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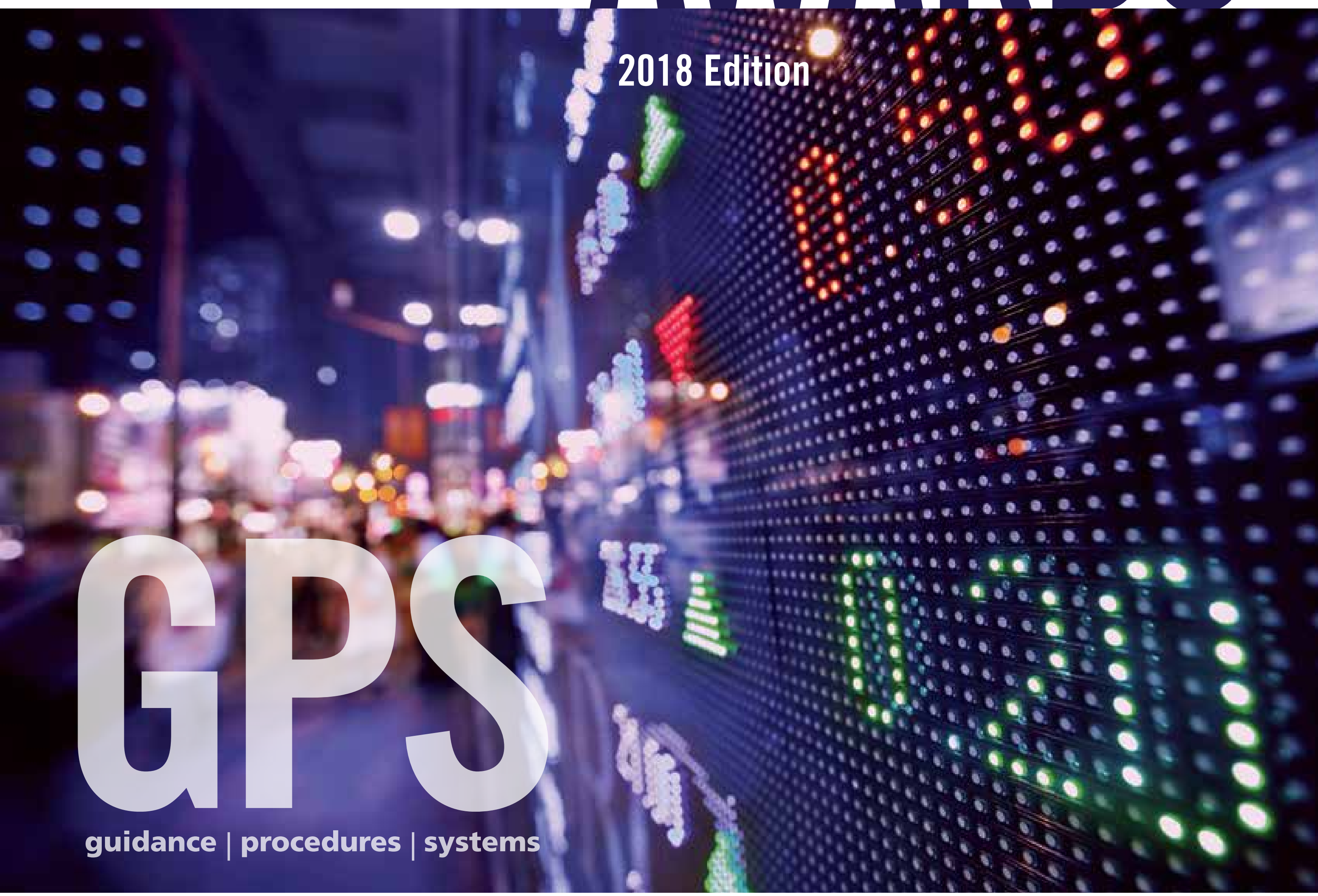
PERFORMANCE AWARDS



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Performance Awards

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Exhibits

Introduction.

1.1. Overview.

1.1.1. In the never-ending quest to identify the ideal compensation structure to retain and motivate employees, companies have long embraced equity compensation as a component of long-term incentive compensation. The term "equity compensation" covers a broad range of equity awards, including stock options, restricted stock, restricted stock units, employee stock purchase plans, stock appreciation rights, performance awards, and innumerable variations on these equity awards. Stock options were the long-favored tool for delivering equity compensation due to relative simplicity, beneficial cash flow for the issuing company, and, historically, little or no related compensation expense in the financial statements. The introduction of FAS 123R (now known as ASC Topic 718) coupled with growing concerns over dilution, burn rate, and pay for performance, gave rise to a marked increase in the use of restricted stock units and restricted stock, and, ultimately, the addition of performance goals to these awards. While performance awards have existed for decades, the combination of the following factors converged to create an increased use of performance awards as a supplement to time-based grants for executives.

- Accounting rule changes "leveled the playing field." The financial statement expense for performance awards had been unpredictable and often prohibitively expensive compared to stock options. Under ASC Topic 718, all types of equity awards result in an income statement expense.
- Stock options can deliver greater compensation in a bull market due to the larger number of options often granted. Even though a bull market has existed for the last several years, this latest rise was preceded by the market volatility of 2008 and 2009, when the use of performance awards increased. Restricted stock and restricted stock units, with or without performance goals, may better deliver compensation in a bear market, but performance awards can deliver great compensation regardless of the type of market environment.
- The ability to specify corporate, business unit, team, and/or individual objectives opens opportunities to strengthen the line of sight and resulting behavioral impact while responding to the continued evolution of corporate governance standards.
- In some cases, the use of restricted stock and units resulted in considerable compensation to executives at a time when shareholders had experienced significant losses. Certain proxy advisors that advocate for shareholder interests have since encouraged the use of performance awards to create better align pay for performance with shareholder interests.
- Increased market volatility has resulted in option grants where the grant date is a more important factor in the value of the award than the actual company performance. As a result, grant timing could be a more important factor than company performance in compensation outcomes, creating employee inequities.

Initially limited to top executives, companies are beginning to extend performance awards to broader groups of employees.

1.1.2. The increase in the use of performance awards has been accompanied by a proliferation of terminology, design concepts, plan features, and the associated administrative and communication challenges.

This publication addresses the unique issues associated with performance awards, particularly with respect to the administrative requirements and the necessary cross-functional support of Human Resources and Financial Reporting.

When managing an equity compensation program that includes performance awards, all parties must understand the unique aspects of the performance awards. The key parties responsible for this critical area include the professionals involved in the day-to-day administration of the equity plans, Finance, Human Resources, Payroll, and, where applicable, the third-party administrator and other third-party vendors. This publication addresses the unique issues associated with performance awards, particularly with respect to the administrative requirements and the necessary cross-functional support of Human Resources and Financial Reporting.

1.1.3. Any equity vehicle may have a performance goal attached and be construed as a "performance award." When attaching performance goals to any equity award, the underlying fundamentals of that award are largely unchanged. The most commonly used performance award is a performance stock unit – a full-value award defined in share units with a performance goal determining when, if, and/or how much of the contingent award will vest and be paid to the employee. The types of compensation arrangements that fall under the term "performance awards" can include any equity award (stock options, stock appreciation rights, restricted stock units, or restricted stock awards) with one or more explicit performance goals. These awards may be structured to grant upon the achievement of a specific goal, or the achievement of the goal may determine the amount and/or timing of compensation to be received.

1.1.4. Performance stock units and performance stock awards are full-value awards. The employee receives the full value of the underlying stock when the award is paid out. Performance stock units, which are restricted stock units with associated performance goals, are more common than performance stock awards, which are restricted stock awards with associated performance goals. Both ultimately deliver similar economic benefits. The mechanics of the delivery and taxation are substantially different, however, and performance stock units offer clear advantages in flexibility and administrative ease.

1.1.5. A performance stock option delivers the economic value of the appreciation in the underlying stock when the option is exercised. A performance stock option is treated in a similar manner as a performance stock unit and a performance stock award in terms of granting an award, tracking performance goals, and change of employment status. A performance stock option is treated differently at the vest date, for tax/payroll purposes, and in valuing the award for financial reporting purposes. These differences are highlighted in the appropriate paragraphs of this publication.

1.2. Scope of Publication.

1.2.1. Terminology associated with performance awards can vary widely. Care should be taken to understand the specifics of the underlying award, regardless of company-assigned terminology. For purposes of this publication, "performance awards" are restricted stock units, restricted stock awards, or stock options with attached performance goals. This publication is focused on awards granted to US employees of US-headquartered, publicly-traded companies and awards settled in stock. Cash-settled performance awards are outside the scope of this publication. Performance granted stock options, restricted stock awards (RSAs), and restricted stock units (RSUs) are treated the same as regular stock options, RSAs, and RSUs following grant and are not covered by this publication.

GLOBAL ISSUE

Performance awards have been a significant component of compensation for companies headquartered in the Europe and Australia. The taxation and regulatory considerations of performance awards may mirror that of the underlying vehicle (restricted stock units, restricted stock, or stock options.) In any particular jurisdiction, plan design features may be more or less favorable due to local law and practice. This publication contains some references to global issues and other types of performance awards. These references provide a high-level overview of some related key concepts and are not intended to be comprehensive as global issues are outside the scope of this publication.

1.2.2. For purposes of this publication, the following terminology will be used:

TERMINOLOGY	
Performance Award	A stock-settled performance stock unit, performance stock award, or performance stock option.
Performance Stock Unit (PSU)	A restricted stock unit with performance goals attached; A promise to award shares for no cost in the future contingent on achieving associated performance goals and meeting the requisite service period.
Performance Stock Award (PSA)	A restricted stock award with performance goals attached; Shares awarded at grant for no cost contingent upon achieving associated performance goals and meeting the requisite service period. When the performance goals and service period are met, shares are released to the employee.
Performance Stock Option (PSO)	A stock option granted with vesting or price contingent on achieving associated performance goals and service requirements.

A more extensive glossary of terms can be found in Appendix B.

1.2.3. Performance awards and associated processes can be varied and complex. This publication is not intended to cover every possible contingency. The processes described represent standard practice, but each company's processes may differ to reflect their unique needs and resources. These recommendations should be considered general guidelines and applied as appropriate.

1.2.4. Topics covered in this publication may need to be considered within the particular facts and circumstances of a company. For example, many of the financial reporting processes in this publication are specified as quarterly. Some companies may undertake these tasks on a monthly basis or on a different schedule. For those reasons, clarifications such as "typically" and "generally" are not always included, but should be assumed. Please consult your own professional advisors with respect to the application of the information in this publication to company-specific circumstances.

1.2.5. Previous publications specifically address issues of stock options, restricted stock, and restricted stock units without performance goals attached. Much of the guidance in those publications is applicable to performance awards. For a copy of those publications, or for information on future publications, visit www.scu.edu/business/cepi/.

1.3. Basics of Performance Awards.

1.3.1. The basic lifecycle of PSUs and PSAs is outlined in Exhibit 1-1 and of PSOs is outlined in Exhibit 1-2. As discussed in paragraphs 3.2.7 and 5.2.2, the determination of goals and the grant date are interrelated. In certain scenarios parts of the lifecycle may occur simultaneously.

1.3.2. Each element of performance award design, from the determination of performance goals to the performance period definition and the ultimate vesting determination, has potentially significant implications for the ultimate complexity and total cost of the award. The structure of the performance goals creates the greatest diversity of award design of any form of equity compensation.

1.4. Public Comment.

1.4.1. The CEPI invited individuals and organizations to send written comments on all matters in a draft version of this publication. All comments received were reviewed and incorporated as appropriate into this final document.

Note: Each paragraph is numbered and cross-referenced. The document should be used in its entirety. Users of one section will need to reference other sections for a comprehensive understanding.

EXHIBIT 1-1 – LIFECYCLE OF A PERFORMANCE AWARD – PSU or PSA

Performance goals determined ➡ Grant ➡ Performance period ends ➡ Performance is certified ➡ Service period ends ➡ Award vests ➡ Award paid out

EXHIBIT 1-2 – LIFECYCLE OF A PERFORMANCE AWARD - PSO

Performance goals determined ➡ Grant ➡ Performance period ends ➡ Performance is certified ➡ Service period ends ➡ Option vests and is exercisable ➡ Option exercised

This publication highlights the design decisions that impact the perception of corporate governance, financial reporting for the awards, the employees' understanding and perception of the benefit provided, and the cost of administering and communicating the plan.

Strategic Issues.

2.1. Overview.

2.1.1. Performance awards are frequently an important component of a total rewards package for employees. Much has been written about selecting the correct performance goals to align employee/shareholder interests and reward employee behavior. Less attention has been given to the financial reporting implications of performance awards or the processes that must be implemented to support these awards. This publication highlights the design decisions that impact the perception of corporate governance, financial reporting for the awards, the employees' understanding and perception of the benefit provided, and the cost of administering and communicating the plan. The key strategic issues are discussed in this section.

2.2. Selecting the Appropriate Equity Vehicle.

2.2.1. Selecting the appropriate equity vehicle to meet a company's needs is critical. Exhibit 2-1 identifies the most appropriate award(s) in certain circumstances. In many cases, other award types may be used, but would generate ancillary issues, including administrative complications, financial reporting issues, tax consequences, and employee communication challenges. In most cases a PSU offers advantages that are not available with a PSA.

2.3. Establishing the Vest Date.

2.3.1. The vest date is the date on which the employee has the unrestricted right to receive the underlying stock. When establishing the vest date many factors should be considered including:

- Adequate time to certify the performance results
- Tax consequences
- Impact on financial reporting
- Time required to process the award
- Trading restrictions

These issues are discussed in Section 3, Design; Section 6, Performance and Service Period; Section 7, Tax/Payroll Issues; Section 8, Legal Issues; and Section 10, Financial Reporting.

2.3.2. A change of employment status may occur before the vest date. The design should anticipate changes in status and address the impact of the change in status on the vest date and when the underlying shares are released to the employee. Implementing a design that provides for full or partial vesting where the underlying shares are released before the end of the performance period may result in unforeseen consequences. These issues are discussed in more detail in subsection 3.4 and paragraph 7.5.5.

EXHIBIT 2-1 – SELECTING THE APPROPRIATE PERFORMANCE AWARD

	Performance Stock Unit	Performance Stock Award	Performance Stock Option
Number of shares to be paid out varies with level of achievement of performance goals	●	●	●
Number of shares to be paid out is fixed, but vesting is accelerated on achievement of performance goals	●	●	●
Payout of award may be deferred	●		
Accelerate or continued vesting upon retirement may occur	●		●
Payment of dividend/dividend equivalent on unvested award	●	●	
Voting rights on unvested award		●	
Transfer agent involvement not required at time of grant	●		●
Vesting schedule or payout rate may be modified as a result of changes of employment status	●		●
Timing of taxation controlled by employee			●
Underlying shares are available when the shares are taxable for income tax purposes	●		●
Facilitates trading shares in an open window			●
Award may count toward stock ownership guidelines	●	●	
83(b) election permissible		●	

2.4. Treatment of Dividends.

2.4.1. Dividends or dividend equivalents may be paid on performance awards to allow the employee to receive the equivalent value of dividends during the vesting period. Dividends may be paid currently or deferred to a future date. Because performance awards may never vest, paying dividends currently may be inappropriate. In addition, the treatment of dividends should be addressed in the design even though the Company is not currently paying dividends. These issues are addressed in more detail in Section 3, Design, and Section 6, Performance and Service Period.

2.5. Implications of Design Decisions.

2.5.1. Performance awards vary greatly. Design decisions impact employee behavior, shareholder perception, financial reporting, proxy disclosure, employee communication, and administrative processes. Frequently minor adjustments to the design of a plan will have a dramatic impact on the financial reporting and administrative processes. Although administration and financial reporting do not determine appropriate design, design decisions should be made with a full understanding of the administrative and financial reporting consequences. There is a direct correlation between the complexity and the design of a performance award and the additional resources (e.g. increased budget and headcount) required. This publication discusses those consequences in detail.

GLOBAL ISSUE

Labor law and tax regulations may restrict or inhibit the use of certain design features of performance awards granted to employees in specific countries. The complexity of this issue is beyond the scope of this publication but it should not be assumed that extending the concept of performance awards to employee groups outside the US will parallel the extension of stock options or RSUs to those jurisdictions.

DESIGN.

