust for a spin or M&A." says Brett.

Choosing your peer companies can be the trickiest part of these relative plans. And do be sure that the plan delineates what should happen if a peer no longer exists at the end of the performance period, either due to an acquisition or a bankruptcy.

Shareholder Watchdog Groups

Per Brett, shareholder watchdog groups are now starting to push companies to use only GAAP numbers in their PSU targets. This way they can "double check" the numbers versus payout.

Removing the subjectivity noted above makes the payout determination process less of a black box.

Administrative Suggestions and Solutions

The administration of performance plans, as you may have sensed, is generally more challenging than the plain vanilla options and RSUs which the equity compensation world is now used to. But with a few tricks up your sleeve you can make even the oddest performance plans manageable.

1. **Upgrade your software**
   We're not suggesting that you switch systems or change vendors, but if you are working with an older version of your in-house software, contemplate an upgrade. Many of the softwares have been or are being enhanced to handle performance shares much more effectively and these enhancements are worth their weight in gold. Getting your data out of spreadsheets and into a database is likely to make everyone's life better, even if some workarounds are still required to perfect the tracking of the grants.
2. **Keep an eye on your plan balances**
   If you're working with a system that doesn't track "granted" and "maximum" payout amounts separately, keep a close eye on plan balances. Before every new grant of any type is made, be sure to run a plan balance report, calculate the number of performance shares that would pay out if the maximum payout was achieved. Communicate with a summary of this information to management and HR on a regular basis and be sure that they acknowledge receipt and understanding. The last thing you need is to run out of plan shares because a performance target was unexpectedly met and you have the unenvied role of letting management know. Guess where the blame is likely to fall? Not on those that designed the 200% payout plan...
3. **Continue vesting during leaves of absence**
   If you have any influence in the design of the plan, suggest that for performance shares vesting not be suspended for leaves of absence. Administratively this can be challenging to track and get right and it's also very difficult to communicate to your participants.
4. **Countdown to assessment**
   If you have performance-based shares, as the end of each quarter draws near, start communicating with the person/people that will be responsible for the assessment of "probability" of the attainment of goals early. Quarter end is hectic for everyone and you want to make sure you've made the assessment requirement visible to your team as early as possible so that it's not a last-minute rush to get the assessment completed.
5. **Document measurement steps**
   Be sure to carefully document exactly how the goal will the measured, if you plan doesn't already do this for you. Some companies have run into issues with goals because different groups were "counting" the goal differently - using non-GAAP measures to assess revenue for example. If the metric is financial, make sure that your finance group is involved in the documentation of the measurement process.
6. **Set goals at time of grant (courtesy of Barbara Baksa, Executive Director of the NASPP)**
   If the awards are granted but the terms are not specifically defined until sometime later,

you won't have "a grant date" for accounting purposes and you'll need variable accounting until the specific terms of the grant are set.

I set out to write a short article on some of the types of performance designs we're seeing in the industry today. Unfortunately "short" is not a goal I attained, perhaps I should forfeit our performance shares payout for this article. If you have questions on performance awards, their design, taxation, accounting consequences or really anything else, feel free to drop me a line. I'm always happy to hear from our readers.

Thanks to Terry Adamson and Brett Harsen, both of Radford Consulting, for their review of and significant contributions to this article.

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