

the battle of the high performers

Equity Vesting Alternatives that Make a Difference

Round One

From the time that widespread use of equity-based compensation first took off in the United States in the 1980s, most long-term incentive designs were dominated by accounting considerations, rather than issues particular to a company's unique strategy or culture. Stock options were by far the preferred equity vehicle, since unlike grants of full-value shares, they generated no cost to the bottom line, with time-vested restricted stock a distant second. Few companies even considered the use of performance-linked long-term incentive designs, which resulted in an accounting charge that could otherwise

be avoided. Under APB 25, such performance-contingent awards also were subject to accounting charge volatility on a quarterly basis—and CFOs, as a general rule, are not enamored of plans that generate lumpy charges to earnings.

Round Two

The equity environment has changed profoundly in the past five years, triggered by the dot.com implosion, corporate financial scandals and, most recently, allegations related to opportunistic timing and pricing of stock option grants. In addition to these market events, the implementation of SFAS 123(R) in 2005 effectively leveled the playing field for equity vehicles from an accounting standpoint. By instituting a charge to earnings for stock options and eliminating the concept of "variable" accounting for most equity grants, the Financial Accounting Standards Board (FASB) offered companies the freedom and flexibility to make equity choices based on more than just cost, in theory making it more viable to incorporate performance-based considera-

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QUICK LOOK

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- ➔ In some situations, performance-vested stock options may result in an inverse relationship between pay and performance from the participant's point of view.
- ➔ The purpose of adding achievement metrics to an equity grant is to put more performance focus in the grant.



tions into equity awards.

Yet three years later, corporate equity use continues to be characterized by the same two traditional vehicles—time-vested stock options and time-vested restricted stock. Why are companies continuing to shy away from performance-vested equity designs?

Part of the reason is that for employees and boards, stock options are a familiar and easily understood means of incorporating equity into compensation programs and providing linkage to shareholders' interests. In contrast, time-vested restricted stock has generally been viewed as a vehicle with strong retention value, but one that comes up woefully short in linking value delivered to performance. But do these assumptions still hold when performance vesting enters the picture? Let's take a fresh look at a few issues to understand the financial and motivational implications of granting equity with performance requirements.

The Sparring Begins

To best understand the characteristics of equity awards with performance-vesting, let's examine several design considerations and contrast them with their time-vested brethren. Consider the following:

Are Performance-Vested Equity Vehicles Too Performance Oriented?

Possibly, depending on the design of the program. Performance-vested stock options tend to be highly performance oriented, since participants must overcome two separate hurdles before a grant will deliver any value. For example, assume a grant of stock options will vest on the last day of a three-year performance period if the company hits a specified financial goal during that period. For the option grant to be worth anything, not only must the stock price increase over the exercise price, but the company

also must meet the stated performance goals for the grant to even vest.

In some situations, performance-vested stock options may result in an inverse relationship between pay and performance from the participant's point of view: performance, but no pay. For example, if a company met the financial performance goals required for the grant to vest, but there was no appreciable increase in the stock price, the executive would end up holding an option with little or no value on the day it vests, resulting in no reward even though the financial performance goals were met. The executive's only hope would be to hold onto the option and exercise it later in the option term in the hope that the stock price increases before the option expires. Although stock price generally increases with stronger financial performance, there is no guarantee.

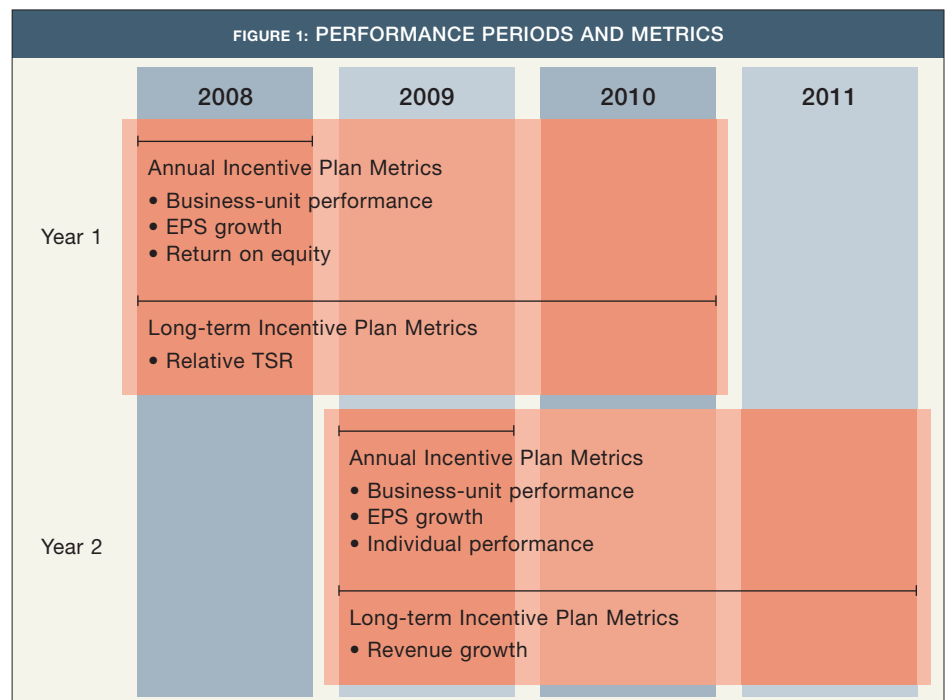
In contrast, restricted stock may be a more appropriate equity vehicle for incorporating performance-vesting conditions, because the grant will retain value even if the stock price is stagnant or declines. Of course, because restricted stock doesn't offer the same leverage as options, generally fewer