3.1. Overview.

3.1.1. The infinite flexibility in the design of performance awards creates considerable opportunities and considerable challenges. The implications of design decisions are significant to the ultimate behavioral impact, shareholder perception, financial and reporting impact, proxy disclosure, employee communication, and administrative requirements of the plan. The complexity and the expense of performance awards can be better managed with a clear understanding of the design issues and implications.

3.1.2. Any type of equity vehicle can have performance goals attached, converting it into a "performance award," as discussed in paragraph 1.1.3. In practice, the most common types of performance awards are PSUs and PSAs. Both units and awards deliver similar economic benefits. The mechanics of the delivery are distinct and PSUs offer clear advantages in flexibility and administrative ease, while PSAs have inherent challenges. Exhibit 2-1, paragraph 2.1.2, summarizes the issues that should be considered when selecting the type of performance award to be used. **In most situations PSUs, rather than PSAs, will be better suited to achieve the Company's goals.**

Administration and financial reporting should not determine appropriate design, but design decisions should be made with an understanding of the administrative and financial reporting consequences.

3.1.3. The nature of performance awards leads to a potentially infinite number of plan designs. The four core design aspects of performance awards include –

- Performance measures - the measures that are the basis for the assessment of performance
- Performance period - the period over which performance is measured
- Vesting provisions - when the employee has the unrestricted right to the underlying shares
- Payout provisions - how those variations in deemed performance level adjust the compensation earned from the award

This section outlines the possible design features related to these four aspects of performance awards. A detailed discussion of designing performance awards is outside the scope of this publication.

3.2. Performance Measures.

3.2.1. Performance measures are the basis for the assessment of performance. Designing a performance award incorporates decisions about what specifically will be measured and how it will be measured. These factors are summarized as one or more performance goals and incorporated into the terms of the Award.

3.2.2. The types and number of performance measures used vary widely. In addition, the plans vary in how performance is defined. For example, revenue may be defined as gross revenue, backlog, revenue from contracts signed, revenue from invoices billed, "adjusted" revenue, or collections. This highlights the criticality of thorough definitions and the associated financial modeling. For accounting purposes, performance awards are broadly grouped into awards that have either "market conditions" which are stock price related or "performance conditions" which are not related to stock price. See Exhibit 3-1 for examples of performance measures.

EXHIBIT 3-1 – PERFORMANCE MEASURES	
MARKET CONDITIONS	
Stock Price Measures	
Absolute Price Growth (%) Stock Price Target ($) Ratio of stock price at grant vs. stock price at vest date Total Shareholder Return (TSR)	
PERFORMANCE CONDITIONS	
GAAP Measures	**Non-GAAP Variations**
Revenue Gross revenue Net revenue	Backlog Contract revenue
Profit Net income (after tax) Net income (pretax) Operating income Earnings per share (EPS) EPS growth	EBIT (Earnings before interest and taxes) EBITDA (EBIT and before depreciation, amortization, and impairment) Adjusted net income Adjusted operating income Adjusted EPS
Cash Flow Operating cash flow Cash flow	Cash flow excluding items
Balance Sheet Net asset value per share Working capital	
Financial (not accounting) Measures: GAAP	**Financial (not accounting) Measures: Non-GAAP Variations**
Return on Equity (ROE) Return on Assets (ROA) Return on Sales (ROS) Return on Invested Capital (ROIC)	Economic profit Adjusted ROE/ROA/ROS/ROIC
Operational Measures	
Unit volume Market share Customer satisfaction index Employee attitude survey results Safety rating (number of incidents) Product quality index (warranty incidents)	
Milestone Measures	
Product release or shipment Launch of beta version New drug approval by FDA Completion of phase of clinical trials Filing of new drug application	

3.2.3. Once the measure has been clearly defined, the next step is to set a standard against which the performance is measured. This decision affects the behavioral impact of the plan, valuation, and financial reporting. The first step is to determine if internal or external measures will be used.

EXHIBIT 3-2 – EXTERNAL REFERENCE MEASURES	
Peer group	Most publicly-traded companies have a group of peer companies used as a reference point for executive compensation purposes. This group may also be used as the group against which performance on a particular measure is determined for a performance award. The peer group may be based on financial or operating characteristics, global industry classification, size within an industry, or other factors.
Multiple Peer Groups	A peer group for executive compensation may not always be appropriate for performance comparisons. Separate performance peer groups may be used for performance comparisons and may have overlapping membership with the compensation peer group.
Indexes	As an alternative, an index (e.g., S&P 500 or NASDAQ 100) may be used for performance comparisons. An index is helpful when a limited number of public companies are available as useful peer comparisons. An index may be an industry index or broad market index. An index automatically incorporates changes to the group as a result of delisting, merger and acquisitions, or other eligibility changes.

- Externally-referenced measures – Performance is assessed against an external reference point. Exhibit 3-2 includes examples of external reference measures.
- Internal goals – Performance is assessed against internally determined targets (e.g., a specific dollar target, percentage growth over previous year(s), or a ratio relative to other measures).

A goal is a particular level of attainment on a measure. For example, "EPS of $3.50" represents EPS as the measure and $3.50 as the goal.

3.2.4. The next step is to specify an absolute/target-based or relative performance goal.

- Absolute/target-based – Internal or external points establish a simple absolute target, with associated variations (e.g., EPS = $3.50).
- Relative – Performance is assessed relative to an external reference points (e.g., stock price performance exceeds the median of the group of peer companies).

It can be difficult to determine appropriate targets and range of performance over a multi-year period in a complex business and economic environment. This may lead a company to prefer assessing performance relative to an external reference point. Alternatively, goals for a subsequent period could be dependent on prior period results (e.g., 20% revenue growth year-over-year). Absolute/target-based performance goals may be used as a secondary measure. A plan may combine a relative performance measure with an absolute minimum level of required performance. For example, a company may establish performance goals that include TSR exceeds the 50th percentile of the TSR of a peer group with the requirement that absolute TSR must be greater than zero.

3.2.5. Where performance awards have a single performance measure, the award may be designed to provide for variable payout depending on performance against that single measure. Exhibit 3-3 provides an example of a performance award with a single performance measure.

EXHIBIT 3-3 - SINGLE MEASURE

	Return on Equity (ROE)					
	Less than 9%	9% - 9.99%	10% - 11.99%	12% - 12.99%	13% - 14.99%	15% and higher
Percent of Target Shares Earned	0%	50%	80%	100%	120%	150%

EXHIBIT 3-4 – MULTIPLE MEASURES WITH WEIGHTED OBJECTIVES					
		Relative Weight	Threshold Level	Target Level	Above Expectation
Revenue	Performance	40%	75%	100%	125%
	Payout		50%	100%	150%
Operating Margin	Performance	40%	90%	100%	110%
	Payout		50%	100%	200%
ROIC	Performance	20%	80%	100%	120%
	Payout		75%	100%	150%

3.2.6. Where performance awards have multiple performance measures, these measures must be combined to determine the appropriate payout. The most common ways to handle multiple measures are –

- Weighted objectives – This approach assigns a relative weight to two or more performance objectives which are used in the payout calculation. Exhibit 3-4 shows an example of a weighted objective approach.
- Matrix – Independent objectives are combined in a matrix. Each cell of the matrix represents a combination of performance levels of the measures that creates a performance outcome translated into a number of shares vesting. Exhibit 3-5 shows an example of a matrix approach.

EXHIBIT 3-5 - MULTIPLE MEASURES WITH MATRIX				
		Total Shareholder Return		
		Below 50th Percentile	Between 50th and 59th Percentile	60th Percentile and Higher
Return on Equity	Greater than 15%	75%	150%	200%
	10% to 15%	50%	100%	150%
	Less than 10%	0%	50%	75%

- Modifiers - Two or more performance measures interact using a modifier, a factor that adjusts the payout from one or more measures based on the performance on another measure. For example, revenue is 60% and profit is 40%, but a safety score can increase or decrease the revenue and profit-based preliminary payout by plus or minus 25%. Exhibit 3-6 shows an example of a modifer.

EXHIBIT 3-6 - MODIFIERS		
	Calculated Result from Objectives ↓	
	Assessment	Payout Modifier
Safety Score	Exceeds	125%
	Meets	100%
	Below	75%
	↓ Final Amount of Payout	

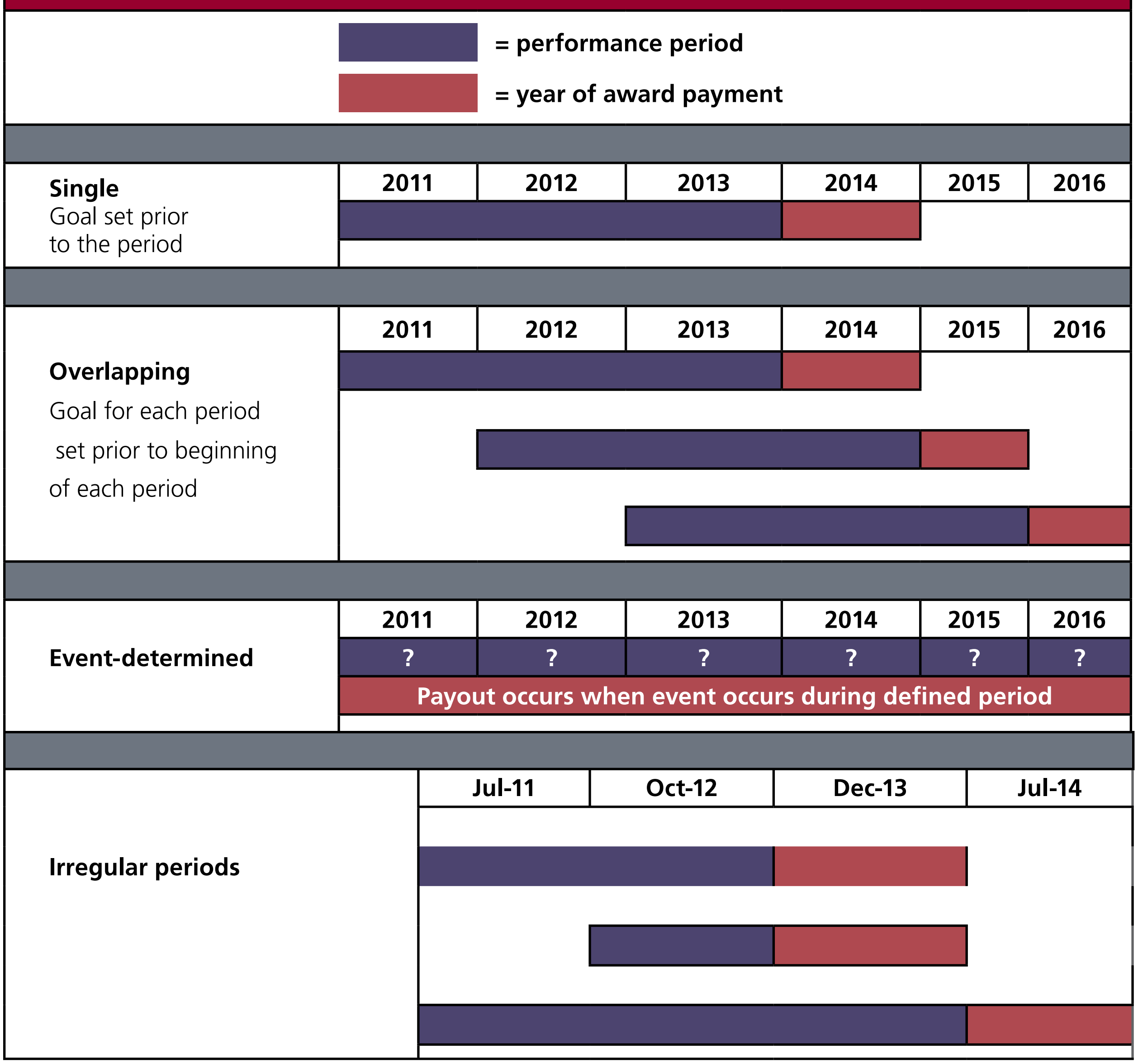
3.2.7. Performance goals must be established no later than the grant date in order to establish a grant date for the award and to determine a fixed value per share for the award. The fair value of the award for financial reporting purposes is determined on the grant date. As discussed in paragraph 5.2.2 the grant date is established when there is a mutual understanding by the employer and employee of the key terms of the award. If the Board has merely determined a performance award will be granted, but has not defined the specific performance goals, the grant date has not occurred.

3.2.8. The performance measures associated with an award can have a significant impact on how an award is treated for financial reporting purposes. Small changes in plan design may have large financial consequences. For example, for accounting purposes performance awards are grouped as those with performance conditions and those with market conditions. (Exhibit 3-1, paragraph 3.2.2, summarizes what measures are considered performance conditions and market conditions.) In general the quarterly expense of awards with market conditions is less volatile than the quarterly expense of awards with performance conditions. If financial statement volatility is a concern, performance goals with market conditions will yield a more stable expense. See Section 10, Financial Reporting, for a more detailed discussion of the financial implications of design decisions.

The selection of performance measures can directly impact the volatility of the quarterly expense accruals for financial reporting purposes.

3.2.9. Performance awards are designed to drive desired employee behavior. While more intricate performance measures may be conceptually preferred in terms of shareholder value creation and underlying business strategy an overly complex set of measures is likely to inhibit employee understanding and motivation. As noted in paragraph 3.2.8, the employee must understand the key terms of an award to establish the grant date. While having complicated,

EXHIBIT 3-7 - TYPES OF PERFORMANCE PERIODS



difficult to understand goals does not preclude the establishment of a grant date, best practice is to fully communicate the terms of the award to maximize employee understanding. An overly complicated design may not be understood by the employee and may not drive desired employee behavior. Key elements of employee communication are discussed in paragraphs 5.7.1 and 5.7.2.

Best practice is to carefully consider employee understanding in the design process. The implementation and communication of more complex plans will be easier for companies that have an established culture of frequent employee education and communications.

3.3. Performance Period.

3.3.1. The period of time over which performance will be measured must be determined as an element of the grant design. The performance period may be –

- A single period
- Overlapping cycles
- Event-determined
- Irregular non-fiscal year periods

Exhibit 3-7 shows an example of these types of performance periods.

3.3.2. The performance period as incorporated in the terms of the award impacts financial reporting by determining the service inception date discussed in subsection 10.7 and the requisite service period discussed in subsection 10.8. Small changes may have a significant impact on the expense associated with an award.

3.3.3. Generally an award also incorporates a service period that requires the employee to provide employment services during a requisite time period. The service period may coincide with the performance period or extend beyond the performance period. Normally the service period is not less than the performance period.

3.4. Vesting Provisions.

3.4.1. The vesting date is the date on which the employee earns the unrestricted right to receive the underlying stock. The vest date for performance awards is after the performance goals and service period have been met. The payout may be delayed to a future date, but the employee has the right to receive the underlying stock. An award may vest at a specific point in time (i.e., cliff vesting) or a percentage of an award may vest at designated points in time (i.e., graded vesting). In the case of graded vesting, each tranche (i.e., the portion of an award that vests) may be treated as a separate unit for financial reporting purposes. See subsection 10.4 for a discussion of accounting treatment of performance awards with graded vesting.

3.4.2. The vest date is defined by the terms in the Plan/Award Agreement. The vest date also impacts the point of taxation for a PSU/PSA, as discussed in subsection 7.2, and the requisite service period for financial reporting, as discussed in subsection 10.8. In defining the vest date of an award, these factors must be balanced. For example, a PSU may vest immediately when the performance goals and service period are met. In many cases the vesting occurs after the performance has been certified to provide confirmation that the performance goals were met and the service period has been met. Another approach would be to define the vest to coincide with the payout of the award at the next open trading window so as to ensure the employees are able to generate funds to meet the employee's tax withholding obligations. The vest date may be structured to verify the performance goals are met, simplify tax withholding, allow sufficient time to process the award, or coincide with an open trading window. Best practice is to specify a vest date no earlier than the certification date. In all cases, if the employee terminates before the vest date (even if the termination occurs after the performance goals and service period have been met), the employee would forfeit the shares.

