

Design

Second Chance Shares- Is there any data to support the assertion made that this is becoming more common?

We have only anecdotal data on this point, no survey data. When we first heard of this sort of design several years ago, we thought it was highly unusual. However, just in the last 6 months or so we've encountered around 5 - 7 companies that did have this sort of design.

For purposes of this presentation, the term "Performance shares" is being used to describe grants in which the attainment of the goal determines if the shares are earned, not originally granted, correct?

Correct. The type of performance shares that we are discussing in this webinar are shares that are variable payout based on the attainment of performance goals.

Another type of performance grant is one which is granted *if* a certain performance target is achieved. Our understanding is that this sort of "performance-conditioned grant" requires variable accounting from the time that the "understanding is reached" or "the promise is made" up until the time the grant is actually made, at which point the fair value can be determined. We have not seen as many of these types of grants probably because of that negative and unpredictable accounting expense.

On prorating... is the practice to payout the prorated portion at termination or to measure at the original measurement date and pay the prorated portion at that time (which is after termination)?

Our anecdotal experience is that it is more common to prorate the shares at termination (change the "baseline number" from 100 to 50 shares, let's say), but then to wait until the measurement date to apply a percentage "mark up" or "mark down" to the shares and perform payout. So if you had an 80% payout, you would receive 40 shares (50 x 80%) instead of 80 shares from the original 100. And if you had a 120% payout, you would receive 60 shares instead of 120.

And now, with the new [Rev Ruling 2008-13 on 162\(m\)](#), prorating and paying out at the time of termination might make the performance award subject to the \$1 million cap on the deductibility of compensation expense. (In general, performance grants are exempt from the cap as long as certain requirements are met.)

We have encountered one issuing firm that did prorate and payout at termination. However, they have since eliminated this clause for reasons of fairness. (The terminating participant ended up getting more shares than those that stayed on.)

Share Ownership Guidelines

From your experience, do you have any clarity on whether companies count PSUs in the calculations under Share Ownership Guidelines?

Our anecdotal experience is that RSUs and PSUs are often not included in ownership guidelines because they are not “real stock”. We have pulled some data from the NASPP survey, below, that seems to contradict that experience for RSUs, but support it for PSUs.

Per the NASPP Survey Data (available here:

<http://www.naspp.com/members/StockPlanSurveys/survey07.pdf>, see page 99), most companies do not count unvested performance shares (of any type) toward the ownership guidelines:

Instrument	Offered and Does Not Count Toward Guideline	Offered and Does Count Toward Guideline
Unvested restricted stock	24%	53%
Unvested phantom stock/restricted stock units	23%	40%
Vested phantom stock/deferred stock units	4%	38%
Unvested performance shares	35%	21%

Proxy Disclosure

Don't the proxy disclosure rules require a description of the goals unless any sharing of the information would compromise proprietary business practice?

Yes. They do, however, some companies, after asserting that sharing the information *would* compromise proprietary information, have gotten push back from the SEC to disclose the information anyway. See the follow article on the NASPP website

(http://www.naspp.com/members/memos/Cleary/09_07_SEC.pdf) from which this quote is taken:

While compensation disclosure has improved with additional detail and analysis, it has been notably less robust in the high profile area of performance targets. While some companies did disclose performance targets in the 2007 proxy season, roughly half of large issuers did not provide disclosure about specific performance target levels. One review of SEC comment letters states that all but one of 23 large companies were asked to provide disclosure and analysis concerning the quantitative and qualitative aspects of performance goals. These statistics suggest that a significant portion of large companies had substantial doubts or concerns about disclosure of performance targets. Some companies may have considered that the disclosure could reveal to competitors information about fine-grained and highly specific internal measures of results, even if it would not demonstrably cause competitive harm and be eligible for confidential treatment under SEC rules. Others may have been concerned about the potential for investor confusion if “target” results for compensation purposes were inconsistent with routine guidance that they provide about their results.

Accounting

Why is accelerated expense required for "most" performance grants?

Paragraph A67 of FAS 123(R) states (in part): “However, each tranche of 10,000 share options *should be accounted for as a separate award with its own service inception date, grant-date fair value, and 1-year requisite service period, because the arrangement specifies for each tranche an independent performance condition for a stated period of service.*” [Emphasis added]

The exception to this rule is if the attainment of a second or third goal is dependent on the attainment of a prior goal (e.g. a cumulative target of 20% increase in operating income, year after year for three years in three tranches with three independent payouts. See the article by Takis Makridis on the NASPP website for more information: <http://www.naspp.com/members/dlib/files/N681.PDF>

FAS123R states that amortization can be either straight-line or accelerated, but the elected option should be consistent. Does straight lining expense for time based options and using the accelerated method for performance awards violate this provision?

No. Our understanding is that you can still use straight-line attribution for options and restricted stock and/or units, even though you are required to use an “accelerated” attribution for performance-based (or market-based) grants.