shares are needed to deliver the same value as an option award. However, a performance-vested restricted stock grant combined with a time-vested option grant might capture the best of both worlds, without making the equity program overly complicated.

Is Incentive Plan Metric Selection a Nightmare?

Not necessarily. Performance vesting is a means for companies to reward executives for meeting goals that support the business plan. A simple example would be an organization that has three goals in its annual incentive plan, of which one goal is built into a performance-vested equity grant. On the surface, this approach seems simple enough and may work well. But it will be more likely to prove effective if the company also ensures that the goal or goals used under the long-term incentive plan complement those in the annual incentive plan. Figure 1 illustrates this point.

In year one, the company has three annual and one long-term incentive plan metrics (four metrics in total). In year two, the company changes two of the four metrics—one in the annual plan



and one in the long-term plan. As a result, the performance focus of the incentive plans becomes less clear. In year two in Figure 1, the participants now have five metrics, since the year one long-term incentive plan performance period is still in force. This approach is not likely to be a major issue for organizations in a relatively stable industry, where strategies are likely to be more long-term and business measures more consistent from year to year. But performance-vested long-term equity vehicles may not be a good choice for companies in an acquisition or divestiture mode, or in a cyclical business, which needs a flexible business strategy and the ability to change performance targets as the company's business needs evolve. For such companies, time-vested equity may be a better fit.

How Should Performance-Vested Equity Grants Be Sized?

When replacing stock options with restricted stock, many have argued that the value of a time-vested restricted stock grant should be reduced by 15 percent to 25 percent of the option value on the grounds that restricted stock has a known value at the grant date, while options have only a theoretical Black-Scholes value at grant. Furthermore, the restricted stock grant retains significant value even if the stock price stays flat or even decreases over the vesting period.

This line of reasoning muddies the waters. It can equally be argued that since a performance-vested equity grant has less inherent value than its time-vested cousin, the value of the performance-based grant should be increased to make the executive whole. While it is possible to conduct an analysis of the appropriate conversion rate between a time-vested and performance-vested equity vehicle, it is neither necessary nor desirable. The purpose of

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adding achievement metrics to an equity grant is to put more performance teeth in the grant. It would defeat the purpose of incorporating a performance hurdle to boost the value of the grant to compensate for the greater risk of forfeiture.

How Will it Look in the Proxy?

The Securities and Exchange Commission's (SEC) new proxy-disclosure requirements were adopted to give shareholders a clearer and more complete picture of the amount and structure of total compensation delivered to the company's top-paid executives. In one sense, the new reporting mandates would seem to favor those companies that adopt performance-vested equity programs, because they include a requirement to explain to investors how an executive compensation program is structured to support a strong pay-for-performance orientation. However, the way in which the value of performance-vested equity plans is reported under the new rules may obliterate that advantage.

