3.4.3. Most equity plans have change of status provisions defined in the Plan. These terms determine what happens to outstanding unvested awards in the event of an employee's voluntary and involuntary termination of employment, death, disability, retirement, and a company's change in control. Alternatively, plans may reference the provisions in individual award agreements, affording the Company more flexibility to vary these among different grant types and situations. The Plan/Award Agreement will determine what will be paid out and when it will be paid. The most common treatment for any type of status changes include –

- Forfeiture of unvested awards – This is administratively the simplest, and is likely to be considered the most equitable to the Company in the event of a voluntary termination by the employee or an involuntary termination for cause.
- Pro rata vesting with payout determined at the end of the performance period – The payout amount is determined after the performance period is met. The payout is a pro rata allocation based on the proportion of the period completed to the actual results under the terms of the performance award. This is common in the event of retirement.
- Vesting based on assumed performance at target – This is often used for change in control situations, in which the performance awards must be terminated due to the change and it is deemed punitive to require full forfeiture and overly generous to assume that maximum performance would be achieved.
- Pro rata vesting based on portion of period completed – This method calculates the proportion of the period completed and also requires an assumed performance level. This is often used for death, disability, and retirement situations
- Vesting based on estimate of performance period-to-date – This method calculates the payout based on performance–to-date.
- Full payment of unvested awards at the minimum, target, or maximum levels - This provision is often used for change in control, retirement, and disability situations to provide a benefit to the employee for a change in status that is outside of their control.
- Payout determined at end of performance period based on actual performance– The payout amount is determined after the performance period is met. The payout is based on actual results under the terms of the performance award. This is common in the event of retirement.

3.4.4. Implementing a design that provides for full or partial vesting where the underlying shares are released before the end of the performance period may result in unforeseen consequences and negative shareholder reaction. For example, an employee may terminate and a pro rata portion of the award is paid out upon termination prior to the end of the performance period. If the performance goals are not met at the end of the performance period, only the terminated employee would receive a payout, while other employees receive nothing. In addition, this may have negative tax consequences under IRC §162(m) as discussed in subsection 7.7. In the case of awards whose payout varies depending on the attainment of performance goals (e.g., the award is paid at 100% of target if the EPS is $4 or less and is paid at 125% of target if the EPS exceeds $4 per share), calculating the appropriate payout required for employees with a change of status can be difficult and result in inequities among employees.

3.4.5. Unforeseen labor, tax and financial reporting consequences may also occur if the Plan/ Award Agreement provides for full or partial vesting upon retirement. Further discussion on the tax consequences is discussed in paragraph 7.5.5. Review retirement provisions carefully to minimize unexpected situations.

KEY TERMS

For purposes of this publication, the following terms are used:

Vest: Award no longer subject to substantial risk of forfeiture

Payout: The process of determining the amount to be paid on the award; sometimes refers to the release of shares, as well as the payout of the award

Release: Transfer of shares to the employee

For example, a PSU is granted on 1/1/2010. On 3/1/2012, the performance goals are certified, the service period is met, and the award ***vests****. The* ***payout process*** *determines the number of shares earned. On 3/15/2012, the* ***payout*** *occurs and the shares are* ***released*** *to the employee's account.*

DIVIDENDS AND DIVIDEND EQUIVALENTS

Dividend or dividend equivalents may be attached to a PSU or a PSA to allow the employee to receive the value or equivalent value of dividends paid to shareholders during the vesting period. Usually dividends are not paid on PSOs. Providing for dividends/dividend equivalents is not required, but is common practice. For awards with a fixed payout, the calculation of the dividend is straightforward. For awards with a payout that varies depending upon the level of performance, the dividend calculation typically is not performed until the number of units earned is known at the end of the performance period.

Shareholders and proxy advisors have criticized PSUs and PSAs that pay dividends before the ultimate vesting of the shares providing another reason to delay the payment of the dividend until the award vests. This issue should not be ignored simply because a company may not currently be paying dividends. Awards should specifically address the payment of dividends in anticipation that the Company may change its dividend policy during the performance period(s).

For purposes of this publication we will refer to dividends and dividend equivalents under the term "dividends."

3.5. Payout Provisions.

3.5.1. Central to the performance award concept is the determination of compensation earned as a function of performance. This is accomplished by defining the number of units, awards, or options that vest based on the defined performance measures, performance period, and vesting provisions. The payout can be determined in a variety of ways including –

- Formula-based – The most common approach to determine payout based on performance is a direct formulaic scale between performance level and payout. This type of variable payout typically includes a minimum (threshold) level of performance required below which there is no payout, and a maximum level of performance above which no additional payout occurs.
- Discretion – The Compensation Committee has the ability to vary the formula-based outcome by some amount (e.g., plus or minus 20%), or the determination of the number of shares has two or more performance factors, one of which is a discretionary assessment of performance. Discretion may be a vague judgment that cannot be clearly articulated.
- Subjective Assessment – Subjective assessment structures discretion into clearly articulated performance conditions that may not be able to be quantitatively measured.

Incorporating discretionary or subjective elements into plan design has important implications for financial reporting. In some cases, when discretion or subjectivity is involved, the conditions of the award may not be known and the grant date may not be established, resulting in liability treatment for accounting purposes. In addition, allowing the Compensation Committee discretion to increase the payout of a performance award may have tax consequences, as discussed in subsection 7.7. Monitor the share reserves to ensure sufficient shares are available in the Plan to payout the maximum number of shares under the payout provisions.

3.5.2. The payout schedule may include provisions that impact the number of shares that vest. The schedule may incorporate the following provisions –

- Minimum (Threshold) -Minimum level of performance required for payout
- Target – Expected level of performance
- Maximum – The maximum payout paid for performance
- Floor – A guaranteed minimum payout
- Ceiling– A downside-only scale used when there is no upside to the performance goal or the Company does not want to or should not incent performance above the target due to capacity constraints or burn rate considerations
- All-or-nothing – The payout is calculated for the achievement of the performance target with no provision for exceeding or falling short; best suited to event-based goals that are sensitive to timing

In addition the payout schedule may include provisions that impact when an award vests. For example, if the original target is missed, there is a secondary opportunity to vest in the award (typically at a reduced rate). This may be referred to as "second-chance" shares.

3.5.3. The payout provisions may determine the type of equity vehicle best suited for use as a performance award and influence the structure of the performance provisions. For example, an award that provides for changes in the number of shares that vest upon achieving certain performance goals may be unsuitable for a PSA. Shares are issued to the employee at the time of grant. If the actual number of shares earned upon payout is different from the shares issued at the grant date, additional shares must be issued or excess shares must be cancelled. Both alternatives create complications that could be avoided by using a PSU rather than a PSA. A performance-accelerated award may be structured as a PSU or PSA. A PSA would allow additional flexibility for employees to file an 83(b) election, as discussed in Section 7, Tax/Payroll Issues.

3.5.4. Some awards may provide for a delayed payout. This deferral may be elected by the employee receiving the award or may be a requirement under the terms of the Award Agreement. The deferral of the payout date may create tax issues. See subsection 7.6 for a discussion of the tax impact of deferral provisions.

3.6. Issues Associated with Implementation.

3.6.1. Because performance awards are more complex than equity awards with service-based vesting only, it is more important to broaden the team involved in the design process. Effective design incorporates input of all relevant parties, including Human Resources, the CEO, CFO, Board of Directors, Compensation Committee, and Investor Relations. In addition the complexities require the involvement of Financial Reporting, Legal, Tax, and Equity Compensation during the design phase.

3.6.2. Performance awards frequently require special handling. The stock plan system may require some level of workarounds due to limited functionality to support performance awards. Valuation of the awards may be more complex and require external resources. Employee communication should be more robust to maximize the employees' perception of the value of the awards and to obtain the desired effect. This special handling may require additional resources, including increased budget and headcount. There is a direct correlation between complexity in the design of a performance award and additional resources required.

3.6.3. As discussed in this section, many design features complicate the administrative process and financial reporting. Exhibit 3-8 summarizes some these key design features impacting administration and financial reporting.

EXHIBIT 3-8 – SUMMARY OF KEY DESIGN FEATURES THAT IMPACT ADMINISTRATION AND FINANCIAL REPORTING

- Performance goals must be established prior to the grant date in order to finalize the fair value of the award.
- Performance measures can directly impact the volatility of the quarterly expense for financial reporting purposes. Market conditions provide less quarterly volatility than performance conditions.
- Vest date must be clearly defined to provide for –
    - Certification of the performance results
    - Meeting tax withholding requirements
    - Transactions during an open trading window
    - Administrative processing
- Continued or accelerated vesting upon retirement may create financial and administrative challenges.
- Discretion by the Board of Directors or Compensation Committee to increase the payout may have tax consequences.
- Small changes in plan design may have large financial reporting and taxation consequences.
- Balance design complexities with employee understanding.

General Administration.

4.1. Overview.

4.1.1. Performance awards can be challenging to administer. The complexity of the administrative process is closely tied to the design details of the Plan and the number of employees receiving performance awards. If performance awards are limited to the executive population, the number of grants is limited and a manual process may be acceptable. If the awards are broad-based, the higher volume of grants requires a more automated administrative process.

4.1.2. Because of the flexibility in the design of performance awards, automated solutions frequently do not address all of the administrative requirements and some level of manual workarounds may be required. When developing an administrative process for performance awards, close communication with Financial Reporting is required to ensure the solution considers the financial reporting implications. In addition, special attention must be given to appropriate internal controls any time a manual workaround is utilized.

4.2. Plan Details.

4.2.1. A company may have numerous plans operating at any time – each with unique attributes and administrative requirements that must be followed. An omnibus plan may allow for the grant of performance awards or the Company may have a separate performance plan. (Plan design has evolved further in recent years as proxy advisory services such as ISS and Glass Lewis have focused on how they believe performance plans should be structured. These guidelines are updated annually.) The Plan may specify the parameters of performance awards and the details of a specific performance award must meet the requirements of the Plan. Key plan features relating to performance awards may include –

- Types of performance awards that may be granted
- Total number of shares that may be granted as performance awards
- Standard performance period
- Permitted deviations from term and performance period
- Award eligibility requirements
- Share counting conventions
  - Impact of grant/award on the share reserve
  - Shares returned to pool upon expiration, forfeitures, cancellation, termination, or other changes of employment status
  - Surrender or withholding of shares to pay award price (if any) and/or tax obligations
- Vesting provisions including accelerated vesting
- Impact of change in status, including retirement, terminations, death, and disability
- Dividends and dividend equivalents
- Change of control provisions
- Permitted methods of paying tax obligations

In some circumstances stock must be issued for par value. (This requirement applies to companies incorporated in certain states.) In most cases par value is immaterial and the Company considers past services rendered as payment for the par value. A complete discussion of this issue is outside the scope of this publication.

Develop a standard template to document the plan requirements. Document how the requirements are incorporated into the administrative processes, system functionality as discussed in paragraphs 4.4.1 and 4.4.2, and documentation provided to employees. Particular attention should be paid to new plans implemented or new plan requirements. See Exhibit 4-1 for internal controls associated with plan details.

4.2.2. The Plan must receive proper corporate approvals to be a valid source for the grant of performance awards. Under state law, the issuance of stock requires approval of the Board of Directors. Therefore, Board approval of a stock-based performance plan is required. As part of that process, the Board typically delegates authority to the Compensation Committee or other parties to approve individual grants under the Plan. Also, the listing standards of most stock exchanges, including the NYSE and NASDAQ, require that the Shareholders approve any plan under which stock can be granted to employees or Directors. Failure to receive stockholder approval can subject a company to being de-listed from the exchange. In the case of acquisitions, special care must be taken to determine if the Plan continues and if it is a valid plan.

4.2.3. Various legal requirements must be addressed such as –

- Was the Plan filed with the SEC as an exhibit to an appropriate periodic report filed under the Securities Exchange Act of 1934?
- Was a registration statement filed with the SEC to register the offer and sale of stock under the Plan under the Securities Act of 1933?
- Have appropriate state laws been met?
- Were prospectus delivery requirements met?

See Section 8, Legal Issues, for a more detailed discussion.

4.3. Award Details.

4.3.1. The terms of an award may be detailed in the Award Agreement or incorporated by reference to the Plan as discussed in paragraph 4.2.1. The Award Agreement should incorporate the design features discussed in paragraph 3.1.3. Administrative challenges do not drive the design of performance awards, but small tweaks in the design may ease the administrative burden. As noted in subsection 3.6. and Exhibit 3-8, paragraph 3.6.3, specific design features may generate administrative challenges.

4.4. Stock Plan System Functionality.

4.4.1. The flexibility of performance awards allows each company to customize the design of the award and the performance goals. This flexibility creates challenges in developing systems to handle these awards. The stock plan system may incorporate various software products including the stock plan database, an employee portal, and a financial reporting package. The system may be used internally by the Company or by a third-party outsourcer. Some systems have some level of limitations in recording, tracking, and processing performance awards. Review the system functionality to identify the capabilities to handle each stage in the lifecycle of a performance award, as discussed in Exhibits 1-1 and 1-2 and paragraph 1.3.1. Some common questions regarding the administrative functionality of the stock plan system are summarized in Exhibit 4-2.

4.4.2. Understand the functionality of the stock plan system and how it provides data to Financial Reporting. Establish and document a process to provide required information to value performance awards. See Section 10, Financial Reporting, for a more detailed discussion.

EXHIBIT 4-1 - INTERNAL CONTROLS ASSOCIATED WITH PLAN DETAILS

	Illustrative Controls	Illustrative Test of Controls
1	Develop a standard template to summarize key plan requirements for each Plan. Use the standard template to document the plan requirements. Document how the requirements are incorporated in the administrative processes, system functionality, and documentation provided to employees.	Confirm documentation of all plans. Verify that details of new plans have been documented. Test that plan requirements have been properly implemented.
2	Document the Plan approvals such as Board minutes, Annual Shareholders' Meeting minutes, SEC filings, etc.	Verify that all plans (including plans of acquired companies) have been approved.

EXHIBIT 4-2 – COMMON QUESTIONS REGARDING THE ADMINISTRATIVE FUNCTIONALITY OF THE STOCK PLAN SYSTEM

Performance goals determined
- How will the employee communications from the stock plan system reflect the performance goals?
- Can the employee access updated information about the progress toward achieving the performance goals?

Grant
- How is a performance award recorded?
- What type of performance awards (e.g., stock-settled PSU, PSA, and PSO) are supported in the stock plan system?
- How does the system record and track awards with variable payouts?
- Is the employee notification of the grant from the stock plan system adequate to support a clear understanding of the terms of the Award, including the performance goals and service period?
- For share reserve purposes, is the award tracked at the maximum payout?
- What share amount is used in the Award Agreement?
- Does the system support the tracking and payment of dividends, if required under the terms of the award?
- Is the award recorded in sufficient detail to support the proper financial reporting of the award?

Performance period ends
- Does the system highlight when a performance period ends?
- Does the system handle an extension of the performance period that is considered a modification to the award?
- How does the system handle changes to awards when all or a portion of the award is cancelled because the performance goals have not been met?
- How does the system handle changes of employment status before the performance period ends?
- Does the system support multiple vesting periods and secondary opportunities to vest in awards (i.e., overlapping cycles or second-chance shares as discussed in paragraph 3.5.2.)?

Performance is certified
- How does the system record that the performance goals have been met and the results have been certified?
- In the case of variable payouts, how does the system handle changes in the number of shares to be received?
- Does the system notify employees that the performance goals have been met and the results certified?

Service period ends
- Does the system automatically vest the shares at the end of the service period, when the service period ends after the end of the performance period?
- How does the stock plan system handle changes of employment status before the service period ends?
- Can awards be prorated for changes of employment status?
- Does the system track retirement-eligible employees for the awards granted to facilitate appropriate taxation?
- Does the system allow prorated payouts for leaves of absence?

Award vests
- Is the vest of an award automatic or is a manual process required to record the vest?
- In the case of accelerated vesting, how is the acceleration recorded and reflected in appropriate reports?

Payout Process
- How are deferred dividends or dividend equivalents processed?
- How are deferred PSUs handled?
- Is the payout of a PSU/PSA processed automatically or does it require manual processing?
- How is rounding of shares handled if the award does not pay out at 100%?
- In the stock plan system is the payout of a PSU/PSA handled differently than an award without performance goals?
- Is the exercise of a PSO handled differently than the exercise of a stock option?