If market based awards are settled with cash (but are equity-based and accordingly are recognized as a liability under FAS123R) how would the liability get off the books if the market condition is not met?

From Jon Burg, of JPMorgan Compensation and Benefits Strategies:

A cash-settled, market-based PSU is classified as a liability. We run a Monte Carlo simulation valuation at each reporting period, reflecting the new economic conditions. The final expense will equal cash payout, so it would be fully reversed if \$0 payout. We made an argument that it could be accounted for using intrinsic value as opposed to running a full Monte Carlo simulation since it would ultimately be trued up at the end of the performance period. One audit firm allowed it for a year, but then pushed back on us and we have been doing Monte Carlo valuation each quarter since.

On RSA's is it uncommon to have both a time based 3 year period and for company insiders an additional 3 year cumulative earnings target performance goal. Since the performance goal is cumulative over the whole three year period, the same service period as the time based awards, are we correct in using straight-line expense amortization?

In our experience that is a fairly common design and yes, the type of grant you describe, wherein there really is only one goal, and one payout, albeit over a three-year period and with cumulative targets based on company performances, is accrued for using the straight-line method.

Taxation

How are 83-b elections applied to awards where the number of shares cannot be determined until the end of the performance period?

Great question! My colleague, Andrew Schwartz, CEP and CPA for BNY Mellon Shareowner Services took a look at the code and the regulations and couldn't find anything to prohibit it. Our assumption is that since you file an 83(b) for a specified number of shares, if you were to receive more shares, the election would not apply to those additional shares (and in fact, if those shares weren't issued at the time of grant, but later at the time of measurement, you would likely have a difficult argument to make that they truly fell under Section 83). For PSAs it seems you would have to issue the maximum possible number of shares at the time of grant and then "retrieve" them if the maximum goal was not met.

And, if you were to receive fewer shares, you would forfeit the taxes paid on those shares (just as with a regular 83(b) on Restricted Stock).

And the disadvantages of filing an 83(b) on restricted stock (chance that you will not meet the service requirement or that the stock price will decrease) are compounded when you are dealing with a performance grant – you have another opportunity to forfeit the shares if the target is not achieved.

Does paying dividends on performance awards have some of the same international implications as paying dividends on RSUs (i.e. in some countries paying dividends moves taxation to grant)?

Yes, our understanding is that the treatment is the same. So if you are paying dividends on unvested RSU (or PSUs), in some countries this will accelerated the taxable event from vest to grant because the participant is "receiving the value" of the actual shares which makes them more than a "promise of future shares".

Measurement

Who is responsible for tracking the performance criteria?

In our experience, since these are most often financial metrics, it is typically the finance group in conjunction with the CFO who makes the call each quarter about the "probable payout". At the end of the performance period, generally the compensation committee will "certify" the results and determine the appropriate payout. Certification via the compensation committee triggers the measurement and payout.

General

Why do you say RSUs are a lot easier administratively than RSAs?

RSUs tend to give you (most of) the same advantages as RSAs, but are generally a little more "flexible" and allow you to design your plans without "the restriction" of the fact that these are issued and outstanding shares.

RSAs are issued “to the participant” at the time of grant but are “kept in escrow” (usually just a restricted Transfer Agent account) until they vest, at which time the restrictions are removed. Therefore since they are considered property for tax purposes, they fall under Section 83 of the IRC.

Some administrative challenges you’ll find on RSAs(that are generally absent from RSUs) include:

1. The actual issuance of the shares at the time of grant – moving the shares into the restricted account, but treating them the same, but differently as other outstanding shares.
2. If the issuing company pays dividends, dividends are generally paid on RSAs (and often cash dividends at the time of the payable date). However, while the RSA shares are unvested, these cash dividends are NOT dividend income, but instead are ordinary income. They should not be included on the 1099-Div that your Transfer Agent sends out for all other outstanding shares, but should be included in W-2 income. We’ve encountered several situations where the taxation was not understood and the income was not being reported to the participant correctly. Many fewer companies pay dividends equivalents on RSUs than they do on RSAs since it is much easier to avoid doing so.
3. 83(b) elections are generally allowed on RSAs, but not on RSUs. Tracking and reporting, and communicating about 83(b) elections can be challenging. Some companies prohibit them on RSAs by adding language to their plan or agreement, but even that is an additional administrative challenge.
4. If the company has retirement acceleration (or continuation of vesting) in their plan, at the time the individual becomes retirement eligible (or at the time of grant if the individual is already eligible), the taxable event is deemed to have occurred. (There is no longer a “substantial risk of forfeiture”.) With an RSA, all the taxes are then due. With an RSU, only the FICA taxes are due. And FICA can be deferred until the end of the year, at which time many individuals will have met the maximum withholding threshold for Social Security, so only Medicare will remain to be collected.

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