The SEC requires that the disclosure

of the timing and valuation of equity compensation parallel the company's accounting expense under SFAS 123(R). Instead of the full value of equity granted to an executive in a given fiscal year being shown in the Summary Compensation Table, only the portion of the grant that is attributable to that year for expense purposes is shown. Consequently, the "total" pay reported in the table is not the amount granted to the executive in a particular fiscal year, nor is it what a consultant would view as total pay in a fiscal year. Why is this important? Current year compensation costs as shown in the Summary Compensation Table may also reflect the value of multiple awards made in previous years. That means that reported "total" compensation could actually *increase* in a year that a company missed the targets in its performance-vested program, because the value of prior equity grants is included. Companies can address the apparent discrepancy in the disclosure by referencing the full value of long-term incentives granted that year in the

FIGURE 2: KEY ACCOUNTING CHARACTERISTICS OF PERFORMANCE-VESTED OPTIONS AND RESTRICTED STOCK

Provision	Performance Condition	Market Condition	Service Condition
Determination of cost	Fair value	Fair value adjusted for probability of achievement	Fair value
Allocation of cost	Over performance period	Over performance period	Over service period
Forfeiture of cost	Cost reversed if performance condition not met	Cost not reversed if market condition not met	Cost reversed if service condition not met

FIGURE 3: TALLYING THE SCORE

Consideration	Performance-Vested Equity	Time-vested Equity	Comments
Link to shareholder Interests			<p>With an appropriate vesting schedule, both can tie pay to long-term performance.</p> <ul style="list-style-type: none"> • Performance-contingent and performance-accelerated features can enhance the performance tie. • Time-vested equity can be a strong complement to a performance-vested grant.
Consistent with Market Trends			Although time-vested equity still dominates the market, performance-vested equity is becoming more prevalent.
Proxy Disclosure			Understanding the total amount of compensation granted to an executive with performance-vested grants can be difficult and confusing.
Pay and Performance Alignment			Performance-vested equity plans clearly offer the best means of aligning pay to performance, but also can raise the overall complexity of the program.
Retention			If it is clear the performance goals will not be met, performance-vested plans offer no retention value, while time-vested equity provides strong retention value.
Accounting			Accounting for performance-vested equity awards is potentially more confusing than for time-vested awards.
Industry/Economic Volatility			Time-vested awards can be more effective because performance-vested awards, which rely on accurately forecasting a company's long-term financial results, may give unintended results.
Approach to Sizing Award			Assuming there is no desire to adjust award values for the increased risk of performance vesting, this is a draw.
Total Effectiveness	21 gloves	30 gloves	

Scale:  = Worst  = Best

The accounting costs are **not reversed** if the goal is not met, which might appear to be **a strong incentive** to avoid using market performance as the hurdle.

Grants of Plan Based Awards table. But this approach assumes a close regulatory understanding of how pay is calculated for reporting purposes and may entail additional analysis to understand the real relationship between pay and performance, which the average investor may not bring to the table.

If the equity grant uses stock price appreciation as a performance goal (which SFAS 123(R) considers a “market condition”), the reporting results may be even more confusing because compensation costs are not reversed if “market” condition goals are missed. In that case, a company will end up reporting the same total pay amount for an executive, regardless of whether the performance goals were met or missed.

More Complicated Accounting, But is it More Favorable?

Under some circumstances, yes. SFAS 123(R) describes three conditions under which equity awards vest:

- **Service condition:** An employee must render services through a stated period (traditional time-based vesting.)
- **Performance condition:** A performance goal must be met within a prescribed period of time (e.g., hitting a revenue


or profit target within three years.)

- **Market condition:** The company’s stock must hit an absolute or relative target within a prescribed period of time (e.g., the stock price must exceed the median of the peer group in three years).

The key accounting characteristics covering performance-vested options and restricted stock is summarized in Figure 2 on page 56.

Under performance and service conditions, the accounting cost for both types of vehicles is spread over the performance and/or service period, and costs are reversed if the goal/service requirements are not met. From a company and shareholder perspective, this makes sense: If the goal/service period is not met, no compensation is paid, and accounting costs are reversed.

Market conditions are a little more intriguing. The accounting costs are not reversed if the goal is not met, which might appear to be a strong incentive to avoid using market performance as the hurdle. But because the fair value of the grant also is adjusted for the probability of achievement, a market condition can be more attractive. For example, assume an option or restricted stock grant

with a performance condition has a fair value of \$100 spread over a four-year performance period, or \$25 per year. Contrast this to the same grant with a market condition that reduces the fair value to \$60. The market condition grant produces a \$15 annual charge. This may be more attractive than the \$25 annual charge, even though the charge cannot be reversed if the goal is missed. From a pure accounting point of view, an equity grant carrying a market condition can be as attractive as one carrying a performance or service condition, depending on the adjustment to fair value. From a shareholder perspective, market condition vesting requirements can be very appealing, since they align the interests of management with shareholders. Figure 3 on page 56 shows a summarized view of the options and rates each option using a scale of 1-5. 

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