4.5. Outsourcing.

4.5.1. The Company may outsource certain aspects of the administration of performance awards. Because vesting is dependent on meeting specific performance goals and performance awards may be tracked outside the stock plan system, companies that outsource the administration of performance awards need to have a higher level of involvement in coordinating the entire process with the outsourcer. Clear communication between the Company and the third-party administrator is critical.

4.5.2. The processes discussed in this publication will apply regardless of whether or not the Company outsources plan administration; however, the group responsible for implementing the process may differ. In all cases, the Company retains overall responsibility for the internal control process. In general, the Company typically –

- Defines the performance goals
- Tracks the performance goals
- Assesses the probably of payout for financial reporting purposes
- Determines if the performance goals have been met and certifies the vesting of the award

The Company may outsource –

- Recording the grant
- Recording and processing the vest
- Processing the payout of a PSU/PSA and the exercise of a PSO
- Valuing the award and calculating period expense based on inputs provided by the Company

Grant.

5.1. Overview.

5.1.1. When an employee receives a performance award accounted for under the accounting model provided in ASC Topic 718, the grant date generally establishes the fair value of the award based upon the grant details. Note that the grant date of an award can have different relevance for financial reporting, Section 16 reporting, and proxy disclosure.

5.1.2. The key processes associated with granting performance awards are similar to the processes associated with other types of equity awards. The following discussion focuses on the unique requirements of performance awards. The grant processes associated with other types of equity awards are included in previous GPS research publications on non-qualified stock options and restricted stock/restricted stock units. Details of this research and the downloadable publication are available at www.scu.edu/business/cepi/.

5.2. Terms of the Award.

5.2.1. As noted in paragraph 4.2.1., the Award Agreement must conform to the terms of the Plan. Award Agreement for performance awards should include –

- The performance goals
- The performance period
- The service period
- The vesting provisions
- The impact of a change of status
- A payout schedule upon meeting performance goals

In addition, the standard terms that should be included in any Award Agreement include –

- The right to receive an established number of shares of company stock
- The type of grant (i.e., stock option, restricted stock, restricted stock units, PSUs, and PSAs)
- An established price (for stock options)
- A vesting schedule
- A description of how performance will be calculated
- A requirement of continued employment with limited exceptions for death, retirement, etc.
- Applicable dividends/dividend equivalents and voting rights (for restricted stock, restricted stock units, and performance awards)
- The acceptable methods of paying applicable tax
- Termination provisions

GLOBAL ISSUE

If a company regularly grants awards or communicates their value as part of compensation paid by the employer, the award may be considered an acquired right of employment. In that instance, the award may no longer be deemed discretionary and the employee may acquire the right to receive such awards in the future. Performance awards are more likely to be considered an entitlement of employment and the employee may have the right to receive such awards in the future.

5.2.2. The grant date is established when there is a mutual understanding by the employer and employee of the key terms of the award. The employer must determine the performance goals and the employee must understand the key terms of the award. If the Board has merely determined a performance award will be granted, but has not defined the specific performance goals, the grant date has not been established, resulting in accounting consequences. See paragraph 10.6.1 for more details.

5.3. Approving the Award.

5.3.1. Corporate law, the Company's corporate governance provisions, and the Plan require the grant to be approved for it to be valid. Therefore, clearly defining the grant approval process and documenting approvals by appropriate parties is a key step in determining that a grant has occurred and the grant date for accounting purposes is established. As noted in paragraph 5.2.2 when dealing with performance awards, the performance goals must also be established prior to approving the award in order to establish the grant date for accounting purposes.

5.3.2. Formalize and document the approval process. Establish and document requirements on who is authorized to approve grants and the limits of their authority. Note when multiple authorizations are required. Indicate who is required to approve grants to specific groups of employees (e.g., Compensation Committee, Board of Directors, or the CEO). Identify individuals with back-up approval authority where appropriate.

5.3.3. For purposes of internal control, the grant approval must be documented in writing. Documentation should include grant employee, number of shares/units awarded, performance goals, performance period, service period, vesting provisions, the impact of a change of employment status, and the payout schedule. Approval at Committee or Board meetings should be documented in detail in the meeting minutes. When unanimous written consents are used, the date of receipt of the final consent determines the grant date. See Exhibit 5-1 for key internal controls associated with approving the award.

EXHIBIT 5-1 - INTERNAL CONTROLS ASSOCIATED WITH APPROVING THE AWARD

	Illustrative Controls	Illustrative Test of Controls
1	Define the grant approval process and develop a matrix of authority. Include approvals that are required and any other individuals that must review and approve grant recommendations.	Verify the grant approval process is documented. Review the matrix of authority to ensure appropriate individuals are authorized to approval grants.
2	Document all grant approvals in writing. Documentation should include grant employee, number of shares/units awarded, performance goals, performance period, service period, vesting provisions, the impact of a change in status, and the payout schedule.	Sample grants to confirm that the grant has been approved and the grant approval is within the limits of the approver's authority and conforms to the grant approval process.

5.4. Recording the Award.

5.4.1. Develop a consistent process to record the grant of the award. As noted previously there are numerous complications when administering performance awards and frequently manual workarounds are required. The grant may be recorded in the stock plan system or tracked separately. Many companies record awards in the stock plan system as of the grant date. The interrelation of an award with both performance conditions and market conditions, as discussed in paragraphs 10.2.2 and 10.2.3, can be challenging, and it may be necessary to record the award as two separate grants – one grant with performance conditions and one grant with market conditions. Other companies track grants of performance awards outside the stock plan system and only record the grant in the stock plan system when the performance goals have been met and the shares vest. If this approach is taken, special care must be taken to ensure that plan reserves are accurately adjusted to avoid unexpectedly running out of shares.

5.4.2. If a company tracks performance awards outside the stock plan system, reconcile activity monthly including –

- Awards granted
- Awards cancelled because the performance goals are not met
- Awards forfeited because of changes of employment status
- Awards expiring
- Awards outstanding, but unvested
- Awards vested (i.e., performance goals and service period met)
- Awards paid out
- Number of employees
- Number of awards
- Maximum number of shares to be paid on outstanding awards

5.4.3. Establish and document a process to provide required information for financial reporting for performance awards. The process will be dependent upon the extent the stock plan system is used to calculate the fair value of the awards and the period expense. The three most common approaches are –

- The stock plan system is used to calculate the fair value of the awards and the period expense
- The stock plan system is used to maintain data for financial reporting purposes but the fair value of the awards is calculated outside the stock plan system
- Performance awards are tracked, valued, and the period expense managed outside the stock plan system

5.4.4. If the stock plan system is used to calculate the fair value and the period expense of the awards, review the stock plan system functionality to ensure the grant is properly recorded. As discussed in Section 10, Financial Reporting, certain types of awards (those with market conditions as opposed to performance conditions) require more sophisticated valuation techniques such as Monte Carlo simulation or binomial models. Understand the functionality of the current version of the stock plan system and whether the stock plan system can meet the financial reporting needs. Special attention may be required when a new release of the stock plan system is installed.

5.4.5. If the stock plan system is used to maintain data for financial reporting purposes, but the fair value of the awards is calculated outside the stock plan system, reports will extract the appropriate information from the stock plan system. Prepare a detailed description of each report to ensure the users of the report understand the parameters of the data reported. The report should include—

- The purpose of the report
- A description of each field and details of how each number is calculated
- Details of what is included and excluded (e.g., types of employees, grant details, transaction details, vesting period, and reporting period)

All appropriate parties should sign-off on the report format. The format should be reviewed and updated periodically, especially when awards are granted with new terms, mergers/acquisitions occur, and the stock plan system is updated. Even though the valuation is calculated outside the stock plan system, the fair value may be stored in the stock plan system for ease of reporting or allocations.

5.4.6. If the Performance awards are tracked, valued, and the period expense managed outside the stock plan system, establish a standard report to provide information to the group responsible for financial reporting. Details about the content, documentation, and update of the report are discussed in paragraph 5.4.5.

EXHIBIT 5-2 - INTERNAL CONTROLS ASSOCIATED WITH SHARE RESERVE MANAGEMENT		
	Illustrative Controls	**Illustrative Test of Controls**
1	Document how the share pool is calculated for different types of equity awards and different types of transactions.	Inspect documentation to ensure that the Plan requirements have been met.
2	Document each reporting period how shares were counted and the impact on the share pool. Performance awards with a variable payout should be included at the maximum payout rate. Verify sufficient shares exist in the share pool.	Verify calculation prepared and reviewed.

5.5. Share Reserve Management.

5.5.1. The Plan provides for a number of shares authorized for issuance but not yet granted. Shares authorized, but not yet granted, are frequently referred to as the "share reserves" or the "share pool". Grants decrease the number of shares in the pool. The Plan may also provide that shares are added back to the pool when shares are withheld to cover taxes or shares are forfeited, expired, or cancelled when the performance goals are not met; however, proxy advisory services take an unfavorable view of this approach. The number of shares in the pool may be increased by approval of shareholders and/or the Board of Directors.

5.5.2. One approach is to use omnibus share plans with a specified fungible share pool. The omnibus plan provides a company with flexibility to determine the type of awards to be offered. All awards count as a share in the fungible share pool, but different types of awards may be counted differently when determining the impact on the share pool.

5.5.3. Because performance awards may incorporate a variable payout feature, share reserve management is critical to ensure the share reserve has sufficient shares to meet the maximum payout requirements. Stock plan software may include functionality to manage the simpler calculations. In some cases calculations must be managed on a spreadsheet by the Company. These calculations are reflected in the financial statements. See Exhibit 5-2 for internal controls as sociated with share reserve management.

EXHIBIT 5-3 - INTERNAL CONTROLS ASSOCIATED WITH NOTIFYING THE EMPLOYEE		
	Illustrative Controls	**Illustrative Test of Controls**
1	Establish procedures to notify the employee of the grant on a timely basis and document that the employees were notified.	Test notification process to ensure that the process is followed and conforms to FASB requirement for timely notification.

5.6. Notifying the Employees.

5.6.1. ASC 718-10-25-5 provides guidance on determining the grant date of an award.

Assuming all other criteria in the grant date definition have been met a mutual understanding of the key terms and conditions of an award to an individual employee shall be presumed to exist at the date the award is approved in accordance with the relevant corporate governance requirements (that is, by the Board or management with the relevant authority) if both of the following conditions are met:

a. The award is a unilateral grant and, therefore, the recipient does not have the ability to negotiate the key terms and conditions of the award with the employer.

b. The key terms and conditions of the award are expected to be communicated to an individual recipient within a relatively short time period from the date of approval.[1]

"A relatively short time period is that period in which an entity could reasonably complete all actions necessary to communicate the awards to the recipients in accordance with the entity's customary human resource practices."[2]

5.6.2. Delayed communication to the employee may indicate the award was not fixed and unchangeable and may impact the date of grant, even when all the other requirements for establishing a grant date have been met, as noted in paragraph 10.6.2. The number of employees to be notified and the geographical dispersion of employees can make timely notification challenging.

5.6.3. Formalize a process to notify employees of the grant and document that the employees were notified. The notification should occur as soon as possible after the grant date. Electronic notification tools may streamline this process, but may have limited functionality related to performance awards. When paper copies of Award Agreements are used, documentation should include the mailing process. See Exhibit 5-3 for internal controls associated with notifying the employee.

1 ASC 718-10-25-5

2 FAS 123R

5.7. Employee Communication.

5.7.1. The Award Agreement is sent to the employee and includes details of the award. Verify that the details included in the Award Agreement reflect the appropriate terms as specified by the Board. A discussion of the strategy of using performance awards may be appropriate upon the grant of the first performance award to each employee.

5.7.2. Employee disclosures may also include information posted on a stock plan website. Make sure the website disclosures reflect the specific plan/award provisions. Care should be taken to monitor consistency of information in all communications. Performance awards are often shown separately from other types of awards to highlight the payout of the performance awards is dependent upon meeting the goals set for the award. The website should include the following information on performance awards –

- Performance period
- Number of target shares
- Target dividends, if applicable
- The performance goals and what is required for the award to vest
- How frequently the performance goal will be measured
- Payout provisions, such as a payout matrix reflecting variable payouts upon achieving specific performance goals

If an award with performance and market conditions was recorded as two separate grants, special care is required to avoid miscommunication with employees.

5.8. Performance Stock Units vs. Performance Stock Awards.

5.8.1. When PSUs are granted, the Company promises to issue stock to the employee when the performance and service conditions are met. The stock is issued when the award is paid out. When PSAs are granted, shares are issued as of the grant date. Issuing shares as of the grant date creates numerous complexities when the award provides for changes in the quantity of awards that vest. For example, if a PSA grants 1,000 shares if revenue equals 100% of targeted revenue and 1,250 shares if revenue exceeds target, how many shares are issued as of the grant date? Does the Company issue 1,000 shares on the grant date and later issue an additional 250 shares if revenue exceeds target? Does the Company issue 1,250 shares on the grant date and later cancel 250 shares if revenue equals target? Either approach requires additional administration and potential employee misunderstandings. **Best practice in these cases is to use PSUs rather than PSAs for grants with variable payouts.**

5.8.2. If PSAs are used, special handling will be required. The issued shares are nontransferable and subject to performance and service restrictions. If the stock will be held in the employee's name, the Company directs the transfer agent to issue stock with restrictive provisions, and provides the transfer agent with the number of shares to be issued and the name of the employee. The transfer agent should be advised when restricted stock is issued whether or not dividends will be paid and, if so, the method of payment. Typically, the transfer agent holds the restricted stock as a book entry in an omnibus restricted account and/or an individual account until the restrictions lapse.

5.8.3. When the performance and service conditions are met, the restrictions lapse and the shares vest. On the vest date, the transfer agent is advised to release the shares to the employee. Whenever possible, best practice is to have the transfer agent release the shares to the employee's broker for deposit into the employee's account. In certain cases the shares may remain in book entry position with the transfer agent and moved at the employee's request in the future.

5.8.4. Reconcile instructions to the transfer agent when shares are issued on the grant date and released on the vest date. Utilize error-checking routines when exporting the file to the transfer agent. Document errors identified, research performed, and resolution of the issues. On a monthly basis, reconcile total unvested grants in the stock plan system to the shares issued by the transfer agent held in the custodial account or in book entry. See Exhibit 5-4 for internal controls associated with PSAs.

EXHIBIT 5-4 - INTERNAL CONTROLS ASSOCIATED WITH PERFORMANCE STOCK AWARDS

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document the process to transfer data from the stock plan system to the transfer agent.	Review the documentation to ensure the process was followed.
2	Utilize error-checking routines when exporting the file to the transfer agent. Document errors identified, research performed, and resolution of the issues.	Review error reports for trends and unusual items.
3	On a monthly basis, reconcile total unvested grants in the stock plan system to the shares issued by the transfer agent held in the custodial account or in book entry.	Verify the reconciliation was completed. Note trends and unusual problems.

Performance and Service Period.

6.1. Overview.

6.1.1. After a performance award is granted, the performance conditions and market conditions must be tracked. In addition the requisite service period must be monitored. Frequent employee communication during the performance and service period reinforces the potential benefits of the award. At the end of the performance and service period, the performance results are certified and the award vests (to the extent the performance conditions, market conditions, and service period are met). In the case of a PSU, the payout of shares may be immediate or deferred. In the case of a PSA, the payout of shares is usually immediate. In the case of PSOs, the vested award may be exercised at the discretion of the employee and subject to the terms of the award.

6.1.2. As noted previously most stock plan systems, including commercially-available software and outsourcing systems, may have some level of limitations in tracking and processing performance awards. The process of tracking goals and triggering the payout of shares may require manual interface, workarounds, or a secondary service provider. Clear communication and strong internal controls are critical to ensure the terms of the awards have been followed.

The terms of the performance award will determine how frequently the performance goals must be reviewed to determine if the goals have been met.

6.2. Tracking Performance Goals.

6.2.1. After an award has been granted, the performance goals must be tracked. Exhibit 6-1 summarizes the key activities associated with tracking performance goals. Different individuals may be responsible for each tracking activity. Assessing the probability the award will be earned is discussed in Section 10, Financial Reporting. Tracking the change of employment status is discussed in Section 9, Change of Status. Determining if the performance goals have been met is discussed in this section.

EXHIBIT 6-1 – TRACKING PERFORMANCE GOALS

Activities Required
• Quarterly review probability the award will be earned and adjust the expense and diluted EPS calculation accordingly.
• Quarterly track changes of employment status and adjust as necessary for terminations, leave of absence, etc.
• Determine if the performance goals have been met at each measurement date. (Frequency of the review is based on the terms of an award.)

EXHIBIT 6-2 - INTERNAL CONTROLS ASSOCIATED WITH TRACKING PERFORMANCE GOALS

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document the process to track performance goals.	Review the documentation to ensure the process was followed.
2	For each date the performance goals are measured, document the performance goals and whether or not the goals were met.	Sample documentation for dates performance goals are measured. Verify the calculations are correct.

6.2.2. The terms of the performance award will determine how frequently the performance goals must be reviewed to determine if the goals have been met. For example, an award with a performance condition based on annual revenue will need to be monitored annually, but may need to be assessed monthly or quarterly for financial reporting purposes. An award with a market condition tied to stock price may need to be monitored each day the stock market is open.

6.2.3. Develop and implement a procedure to monitor performance goals. Identify the individual(s) responsible for the process. Document that the process is followed on the appropriate timetable for the award, even if the tracking calculation is outsourced. Special care is required if the terms of the award provides for a partial cancellation of the award if the performance goals have not been met. In certain circumstances the vesting date may be extended to provide a second-chance for the employee to earn the shares in a subsequent period. These provisions must be incorporated in the process used to track performance goals. See Exhibit 6-2 for internal controls associated with tracking performance goals.

6.3. Employee Communication.

6.3.1. Best practice is to provide employees with frequent updates on progress toward achieving the performance goals. At a minimum, these updates should be quarterly. This communication will enhance the employee's understanding of the performance award, drive desired employee behavior, reinforce the link between the payout and the performance goals, and tie employees to shareholders. This communication can be in the form of a quarterly email to the employee or an update to the stock plan website. Complicated performance goals may be difficult to track and present challenges in communicating interim progress to employees, which is another reason employee comprehension should be considered during the design phase.

6.3.2. There are many values that are associated with performance awards, including the threshold/target/maximum (as reported in the Grants of Plan-Based Awards Table), expected payout, and the probability of achievement for financial reporting purposes. Companies may use a more conservative value for reporting the expected payout to the employees than that used for financial reporting purposes. The more conservative value sets employee expectations regarding ultimate payout without impacting the expected value used for the financial reporting. For companies using a more conservative value for employee communications, the Company should be prepared to explain the difference upon employee inquiry.

6.4. Certification of Performance Results.

6.4.1. Once the performance goals have been met, the performance results should be certified prior to the vesting of the award. Develop and implement a procedure to certify performance results and to ensure the timely communication of the certification to the appropriate parties within the organization. Identify the individual(s) responsible for the process and document that the process is followed, even if the certification calculation is outsourced. In most cases the performance results are certified by the Board of Directors or the Compensation Committee of the Board. See Exhibit 6-3 for internal controls associated with certification of performance results.

6.4.2. Awards that have a variable payout or allow for discretion in the level of payout by the Board or Compensation Committee require special handling. Document the payout and clearly communicate the decision to the employee, the Equity Compensation group, and Financial Reporting.

6.5. Vest Process.

6.5.1. The vest date is defined in the Plan/Award Agreement and is the date the employee has earned the award and has acquired an unrestricted right to receive the underlying shares. At the vest date the award is no longer subject to forfeiture by the employee. The vest date may be –

- The end of the performance period
- When the performance results are certified
- The end of an additional service period after goal certification
- The date a PSU or PSA is paid out
- Some other date as defined by the Plan/Award Agreement

The vest date may also be defined to coincide with an open trading window. The vest date is always the first date the award is no longer subject to forfeiture. If an award is no longer subject to forfeiture upon retirement and the terms of the award provide for a guaranteed payout, the vest date would be the date the employee becomes retirement-eligible.

6.5.2. Once a PSO vests, the employee may exercise the award. For PSUs and PSAs, the vest date also controls when the PSU or PSA is taxable for social tax and/or income tax purposes. See subsection 7.2 for a discussion of the tax issues related to vest dates. The expense of the award is recorded over the period of the grant date to vest date. See Section 10, Financial Reporting, for a discussion of the financial reporting issues associated with the vest date. The vest date is defined in the Award Agreement and should be consistently applied to determine when the employee has earned the award, when a PSO can be exercised, the point of taxation of a PSU/PSA, and the period for amortizing the expense.

6.5.3. The vest of a performance award is typically triggered by a manual process because vesting is tied to performance goals, rather than the passage of time. To facilitate the vesting process, review awards prior to the measurement date to identify awards that may vest. Leverage the functionality of the stock plan system to process the vest. For example, if the awards were recorded at grant, the stock plan system may require the vest to be recorded manually. If the awards were tracked outside the stock plan system, the grant and the vest of the awards may be recorded at vest.

6.5.4. Processing variable payouts can be challenging. Determination of the payout percentage is typically done outside the stock plan system and the payout percentage is manually recorded in the system. The stock plan system applies the payout percentage to the appropriate awards and calculates the award to be paid out (i.e., number of shares vesting). Calculating variable payouts may result in fractional shares rather than whole shares. Since most companies do not issue fractional shares, the number of shares must be rounded up or rounded down. Establish a protocol for handling fractional shares.

6.5.5. Allow for a period of time between the measurement of the performance goals and the payout of shares to process the award. This time is necessary to handle various administrative requirements including certification of the performance results, as discussed in subsection 6.4, processing tax withholding, as discussed in Section 7, Tax/Payroll Issues, considering legal implications, as discussed in Section 8, Legal Issues, tracking changes of employment status, as discussed in Section 9, Change of Status, and providing instructions to the transfer agent, as discussed in paragraph 6.6.1.

EXHIBIT 6-3 - INTERNAL CONTROLS ASSOCIATED WITH CERTIFICATION OF PERFORMANCE RESULTS

	Illustrative Controls	Illustrative Test of Controls
1	Establish, document, and implement the process to certify performance goals.	Review the documentation to ensure the process was followed.

6.5.6. Develop a vest event checklist for handling each type of performance awards. Leverage the process and internal controls for processing service-based awards (i.e., awards without performance and market conditions) to ensure a timely and accurate payout of shares. See Exhibit 6-4 for internal controls associated with the vest process.

6.5.7. Employees may be less familiar with performance awards than other types of equity compensation. Best practice is to communicate with employees upon the vest of the award to emphasize the key aspects of the vest process. Communication of the vest of a PSU/PSA may include –

- How the payout is calculated
- How and when the award will be taxed
- How the tax will be collected and reported
- When the employee can expect to receive the stock and where the shares will be deposited
- Potential market fluctuation between the vest date and when shares get into account and can be sold
- What types of communications the employee will receive for tax filing purposes
- Instructions to contact the broker to conduct a sales of shares after the vest date

When PSU/PSA shares are paid out, advise the employees of –

- Number of shares vested
- Number of shares released
- Tax withheld and/or reported
- Number of shares sold/withheld for tax
- FMV of the shares released
- When and where to locate the shares to be deposited

This communication may be from the Company, third-party administrator, or broker.

6.6. Payout.

6.6.1. The payout process for a PSU/PSA is similar to that of awards with no performance conditions or market conditions. No shares are issued when a PSU is granted. The underlying shares are issued at the payout date. At payout the transfer agent issues the shares and releases them to the employee's account or as a book entry. When a PSA is granted, shares are issued. The shares are nontransferable and subject to restrictions. At payout, these restrictions lapse. The transfer agent is advised to release the shares to the broker for deposit into the employee's account or as a book entry. As discussed in paragraph 5.8.1, a PSA subject to a variable payout may require special handling. If the actual number of shares earned is different from the shares issued at the grant date, additional shares must be issued or unearned shares must be cancelled. Subsection 6.8 addresses the exercise of PSOs.

A PSU/PSA is vested when the award is no longer subject to forfeiture and the payout of a PSU/PSA occurs when the underlying shares are delivered to the employee.

6.6.2. Performance awards typically include a service requirement; however in certain cases, the award may provide for a pro rata payment to employees whose status has changed. See paragraph 3.4.3 and Section 9, Change of Status, for more detail.

EXHIBIT 6-4 - INTERNAL CONTROLS ASSOCIATED WITH VEST PROCESS

	Illustrative Controls	Illustrative Test of Controls
1	Establish and document a process to record the vest of performance awards.	Inspect documentation to ensure that requirements have been met.
2	Establish and document a process to handle fractional shares resulting from awards with a variable payout.	Verify the established process was followed.
3	Establish procedures to notify employees of awards that will vest and awards that have vested.	Confirm process has been followed.

6.6.3. Accounting for the payout of shares in fungible and/or omnibus plans can be challenging. Instructions to the transfer agent must be explicit. For example, when paying out a PSU/PSA the following details should be included:

- Number of shares to be issued and/or released
- Number of shares to be removed from the plan reserves for shares withheld for taxes, if applicable
- Name of the brokerage firm and employee account number where the shares should be deposited

The transfer agent should also receive detailed instructions for handling unique share counting methodologies such as those required by variable payouts or certain types of awards (e.g., each PSU share counts as 1.5 shares in the share pool). If the administration of performance awards is outsourced to a third-party, the share counting methodology and responsibilities for communications with the transfer agent must be clearly defined. On a monthly basis to minimize problems, reconcile total unvested grants in the stock plan system to the shares issued by the transfer agent held in the custodial account or in book entry.

6.7. Deferral Provisions.

6.7.1. PSUs may provide for a delayed payout. This deferral may be elected by the employee receiving the award or may be a requirement under the terms of the Award Agreement. The deferral of the payout date may create tax issues. See subsection 7.6 for a discussion of the tax impact of deferral provisions.

6.7.2. If an award has a deferral provision, the award must be tracked between the vest date and the date shares are released. Develop a process to track these awards. Leverage the functionality of the stock plan system where possible. Reconcile the vested shares periodically. Exercise care to ensure that the vested shares are properly reflected for financial reporting purposes.

6.7.3. Employee disclosures should reflect awards that have been earned, but are not yet paid out. These awards should be shown separately in recognition of their special treatment. Disclosure should include when the shares will be paid out.

6.8. Exercise of Performance Stock Options.

6.8.1. Once PSOs vest, their treatment is similar to that of options with no performance goals. An employee who holds an option may exercise the option and purchase the underlying shares of stock any time after the option is vested and before the term of the option expires. To exercise the options (purchase the shares at the price specified in the Award Agreement), the employee must pay the exercise price that is specified in the Award Agreement. Any increase in the FMV of the stock between the price specified in the Award Agreement and the FMV on the exercise date is taxable income to the employee.

6.8.2. The key processes associated with the exercise of PSOs are similar to the processes associated with options without performance goals.

6.9. Dividends.

6.9.1. An employee receives restricted stock when a PSA is granted. The restricted stock may have dividend rights, but these rights are not mandatory. When a PSU is granted, the employee has received a promise to receive shares at some future date if the performance goals are met. Because the employee does not acquire "shares" and is not a shareholder, there are no dividend rights. The Company may choose to pay dividend equivalents to mirror the treatment of dividends paid on a PSA. Dividends are not typically paid on PSOs. For purposes of this publication we will refer to dividends and dividend equivalents under the term "dividends."

6.9.2. The Plan/Award Agreement specifies the right of the employee to receive dividends. Dividends may be –

- Paid currently in cash or stock
- Paid currently and reinvested in company stock
- Deferred and paid out at a future date in cash or stock

It is more common to pay dividends on PSAs rather than PSUs. The transfer agent should be advised when a PSA is issued whether or not dividends will be paid and the method of payment. Dividends paid on PSUs are typically deferred and paid when the shares are released to the employee. Deferred dividends are usually subject to the same restrictions as the underlying performance award. Even if the Company does not currently pay dividends, dividends should be addressed in the Plan.

6.9.3. Paying dividends on PSUs and PSAs, as compared to the payment of dividends to regular shareholders, requires additional administration and internal controls. For each award, determine if dividends will be paid and how they will be paid. Document the requirements and how they are incorporated into the administrative processes, system functionality, and documentation provided to the employee.

6.9.4. Dividends paid on a PSU or PSA are taxed as compensation income, rather than dividend income and are included on the employee's W-2. This income is subject to income tax and FICA tax. The timing of the taxable event is summarized in Exhibit 6-5.

6.9.5. If the dividend is paid in cash (on the dividend payable date or deferred until a future date and paid in cash), taxable income is the gross dividend paid to the employee. No reduction in taxable income is permitted for any tax withheld. If the dividend is paid in stock (e.g., reinvested dividends or deferred dividends paid in stock), taxable income for income tax purposes is the FMV of stock as determined by the Plan on the vest/release date. Taxable income for FICA purposes is the FMV of stock on the date the dividend is taxed.

EXHIBIT 6-5 – DIVIDENDS: TIMING OF THE TAXABLE EVENT

	Income Tax*	**FICA** (Social Security and Medicare)
Dividend Equivalents Paid on PSUs		
Dividend equivalents paid on dividend payable date	Taxable on dividend payable date	Taxable on dividend payable date
Dividend equivalent deferred (but not subject to the risk of forfeiture) until the underlying shares are paid out	Taxable on release date	Taxable on dividend payable date
Dividend equivalent deferred (and subject to the risk of forfeiture) until the underlying shares are paid out	Taxable on release date	Taxable on release date
Dividend Paid on PSAs		
Dividend paid on dividend payable date	Taxable on dividend payable date	Taxable on dividend payable date
Dividend deferred (but not subject to the risk of forfeiture) until the award vests	Taxable on vest date	Taxable on dividend payable date
Dividend deferred (and subject to the risk of forfeiture) until the award vests	Taxable on vest date	Taxable on vest date

* Taxed as compensation income, rather than dividend income.

6.9.6. The process and controls for paying dividends on performance awards is highly dependent on the capabilities of the stock plan system. The stock plan system may include the following functionality:

- Tracking, recording, and reporting the taxable income from dividends in the payroll system
- Tracking dividends earned, but deferred for future payout
- Processing fractional shares in a dividend reinvestment program
- Prorating dividends when an underlying award is partially forfeited due to termination

Develop and document a process to handle dividend payments. Identify system limitations that require manual workarounds and implement appropriate internal controls.

6.9.7. A corporate tax deduction is allowed for the amount of dividends paid on performance awards that are reported as compensation income to the employee. Reporting for payroll tax purposes does not mean Corporate Tax has appropriate information to claim the corporate deduction. Establish and document a process to advise Corporate Tax of the amount of dividends paid on performance awards each quarter.

6.9.8. See Exhibit 6-6 for internal controls associated with dividends. A more complete discussion of the processes and internal controls associated with paying dividends is included in a previous GPS research publication on restricted stock/restricted stock units. Details of this research and the downloadable publication are available at www.scu.edu/business/cepi/.

EXHIBIT 6-6 – INTERNAL CONTROLS ASSOCIATED WITH DIVIDENDS

	Illustrative Controls	Illustrative Test of Controls
1	For each Plan, determine if dividends will be paid and how they will be paid. Document the requirements and how they are incorporated into the administrative processes, system functionality, and documentation provided to the employees.	Confirm documentation of all plans. Sample awards that receive current dividends. Verify that appropriate dividends were paid or deferred in accordance with the plan requirements.
2	Determine how the FMV of stock dividends are determined for each Award. Document the calculation of the FMV.	Select several payment dates and review the calculation of the FMV of stock dividends to confirm the established procedure was followed.
3	Develop and implement a procedure to pay dividends to employees holding unvested PSUs and PSAs. Provide detailed instructions to the transfer agent, as appropriate.	Review the documentation of the dividend payment process.
4	Establish and document the process to record the taxable income from dividends in the payroll system. Reconcile the dividend paid to the dividend income reported in the payroll system.	Sample dividend payments and verify that the income was reported in the payroll system on a timely basis and to the correct employee.
5	Establish and document a process to advise Corporate Tax of the amount of dividends paid on unvested equity compensation for each quarter.	Verify the process exists and is being followed.

GLOBAL ISSUE

Some non-US countries require that companies calculate the FMV of the shares on the vest date for purposes of calculating the taxable income using a local valuation methodology. For example, the valuation may be based on an average over the month prior to the vest date or a seven-day weighted average. Care should be taken to identify grants made in these jurisdictions to ensure that withholding and reporting is based on the appropriate local FMV.

Tax/Payroll Issues.

7.1. Overview.

7.1.1. Tax and payroll issues are among the most complex and challenging areas of administration. The point of taxation for performance awards is generally the same as the taxation of awards without performance or market conditions.

7.1.2. At the point of taxation the employee recognizes taxable gain equal to the difference between the FMV of the shares and the purchase price of the shares (for a PSU and PSA the purchase price is normally $0 and so the taxable gain equals the FMV of the shares). The Company is required to withhold federal, state, local, and FICA taxes on the taxable income. In addition, the Company must include the taxable gain as income on the employee's Form W-2.

7.2. Point of Taxation.

7.2.1. PSUs are treated like cash compensation and generally considered deferred compensation under IRC §3121(v). As such, they are taxable for social tax purposes at vest under IRC §3121(v) and for income tax purposes upon release (issuance) of the shares. The Internal Revenue Code provides several methods of delaying the collection of FICA tax from the vest date to a later point in time; however, in no case can the reporting of income for social tax purposes be later than the reporting for income tax purposes. For example, if a PSU vests on December 1 and shares are released on the following January 15, a company could elect to have the PSU treated as a short-term deferral. In this case the PSU is taxed for social tax and income tax on January 15 based on the FMV of the award on January 15. Another commonly used provision is IRC §31.3121(v)(2)-1(e)(5) that permits an employer to delay reporting income for FICA tax purposes to any subsequent date within the same calendar year for "administrative convenience." In other words, an employer could report and collect FICA tax on December 31 for a PSU that vested during the year. Assuming the employee had met the limit on the Social Security portion of FICA by the end of the year, only the Medicare portion of FICA would be required to be collected on the award. When using the rule of "administrative convenience," FICA withholding is based on the FMV of the award on the date FICA is collected from the employee. Taxation of a PSU to retirement-eligible employees is discussed in Paragraph 7.5.5. A corporate tax deduction may be claimed when the award is taxable for income tax purposes to the employee provided the employer has reported the income on Form W-2. The corporate deduction equals the amount of taxable income of the employee. A discussion of a potential limit on the corporate deduction under IRC§162(m) is discussed in subsection 7.7.

7.2.2. PSAs are taxable under IRC §83 for income and social tax purposes when the property is no longer subject to a substantial risk of forfeiture. Normally the award is no longer subject to forfeiture when the restrictions lapse on date of vest. Paragraph 7.5.5 discusses taxation of retirement-eligible employees. A corporate tax deduction is permitted as noted in paragraph 7.2.1.

GLOBAL ISSUE

The point of taxation of performance awards may vary in each country. Consult tax and legal counsel to determine the taxation in appropriate countries. The timing of income tax may differ from the timing of social tax in some countries.

7.2.3. PSOs are taxable for income and social tax purposes when the employee exercises the option. Paragraph 7.5.5 discusses taxation of retirement-eligible employees. The Company may claim a tax deduction for the amount reported as income by the employee.

7.2.4. The Plan, the Award Agreement, or plan interpretations may define how the FMV is calculated at the point of taxation. (For purposes of this publication it is assumed FMV is defined by the Plan.) FMV may be determined in a variety of ways such as the market close on the day prior to vest/exercise, the market close on the vest/exercise date, or the average of the high/low on the vest/exercise date. The FMV, as defined by the Plan, is used to calculate taxable income for the employee.

7.2.5. If the vest and release dates are simultaneous, both a PSU and a PSA are taxed for income and social taxes on the vest/release date. As discussed in paragraphs 6.5.1 and 6.5.2, the vest date is defined in the Plan/Award Agreement and will determine if the vest and release dates are simultaneous.

7.2.6. The tax treatment differs for a PSU and PSA if the release of the underlying shares is delayed for any reason such as a delay due to a blackout period, an administrative period to process the award, a post-vesting holding period, or an integral part of the award design to encourage employee retention. If the release of the award will be delayed to a point after the vest date, a PSU is the preferred performance vehicle due to its favorable tax treatment. Since PSUs are taxable for income tax purposes upon the release of the shares, the payout of a PSU may be deferred with minimal tax consequences (i.e., only social tax is due upon vest, rather than income tax). If the payout of a PSU is deferred for more than 2 ½ months beyond the year of vesting, IRC §409A may apply. See subsection 7.6 for a more detailed discussion about the consequences of deferral provisions under §409A.

7.3. Tax Withholding – Performance Stock Units/ Performance Stock Awards.

7.3.1. The tax due may be paid by the employee by withholding a portion of the performance award shares (withhold-to-cover), selling a portion of the shares to fund withholding (sell-to-cover), or having the employee remit cash to the Company to cover the required withholding. The advantages and disadvantages of each method are discussed below.

7.3.2. Withhold-to-cover is used frequently by companies that have sufficient cash to pay the payroll tax. The payroll tax is calculated on the taxable income to be reported. The required tax will be paid to the Company by the employee as shares where the Company withholds shares from the award equal to the amount of tax divided by the FMV of a share. The share value is based on FMV defined by the Plan. (This mirrors the FMV used in the calculation of taxable income.)

IRC §83(b) Election - Normally a PSA is taxed when the award vests. An employee may make an IRC §83(b) election (commonly referred to as an 83(b) election) to have a PSA taxed at grant. Under IRC §83(b) the employee elects to include in taxable income in the year of grant the FMV of the shares as determined on the date of grant. In most cases an 83(b) election would only be appropriate for a PSA if the award provides for a minimum payout. An 83(b) election is not available for a PSU or a PSO. An 83(b) election is not widely used and requires additional employee communication to make sure that the employee understands the tax consequences of making the election. Similar elections to be taxed on a PSA at grant exist in other countries as well.

7.3.3. Most companies do not allow for the issuance of fractional shares. Therefore, the calculation of the number of shares that must be withheld is rounded to whole shares. If the fractional share is rounded up to next whole share, the FMV of the partial share is added to withholding or refunded to the employee. ASC 718 now requires liability accounting if shares are withheld for tax in excess of the maximum individual statutory requirements. In some cases, rounding up may be interpreted as exceeding the maximum individual statutory requirements. Consult with the Company's external auditor to ensure the way fractional shares are handled does not affect the classification of the award as an equity instrument. Further, please consult all tax obligations and policies from the Internal Revenue Service when determining the amount to withhold. The Internal Revenue Service determines taxation requirements on equity awards. The policy under ASC 718 as created by the FASB is focused on the accounting of share-based payments and does not consider other tax consequences should a company withhold at the maximum individual statutory requirements. If the Company chooses to withhold at the minimum individual statutory requirements and the fractional share is rounded down to the next whole share, the shortfall of tax is collected from the employee's earnings in the next payroll cycle or the employee remits cash to the Company to pay the shortfall. (Caution: The Sarbanes-Oxley Act of 2002 prohibits public companies from making loans to their executive officers. Collecting a tax shortfall in the next payroll cycle may be deemed a loan and prohibited under the Act.)

7.3.4. The Company is required to pay cash from company funds for the payroll tax deposit. Since no shares have been sold in a withhold-to-cover transaction, there are no sales proceeds to fund the payroll tax deposit. See Exhibit 7-1 for examples of withhold-to-cover and sell-to-cover.

7.3.5. The advantages of withhold-to-cover are –

- Minimize dilution (In Exhibit 7-1, 310 shares rather than 450 shares are released; 140 shares may be held as Treasury Shares or returned to the plan reserves, if permitted by the Plan)
- Easier to administer than the sell-to-cover or cash method
- Employee does not pay any commissions or fees on the shares withheld

EXHIBIT 7-1 – COMPARISON OF WITHHOLD-TO-COVER AND SELL-TO-COVER

Facts:

450 shares vest

FMV as defined by the Plan = $9.20 per share

Applicable tax rate = 31%

Fractional shares rounded up to whole shares with residual applied as additional withholding

Sales proceeds = $9.20 per share

Shares withheld or sold are rounded up to the nearest whole share

	Withhold-to-Cover	Sell-to-Cover
Taxable Income	$4,140 (450 x $9.20)	$4,140 (450 x $9.20)
Tax Withheld	$1,283.40 ($4,140 x 31%)	$1,283.40 ($4,140 x 31%)
Shares Withheld for Tax	140 ($1,283.40/$9.20 = 139.5 shares rounded to 140)	None
Shares Issued to Employee	310 (450 – 140)	450
Shares Sold for Tax	None	140 ($1,283.40/$9.20 = 139.5 shares rounded to 140)
Funding of Tax Withholding	From company funds	From sales proceeds

- Minimizes involvement of Treasury since no cash is transferred to the Company

The disadvantages of withhold-to-cover are –

- Company must fund the employee's payroll tax by using company cash, rather than utilizing cash generated by the sale of stock
- Rounding up of fractional shares when withholding at the maximum individual statutory rate as discussed in 7.3.3 may create accounting issues

7.3.6. The second method, sell-to-cover, is used frequently by companies that have insufficient cash to pay the payroll tax. Taxable income is calculated based on FMV defined by the Plan. The payroll tax is calculated on the taxable income to be reported. The employee receives the full number of shares and must sell a portion of the shares to generate cash to pay the required tax. The Company, broker, or third-party administrator estimates the number of shares required to be sold to deliver appropriate funds from the stock proceeds to pay the tax and the broker's commissions and fees. The number of shares to be sold may be rounded up to equal whole shares, not fractional shares, and to cover market fluctuation in the shares. (Market fluctuation is the difference in the estimate of the proceeds from the stock sale and the actual proceeds from the sale of stock.)

7.3.7. The sale usually occurs on the day after the shares are released. In many cases, the broker executes a block sale of shares for all employees and the average sales price is applied to each employee. The reporting of the sale of the shares is usually handled by the broker. The sale proceeds equal the sales price per share multiplied by the number of shares sold. The sales price per share may not equal the taxable income per share initially calculated due to the market fluctuation between the vest date and the date the shares are sold. If sales proceeds exceed the amount of required tax withholding, the excess can be refunded to the employee by transferring the additional proceeds into the employee's brokerage account or by adding the additional proceeds to the tax withholding. See Exhibit 7-1, paragraph 7.3.4, for an example of sell-to-cover.

7.3.8. The advantage of sell-to-cover is –

- Sales proceeds fund the payroll tax deposit, rather than using company cash

The disadvantages of sell-to-cover are –

- The challenge of estimating the number of shares to be sold to pay tax and the complications of handling proceeds that exceed or fall short of the required tax
- Significant time and effort is required
- Securing employee authorization to sell shares
- Ensuring the employees have activated their brokerage account
- Selling shares during a closed window may be difficult or prohibited, as discussed in subsection 8.1
- Potential impact on the market price if a significant number of shares are sold on the same date
- Additional dilution (In Exhibit 7-1, paragraph 7.3.4, 450 shares rather than 310 shares are released)

7.3.9. In the third method the employee remits cash to the Company to cover withholding. The calculation of taxable income and associated tax is identical to the calculation in a withhold-to-cover or sell-to-cover transaction. Prompt collection of the payroll tax presents an administrative challenge. The calculation of the tax occurs on the vest date or the subsequent day. Payroll tax is due immediately, but it may be impractical to collect funds from the employee immediately. A wire transfer of funds may be difficult. Even if the employee delivers a check on the vest date, the Company should wait until the check clears before releasing the shares. Companies need to consider the administrative complications associated with this method when allowing employees to pay their tax obligations in cash.

GLOBAL ISSUE

Non-US tax jurisdictions may have different rules. Withholding and reporting requirements may differ. Tax years may be different (e.g., the tax year end may be April 5 rather than December 31). A variety of civil and criminal penalties may be assessed for inadequate withholding. Care must be taken to determine the appropriate tax requirements of each jurisdiction.

7.3.10. Best practice is to use one method to collect payroll tax, either withhold-to-cover or sell-to-cover, for all employees. If multiple methods of payment are offered and employees are allowed to elect which method to use, require the employee to make the election at least 15 days prior to vest. If no election is received within 15 days prior to vest, provide a default method (that does not require employee action) such as withhold-to-cover. Prohibit employees from changing their elections within 15 days of vest. The requirements related to the collection of payroll tax are usually incorporated into the Award Agreement. Note – An Insider may only be able to make an election regarding the way payroll tax will be paid during an open window.

7.4. Tax Withholding – Performance Stock Options.

7.4.1. Tax is due when a PSO is exercised. The employee may pay the tax in a variety of ways including:

- From the proceeds of the sale of stock acquired in the option exercise (same-day-sale or sell-to-cover)
- By withholding a portion of the shares to fund withholding
- Remitting cash to the Company to cover the withholding

7.4.2. In a same-day-sale the employee exercises the option, sells the stock acquired, and uses the proceeds from the sale of stock to pay both the exercise price and tax withholding. The employee pays no out-of-pocket cash to exercise the option and retains no ownership in company stock after the transaction. A sell-to-cover exercise is similar to a same-day-sale. Only a portion of the acquired shares are sold and the employee retains ownership of the balance. See paragraphs 7.3.2 to 7.3.5 for a discussion on withhold-to-cover. See paragraph 7.3.9 for a discussion of the challenges of the remittance of cash to cover the required withholding.

GLOBAL ISSUE

Acceptable methods of paying tax may be restricted and/or require employee consent in certain jurisdictions. Additional flexibility with respect to tax payment methods may be required for non-US employees. Many countries do not have a minimum statutory withholding rate. As a result, companies may require sell-to-cover for non-US employees to avoid adverse accounting consequences.

7.5. Challenging Design Features of a Performance Stock Unit/Performance Stock Award.

7.5.1. The relationship between the vest date and the point of taxation may result in unforeseen consequences when administering the Plan. Certain design features may make compliance with payroll tax requirements difficult. Some of the more common design features that can create tax challenges are –

- Automatic vesting upon achievement of performance goals
- Vesting prior to certification of performance results
- Vesting on the date performance results certified
- Discretion of Board to increase variable payout
- Continued or accelerated vesting upon retirement
- Post-vest holding periods if the grant is not in the form of units

7.5.2. Consider a market condition that provides for the vesting of a PSA when the stock price reaches $60. If the stock price is based on the market high for the day, the award may vest with little or no warning. A PSA would be taxable for income and social tax purposes when the award vests. As noted in previous GPS publications, the tax authorities have stringent requirements regarding timely deposit of payroll taxes. Tax is required to be withheld when the award is taxable (i.e., the day the award vests). If on any day an employer has $100,000 or more of federal employment taxes accumulated, these taxes must be deposited by the close of the next banking day. Tracking the performance goals, administering the vest process, and withholding appropriate taxes within a 24-hour period is difficult to coordinate when there is insufficient time or advance warning of the event. This problem could be avoided with minor modifications to the Plan to delay the vest date to allow for time to administer the payout of the award. An alternative would be to utilize PSUs rather than PSAs.

7.5.3. Certification of the performance results must be considered when establishing the vest date. Assume an employee has an unrestricted right to receive the underlying shares on the date the performance goals are met. A PSA would be taxable for income and social tax on the date the performance goals are met. A PSU would be taxable for social tax on the date the performance goals are met. If the Plan provides that the performance goals must be certified before the shares are released to the employee, the award would be taxable, but no shares would be available to meet the tax withholding requirements. This problem could be avoided by establishing a vest date that is dependent on the certification of the performance results.

7.5.4. Such problems can be exacerbated if the Board has discretion in determining the amount of the award. If the vest date of a PSA is defined in the Plan as the date the performance goals have been met, the award will be taxable on that date. The taxable amount cannot be determined until the Board determines the amount of the award. Establishing a vest date that is dependent on the certification of the performance results and calculation of the award earned would eliminate this problem.

7.5.5. Some plans include provisions that awards immediately vest or continue vesting upon retirement. If an award provides for a minimum payout regardless of whether or not the performance goals have been met, the award will be taxable to the extent of the minimum payout when an employee is retirement-eligible. The acceleration of tax occurs because the retirement-eligible employee no longer has a risk of forfeiture. A PSA would be taxed immediately for income tax and social tax purposes. A PSU would be taxable immediately for social tax and taxed for income tax purposes when the shares are released. Tax would not be accelerated if the award does not guarantee a minimum payout since the award would still be subject to achieving the performance goals. (Plan provisions regarding retirement-eligibility do not impact the taxation of PSOs.) Awards with accelerated/continued vesting on retirement and minimum payouts should be closely examined to minimize any unforeseen tax consequences.

GLOBAL ISSUE

Non-US employees may also be subject to tax at the time the employee is retirement eligible. Further, if the retirement benefits are based on an employee reaching a specific age, the provisions may violate certain age discrimination provisions in some countries.

7.6. Tax Impact of Deferral Provisions.

7.6.1. As discussed in paragraph 6.7.1, some Plans/Award Agreements may provide for a delayed payout for all awards or at the election of the employee. In some circumstances a deferral of an award may create additional tax, penalties, and interest under IRC §409A. A PSU is taxed for social tax purposes at vest and income tax purposes when shares are released. A PSU may be subject to the provisions of IRC §409A if the shares are released more than 2 ½ months after the end of the year in which the vest date occurs. IRC §409A does not apply to a PSA. A vested PSO is exercised at the employee's discretion prior to the expiration of the option. Normally PSOs do not have deferral provisions beyond the exercise date (a PSO with deferral provisions may be subject to IRC §409A).

7.6.2. IRC §409A addresses the taxation of nonqualified deferred compensation (NQDC). A PSU may be considered NQDC, depending on the terms of the award. A PSA and a PSO are generally not treated as NQDC. If an award is NQDC, it must meet the requirements of IRC §409A to avoid immediate taxation and substantial penalties. Unless the IRC §409A requirements are satisfied, amounts deferred under a NQDC plan for all tax years are currently includible in gross income, to the extent the amounts were not previously taxed and not subject to a substantial risk of forfeiture.[3] Compensation is subject to a substantial risk of forfeiture if the employee's rights to such compensation are conditioned upon the future performance of substantial services.[4] If tax is due under IRC §409A, then the deferred compensation is taxable for income tax purposes and the income tax imposed is increased by 20%, plus interest at a penalty rate. There is no deferral of compensation if payment is made no later than 2 ½ months after the end of the year in which the vest date occurs (commonly referred to as a "short-term deferral"). Therefore, if a PSU is paid within the applicable 2 ½ month period, it will not be NQDC and the provisions of IRC §409A will not apply.

7.6.3. A complete discussion of IRC §409A is beyond the scope of this publication. Consult tax and/or legal counsel to determine whether the deferral of the release of shares for a PSU qualifies as a short-term deferral or, if not, whether the deferral meets the requirements of IRC §409A.

7.7. Limits on Corporate Tax Deductions.

7.7.1. A corporate tax deduction may be claimed for the ordinary income recognized by the employee when an equity award is taxed. The deduction may be limited (IRC §162(m)) for "covered" employees whose compensation exceeds the $1 million cap for the year. Specifically, IRC §162(m) limits a publicly-held corporation's deduction for compensation paid to its CEO and its next three highest-compensated officers, excluding the CFO, to $1 million per year.[5] Performance-based compensation is not subject to the $1 million cap provided the terms of the Plan comply with the numerous requirements under the IRC §162(m) regulations.

3 Conf Rept No. 108-755 (PL 108-357), p. 715

4 IRC §409(D)

5 Notice 2007-49, 2007 – 25 IRB 1429

7.7.2. The definition of performance-based compensation requires that the compensation is contingent on the "attainment of one or more performance goals, but only if -

(i) the performance goals are determined by a compensation committee of the board of directors of the [Company] which is comprised solely of 2 or more outside directors,

(ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration, and

(iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and any other material terms were in fact satisfied."[6]

As discussed in paragraphs 3.5.1 and 8.5.4, if the performance goals are modified after 90 days, the award will no longer qualify as performance-based compensation under IRC §162(m).

6 IRC §1.162(m)(3)(C)

7.7.3. The determination of whether an award qualifies as performance-based compensation is made on a grant-by-grant basis. A properly structured performance award will not be subject to the $1 million cap. A complete analysis of the issues associated with IRC §162(m) is beyond the scope of this publication.

7.7.4. SEC proxy rules require that the Compensation Discussion and Analysis state the corporation's policy with respect to IRC §162(m) (i.e., whether compensation paid to the corporation's officers is or is not intended to be fully deductible). This policy should be reviewed annually to determine that it accurately reflects the Committee's policy and the corporation's actual pay practices. See Exhibit 7-2 for internal controls associated with corporate tax deductions.

EXHIBIT 7-2 - INTERNAL CONTROLS ASSOCIATED WITH CORPORATE TAX DEDUCTIONS

	Illustrative Controls	Illustrative Test of Controls
1	Incorporate appropriate provisions in the Plan to meet IRC §162(m) requirements.	Confirm that provisions are included in the Plan.
2	Develop a policy to comply with IRC §162(m) performance-based compensation requirements.	Review policy to verify that appropriate requirements are included.
3	Identify the top three highest-compensated officers other than the CEO and excluding the CFO. For each grant to the CEO and these employees, document that appropriate IRC §162(m) requirements have been met.	Review documentation to confirm that the appropriate employees have been selected and the IRC §162(m) requirements have been met.
4	Document the policy with respect to IRC §162(m) in the Compensation Committee's report. Update the policy annually.	Confirm that the policy has been updated and documented in the Compensation Committee's report.

The SEC disclosure and reporting rules use specialized terminology that is not always consistent with commonly-used terms in equity compensation. For purposes of this publication, terminology in this section is consistent with terminology in the rest of the publication and may not align with SEC terminology.

Legal.

8.1. Overview.

8.1.1. Companies and employees are subject to a variety of legal requirements relating to equity compensation. Noncompliance with legal requirements may not have material financial statement implications, but can generate issues under Sarbanes-Oxley, raise concerns about company management and corporate governance policies, and identify weaknesses in internal controls.

8.1.2. When offering performance awards to employees, a company must adhere to a variety of legal requirements, including federal and state securities laws. A publicly-traded company must also adhere to SEC regulations and stock exchange requirements. This section discusses the unique legal issues associated with Section 16 reporting, proxy disclosures, and blackout periods for performance awards. The grant date of a performance award can have different ramifications for purposes of financial reporting, Section 16 reporting, and proxy disclosure. Highlights of such reporting are included as a high-level discussion. A complete discussion of the legal issues associated with performance awards is outside the scope of this publication.

8.2. Section 16 Reporting – General.

8.2.1. The Section 16 reporting of performance awards on Form 4 can vary, depending on whether the award constitutes a "derivative security," whether it is settled in cash or stock, and whether or not the grant and/or payout of the award is exempt from the short-swing profits recovery rules of Section 16(b). The primary determinant in how such awards are reportable under Section 16 is whether or not they constitute "derivative securities."

8.2.2. "Derivative securities" are awards that have a value derived from the value of an equity security.[7] A performance award that may be settled only in cash still may be a derivative security that is subject to Section 16 so long as the award "derives its value" from an equity security of the Issuer. Performance awards are not derivative securities unless their value is tied solely to the market price of an equity security of the Issuer. Form 4 reporting format depends on whether the award qualifies as a derivative security.

7 Rule 16a-1(c)

GLOBAL ISSUE

If the performance awards are granted to employees outside the U.S., the Company must also adhere to local securities law, exchange controls requirements, and other legal requirements.

Because performance awards can be structured with a wide variety of designs and vesting conditions, they require individual analysis under Section 16 of the Securities Exchange Act of 1934. This discussion focuses on Form 4 reporting. The information provided for Form 4 can also apply to the preparation of Forms 3 and 5.

8.2.3. The majority of performance awards are not derivative securities, because the value of the award is not tied solely to the value of an equity security. Examples of awards that are not derivative securities are awards whose value is based on –

- Return on Equity
- Earnings per Share
- Product quality
- Customer acceptance
- Job performance
- Increases in the Company's book value over time
- Stock price compared to a peer group
- Achievement of personal performance goals
- Attainment by the Issuer of earnings targets

Additionally, when the plan administrator (including the Compensation Committee or the Board) has discretion to adjust the performance goals, the award is not considered a derivative security.

8.2.4. Generally, PSAs that are non-derivatives are deemed acquired when the performance criteria have been satisfied, not as of the grant date. The SEC staff once expressed the view that PSAs carrying voting and dividends rights should be considered acquired on the date of grant, even though subject to forfeiture if the performance criteria are not satisfied. That view is not consistent with beneficial ownership standards, and for purposes of this publication PSAs are considered the same as PSUs for Section 16 reporting purposes. Involvement of Legal Counsel in this interpretation is necessary.

8.3. Section 16 Reporting – Non-Derivative Securities.

8.3.1. Performance awards that are classified as non-derivative securities are reported as follows:

- Grant — Not a reportable transaction
- Vest — Not a reportable transaction, unless vesting triggers payout
- Forfeiture or cancellation — Not a reportable transaction
- Payout — Constitutes a "grant or award" and, therefore, is eligible for exemption from Section 16(b) if the conditions of Rule 16b-3(d) are met; reported on Form 4 by the end of the second business day after the date shares are released, regardless of whether exempt from Section 16(b)

8.3.2. If a non-derivative performance award is settled in stock at the time of vesting, the award itself is never reported, but the Insider's receipt of stock upon payout of the award must be reported in Table I of Form 4. The payout of shares does not involve the disposition of a derivative security and, therefore, does not require reporting of the disposition of the performance awards in Table II of Form 4. Instead, only the acquisition of the underlying shares should be reported in Table I.

8.3.3. Cash settlement of performance awards that are non-derivative securities can be interpreted in two ways. These awards can be viewed as a cash bonus that is not reportable under Section 16. This position is most defensible where the award can be settled only for cash or the holder elects, prior to vesting, to receive cash upon payout of the award. Alternatively, cash settlement of the award can be interpreted as the simultaneous acquisition of stock and disposition of that stock back to the Issuer (both of which are reportable in Table I of Form 4). If the original award was exempt from Section 16(b) under Rule 16b-3(d), the payout would also be exempt from short-swing profit recovery under Section 16(b), but not exempt from reporting under Section 16(a). Involvement of Legal Counsel in this interpretation is necessary.

8.4. Section 16 Reporting – Derivative Securities.

8.4.1. Performance awards that are classified as derivative securities (except as noted below for awards settleable solely in common stock on a one-for-one basis) are reported as follows:

- Grant — Reported on Form 4 within two business days after the grant date, whether or not it is exempt from Section 16(b); report on Table II as the acquisition of a derivative security
- Vest — Not a reportable transaction, unless vesting triggers payout
- Forfeiture or cancellation— Not a reportable transaction, unless for consideration
- Payout — Deemed to involve both the disposition of the derivative security (reported in Table II of Form 4) and the acquisition of the underlying stock (reported in Table I)

Alternatively, derivative securities settled solely in common stock on a one-for-one basis may be reported as follows:

- Grant — Reported on Form 4 within two business days after the grant date, whether or not it is exempt from Section 16(b); may report on Table I
- Vest — Not a reportable transaction, unless vesting triggers payout
- Forfeiture or cancellation— Not a reportable transaction, unless for consideration
- Payout —Nothing to reported on Table II at payout, but report on Table I any additional shares earned over the originally reported target shares

See Exhibit 8-1 for a summary of Section 16 reporting requirements for performance awards.

8.4.2. The cash settlement of derivative securities involves, first, a conversion of the derivative security into the underlying stock, and then a disposition of the stock to the Issuer.[8] The disposition of the derivative security is reportable in Table II of Form 4. The simultaneous acquisition and disposition of the underlying stock is reportable on two lines in Table I.

8.4.3. If the original grant of the award was approved in accordance with Rule 16b-3(d), then (i) the disposition of the performance award and the deemed acquisition of the underlying stock would be reportable using transaction code "M" ("Exercise or conversion of derivative security exempted pursuant to Rule 16b-3"), and (ii) the deemed disposition of the stock to the Issuer (in the case of a cash-settled performance award) would be exempt from Section 16(b) by virtue of Rule 16b-3(e) and reported using transaction code "D" ("Disposition to the issuer of issuer equity securities pursuant to Rule 16b-3(e)").

8.4.4. If the original grant of the award was NOT approved in accordance with Rule 16b-3(d), then the disposition of the performance award and the deemed acquisition of the underlying stock may be exempt under Rule 16b-6(b), but the deemed disposition of stock back to the Issuer (in the case of a cash-settled performance award) would not be exempt, and would be reportable using transaction code "S" ("Open market or private sale of non-derivative or derivative security").

8 American Bar Association (December 20, 1996) (Q.4(b)(4)

EXHIBIT 8-1 – SECTION 16 REPORTING FOR PERFORMANCE AWARDS[1]			
Performance Award Description[2]	**Derivative Security?**	**Form 4 Filing on Grant**	**Form 4 Filing on Settlement**
PSU/PSAs earned if (i) stock price reaches $30 by December 31, 20XX, **and** (ii) EPS exceeds $2.50 for FY 20XX. Award settles in **stock** upon vesting.	No	N/A	Within 2 days after vesting. Table I shows exempt acquisition of stock (Code A).
PSU/PSAs earned if (i) stock price reaches $30 by December 31, 20XX, **and** (ii) EPS exceeds $2.50 for FY 20XX. Award settles in **cash** upon vesting.	No	N/A	Within 2 days after vesting. Table I shows exempt acquisition of stock (Code A) and simultaneous exempt disposition of stock to the Issuer for cash (Code D).
PSU/PSAs earned if (i) stock price reaches $30 by December 31, 20XX, **or** (ii) EPS exceeds $2.50 for FY 20XX. Award settles in **stock** upon vesting.	No	N/A	Within 2 days after vesting. Table I shows exempt acquisition of stock (Code A).
PSU/PSAs earned if stock price reaches $30 by December 31, 20XX, **unless** Committee determines a lower payout based on individual performance. Award settles in **stock** upon vesting.	No	N/A	Within 2 days after vesting. Table I shows exempt acquisition of stock (Code A).
PSU/PSAs earned if Issuer's TSR over FY 20X1 – 20X3 ranks in the top 1/3 of a specified peer group over the same period. Award settles in **stock** upon vesting	No	N/A	Within 2 days after vesting. Table I shows exempt acquisition of stock (Code A).
PSU/PSAs earned if Issuer's TSR[3] over FY 20X1 – 20X3 exceeds Y%. Award settles in **stock** upon vesting.	In some cases[4]	Yes, if derivative security. N/A, if not.	Within 2 days after vesting. Table I shows exempt acquisition of stock (Code A). Table II shows exempt disposition of derivative security, if applicable (Code M).[5]
PSU/PSAs earned if stock price reaches $30 by December 31, 20XX. Award settles in **stock** upon vesting.	Yes	Within 2 days after grant date. Report on Table II as a derivative security (Code A).[5]	Within 2 days after vesting. Table II shows exempt disposition of derivative security (Code M). Table I shows exempt acquisition of stock (Code M).[5]
PSU/PSAs earned if stock price reaches $30 by December 31, 20XX. Award settles in **cash** upon vesting.	Yes	Within 2 days after grant date. Report on Table II as a derivative security (Code A).	Within 2 days after vesting. Table II shows exempt disposition of derivative security (Code M). Table I shows exempt acquisition of stock (Code M) and simultaneous exempt disposition of stock to the Issuer for cash (Code D).

1 This table only reflects reporting for shares released. Reporting for shares sold or withheld for taxes is not addressed.

2 Assume in each case the award was pre-approved by two non-employee directors and is, therefore, exempt from Section 16(b) under Rule 16b-3(d).

3 TSR (stock price appreciation plus dividends).

4 Not a derivative security for companies that pay substantial regular dividends. According to the SEC staff, this may be a derivative security if the Company pays no dividends or only de minimis dividends, such that value is derived almost entirely on appreciation is stock price. See ABA Joint Committee on Employee Benefits, SEC Q&A 9, May 6, 2008.

5 Chart shows normal reporting for grant and settlement of derivative securities. If the award may be settled solely in common stock on a one-for-one basis and may not be settled for cash, may alternatively report the grant on Table I as an acquisition of stock. In that case, upon settlement, no reporting on Table II, but Table I would report the acquisition of any additional shares earned over the originally reported target shares.

8.5. Proxy Statement Disclosure – Compensation Discussion and Analysis (CD&A).

8.5.1. US public companies are required to include in their annual proxy statements a CD&A which is a narrative description and analysis of the Company's compensation objectives, policies, and pay decisions with respect to its top five executive officers. Among the many topics required to be addressed are the Company's incentive compensation arrangements, including the reasons for the selection of specific performance measures, specific goals with respect to each measure, and the resulting performance outcomes.

8.5.2. Performance goals are required to be disclosed if they are material to the compensation decision; however, companies are not required to disclose details that would result in competitive harm. The SEC Staff has been generally skeptical of competitive harm arguments in the context of CD&A disclosure of performance goals. To the extent that a performance target level or other factor or criteria otherwise has been disclosed publicly, a company cannot rely on a competitive harm position to withhold the information. If a company does withhold information on performance goals, the CD&A must discuss the significance of the undisclosed goal, so that an investor could understand the relative degree of difficulty in achieving the goal.

8.5.3. The CD&A must also discuss whether discretion can be or has been exercised – either to award compensation absent attainment of the relevant performance goals or to reduce/increase the size of any award or payout. Companies are required to identify any particular exercise of discretion, and state whether it applied to one or more specified officers or to all compensation subject to the relevant performance goals.

8.5.4. Modification of performance goals can be a sensitive area for shareholders. To minimize the risk of a negative say-on-pay vote, be prepared to provide a thorough and compelling explanation for any such modifications or exercises of discretion.

8.6. Proxy Statement Disclosure – Summary Compensation Table.

8.6.1. The reporting of performance awards in the Summary Compensation Table is determined by whether the award is an "equity incentive plan award" covered by ASC Topic 718, which would include PSUs, PSAs, and PSOs settled in cash or stock, or a "non-equity incentive plan award" that is not covered by ASC Topic 718, such as a performance award payable in cash where the value is not determined in whole or in part on the Company's stock price. This distinction can create timing differences in the reporting.

8.6.2. Equity incentive plan awards are reported as follows:

- Reported in the Option or Stock column of the Summary Compensation Table, the same as if they were time-based awards, using the grant date fair value based on the probable outcome, excluding the effect of estimated forfeitures. The probable payout at the time of grant is always used, even if subsequent assessments change the probable outcome. If the probable outcome at the grant date is less than the maximum payout, disclose the maximum payout in a footnote to the table.
- Reported in the Summary Compensation Table for the year in which they were granted.

8.6.3. Non-equity incentive plan awards are reported as follows:

- Reported in the Non-Equity Incentive Plan Compensation column of the Summary Compensation Table. If, in the exercise of discretion, an amount is paid over and above the amount earned by meeting the performance goals, that excess should be reported in the Bonus column.[9]
- Reported for the year in which the relevant specified performance criteria are satisfied and the compensation is earned, whether or not payment is actually made in that year. In the case of separate performance periods, the disclosure is made on a tranche basis, as earned.
- Also reported in the Grants of Plan-Based Awards Table in the year of grant.
- Once the grant of the award has been disclosed in the Grants of Plan-Based Awards Table and the vesting of the award has been disclosed in the Summary Compensation table, no further disclosure is required when the award is paid.

9 Question 119.02 of the SEC Staff's Compliance and Disclosure Interpretations of Regulation S-K

8.7. Proxy Statement Disclosure – Grants of Plan-Based Awards Table.

8.7.1. When reporting performance awards (equity or non-equity incentive plan awards) in the Grants of Plan-Based Awards Table, the estimated payout based on threshold, target, and maximum performance, or the applicable range of estimated payouts, is required to be reported. For this purpose, the terms are defined as –

- Threshold – The minimum amount payable if specified threshold performance (if any) is achieved. This does not mean "zero."
- Target – The amount payable if the specified target performance level is achieved.
- Maximum – The maximum payout possible under the award.

If the award provides only for a single estimated payout, that amount should be reported as the "target" level. Provide a representative amount based on the previous fiscal year's performance if the target amount is not determinable, and provide an explanation in a footnote or in the narrative following the table.

8.7.2. This table also calls for the grant date fair value of equity awards. In the case of performance awards, report grant date fair value based upon the probable outcome of the performance conditions (which is not always the target amount), consistent with the estimate of aggregate compensation cost to be recognized over the service period determined as of the grant date under ASC Topic 718, excluding the effect of estimated forfeitures. This concept is consistent with the approach used for the Summary Compensation Table disclosure, as discussed in paragraph 8.6.2.

8.7.3. Each award should be disclosed on a separate line, identifying the plan under which it was made. Any consideration paid by the executive officer for the award should be disclosed in a footnote.

8.7.4. The narrative discussion following this table should also cover the material terms of any performance award reported in the table, including a general description of the formula or criteria to be applied in determining the amounts payable and the vesting schedule. Any performance-based conditions or other material conditions that are applicable to the award should be described, unless they would result in competitive harm as discussed in paragraph 8.5.2.

8.8. Proxy Statement Disclosure – Outstanding Equity Awards at Fiscal Year End Table.

8.8.1. Only equity-based awards are reported in the Outstanding Equity Awards at Fiscal Year End Table. These awards should be reported as follows:

- For full-value performance awards (such as PSUs and PSAs), report the number and the payout value of shares underlying the unvested awards as of the last day of the fiscal year. The market value is determined by multiplying the year end stock price by the number of shares that would be earned based on achieving threshold performance goals. If the previous fiscal year's performance has exceeded the threshold, the disclosure must be based on the next higher performance measure (i.e., target or maximum) that exceeds the previous fiscal year's performance. If the award provides only for a single estimated payout, that amount should be reported.
- For PSOs or stock appreciation rights, report the number of shares underlying unvested awards as of the last day of the fiscal year.

8.9. Proxy Statement Disclosure – Options Exercises and Stock Vested Table.

8.9.1. Report the number of shares and amount realized upon the vesting of PSUs and PSAs or the exercise of PSOs. For any amount realized upon exercise or vesting for which receipt has been deferred, a footnote quantifying the amount and disclosing the terms of the deferral must be provided.

8.10. Blackout Period.

8.10.1. A blackout period is a period during which the securities of a corporation cannot be traded by Section 16 Insiders and others who have access to material, nonpublic information about the Company and its affairs. Blackout periods are sometimes referred to as a "closed window." A blackout period is established by the Company and communicated to any affected parties in advance of or concurrently with the action triggering a blackout period. Many companies prohibit all trading by officers and directors outside of open trading window, so that all other times are considered a blackout period by default. The precise reasons for establishing a blackout period and the laws controlling it are outside the scope of this publication. A more complete discussion of blackout periods and internal controls associated with blackout periods is included in a previous GPS research publication on stock options. Details of this research and the downloadable publication are available at www.scu.edu/business/cepi/.

8.10.2. Buying or selling stock during a blackout period may carry regulatory risk, negative company publicity, and the risk of market fluctuation. The execution of any market transaction (such as a sale of shares to cover tax withholding) generally qualifies as a prohibited transaction during the blackout period. Equity Compensation should work closely with the company-designated broker to ensure the broker does not process trades during a blackout period.

Change of Employment Status.

9.1. Overview.

9.1.1. Performance awards are granted to employees as part of the compensation package. Subsequent changes of employment status may delay the vesting or result in forfeiture of outstanding awards. Changes of employment status include voluntary terminations, involuntary terminations (e.g., for cause or layoffs), regular or early retirements, changes between part-time and full-time status, leaves of absence, disability, death, and change of control. The implications of a change in status on a performance award may vary depending upon the reason for the change in status (e.g., termination for cause vs. disability). In some cases a performance award will not be forfeited upon a change in status, but the potential payout will be reduced to reflect the shortening of the service period.

9.2. Impact on Financial Reporting.

9.2.1. An award may not vest due to a change of employment status or because performance goals were not met. A forfeiture of an award as a result of a change of employment status may have different accounting implications than a cancellation due to the nonattainment of performance goals.

9.2.2. To ensure proper financial reporting, understand the functionality of the stock plan system and record the forfeiture or cancellation of an award appropriately. For example, the forfeiture due to termination may be recorded differently in the stock plan system than the cancellation because performance goals were not met. A forfeiture due to termination will impact the estimated forfeiture rates and accruals of compensation expense. A cancellation because a market condition was not met will have no financial reporting impact, as discussed in paragraph 10.2.3.

9.3. Timely Notification of Changes in Status.

9.3.1. Keeping an employee's status current is critical to ensure the proper and timely withholding of payroll tax on a performance award. In addition this process will ensure that an award does not automatically vest for an employee who is no longer eligible to receive the shares.

9.3.2. Update employee data from the human resource system on a periodic basis. Verify that the effective date of change of status in the stock plan system is consistent with the human resource system. Reconcile changes of employment status between the stock plan system and the human resource system on a monthly basis and before any major stock event.

GLOBAL ISSUE

The implication of a change of employment status may differ for US employees and non-US employees. Frequently changes of employment status between the grant of a performance award and the end of the performance period or between the attainment of the performance goals and the release of the shares have dissimilar legal and tax consequences in different countries

EXHIBIT 9-1 - INTERNAL CONTROLS ASSOCIATED WITH CHANGE OF STATUS

	Illustrative Controls	Illustrative Test of Controls
1	Compare changes of employment status in the stock plan database with the human resource system monthly. Document reconciling items, research performed, and resolution of the items.	Review reconciling items for trends and unusual items.
2	Develop a process to handle late notifications of change of employment status. Include these transactions in the report on post-dated transactions and notify Finance as appropriate.	Review report of post-dated transactions. Note unusual items. Review trends to identify areas where further intervention is required.

9.3.3. When Equity Compensation is not notified in a timely manner about the change of status (such as a termination or leave of absence) for an employee, shares may be incorrectly released to the employee. Develop a process to handle the inappropriate release of shares. Involve Legal to ensure the Company's risks are considered appropriately when resolving these issues. Document the process. Late notification of changes of employment status constitutes a post-dated transaction which may result in an inadvertent modification and an accounting charge. See Exhibit 9-1 for internal controls associated with change of status.

A change of control may trigger the immediate vest of an award. This acceleration may be deemed a golden parachute as defined by IRC §280G and subject to the golden parachute excise tax. A complete discussion of IRC §280G is outside the scope of this publication.

9.4. Adjusting the Potential Payout.

9.4.1. As discussed in paragraph 3.4.3, upon a change in status the performance award may be forfeited or the potential payout may be adjusted to reflect the shortening of the service period. The award may vest immediately upon the employee's change in status or it may be delayed until the performance goals have been met under the Award Agreement.

9.4.2. The administrative requirements of adjusting the payout rate or vest date vary depending on what type of performance vehicle was used and the Award provisions. Some of the key administrative requirements when adjusting the payout rate or vest date include –

- Recalculate the adjusted payout or the number of options that vest
- Process an accelerated vesting
- Communicate changes to the employee
- Advise Financial Reporting of changes in the payout rate or vest date
- Advise transfer agent to cancel shares if necessary to reflect the adjusted payout of a PSA

Financial Reporting.

10.1. Overview.

10.1.1. Calculating the financial statement impact of performance awards requires special knowledge and the Company may find it helpful to use outside resources to assist with the process. The equity compensation department may be an integral driver of the detailed accounting calculations or focused on providing data on performance awards to Financial Reporting. Equity Compensation may also be critically engaged in forecasting/budgeting exercises related to the redesign of awards or the expense impact of existing awards on future reporting periods. Regardless of the scope of responsibilities, the equity compensation professional must understand the impact of the underlying data on the valuation of the award, the allocation of the expense to the appropriate period, the calculation of EPS, roll-forward of the deferred tax asset, and compilation of the financial statement disclosures.

10.1.2. This section provides an overview of the key concepts regarding the financial reporting of performance awards. A thorough discussion of the financial reporting requirements of performance awards is outside the scope of this publication.

US GAAP has been reorganized into the Accounting Standards Codification (ASC). FAS 123(R) as it relates to employees will be known as "FASB ASC Topic 718 - Stock Compensation".

Equity compensation professionals must understand the impact of the underlying data on the valuation of the award, the allocation of the expense to the appropriate period, the calculation of EPS, roll-forward of the deferred tax asset, and compilation of the financial statement disclosures.

10.2. Accounting Classifications of Performance Goals.

10.2.1. Generally, ASC Topic 718 broadly categorizes performance awards into 2 types - those with performance conditions and those with market conditions. Awards that do not meet either classification would be called "other conditions." The accounting distinctions between awards with performance conditions and market conditions are significant. These distinctions are not mutually exclusive, as some awards may have a combination of performance, market, and service conditions.

10.2.2. As discussed in paragraph 3.2.2, a performance condition is a goal that is based on the internal operations or activities of the employer or the activities of peer companies, and requires that the employee to provide services for a specified period of time. The goal may relate to the performance of the entire company, a division, or an individual employee. Similar to a service condition, performance conditions are not incorporated into the grant date fair value of an award; but, instead, affect the quantity of awards for which expense is accrued. Therefore, performance conditions require the Company to "true up" the compensation expense to reflect for the number likely to be paid out and ultimately to the number of awards earned. See Exhibit 10-1 for an example of a performance condition.

EXHIBIT 10-1 – EXAMPLES OF AWARDS WITH PERFORMANCE AND MARKET CONDITIONS	
Facts	A company grants 100 PSUs when the stock price is $10. The number of awards that ultimately vest will range between 0 and 200% depending on a performance goal at the end of 3 years.
Performance Condition	If the performance goal incorporates Earnings per Share (EPS), then the goal would be considered a performance condition. If 200% of target is paid out, then the Company will recognize $2,000 of expense (200% x 100 shares x $10 Fair Value). If 0% of target is ultimately paid out, then the Company will recognize $0 of compensation expense (0% x 100 shares x $10 fair value).
Market Condition	If the performance goal incorporates TSR, then the goal would be considered a market condition. Using a valuation model, the Company determines that the fair value of the award is $13.00. Regardless of the final payout amount, between 0% and 200%, the Company will ultimately recognize $1,300 of expense (100 shares x $13 Fair Value).

Further examples of Performance Conditions and Market Conditions can be found in Exhibit 3-1, paragraph 3.2.2.

10.2.3. A market condition is a goal that that is tied to a stock price, either on an absolute basis or on a relative basis against comparable companies. Awards with market conditions reflect the probability of achieving the performance targets within a valuation model. Compensation cost is recognized for an award with a market condition provided the requisite service period is completed, as discussed in subsection 10.8, regardless of the ultimate payout of the performance award. See Exhibit 10-1 for an example of a market condition.

10.2.4. In general the expense of awards with market conditions is less volatile than the expense of awards with performance conditions. Some companies may prefer the "truing up" aspect of performance conditions, because it permits a reversal of compensation expense if the goal is not met. If the performance condition is met, however, the total compensation expense will be higher than it would otherwise have been with a market condition, because a market condition essentially discounts the fair value based on the probability that a market condition may not pay out.

10.2.5. An "other condition" is rare, but represents any goal not classified as a performance, market, or service condition. An example of an "other condition" would be awards that are indexed to the price of gold. An award with an "other condition" is treated as a liability award.

10.3. Vest and Payout Provisions.

10.3.1. Performance awards may have fixed vesting and payout provisions. Other performance awards may have performance goals that affect the vesting, exercisability, exercise price, or other pertinent factors as discussed in subsection 10.10 that are used in determining the fair value of an award. Broadly, the most prevalent categories of these awards are –

- Changes in the quantity of awards that vest
- Changes in the timing of vesting
- Changes in the value of awards

The categories above are not mutually exclusive. Some performance awards can fall into multiple categories, and require careful consideration in preparing the financial reporting.

10.3.2. The first category is awards with changes in the quantity of awards that vest. A performance award can be designed so that the number of awards earned ranges from a downside threshold percentage (typically 0%) to some upside outperform percentage (typically 200%) based on the degree of satisfaction of the performance goal. The goal can be based on a performance condition, a market condition or both. See Exhibit 10-2 for an example of an award where the quantity of award changes.

EXHIBIT 10-2 – EXAMPLES OF AWARD VARIATIONS	
Changes in the quantity of awards that vest	• A Company grants 100 PSUs for which: • 0% will vest if the Company's TSR is below the 25th percentile of the peer group • 100% will vest if the Company's TSR over a three-year period equals the median TSR of their peer group • 200% will vest if the Company's TSR equals or exceeds the 75th percentile of the peer group. The Company will interpolate payouts between those percentiles. *Note: This is a market condition, since vesting is contingent on stock prices. See paragraph 10.10.2 for details on how the Company will value the award.*
Changes in the timing of vesting	A Company grants 100 PSUs. The vesting will occur when the Company receives regulatory approval to market a new product offering. *Note: This is a performance condition, since vesting is contingent on an internal goal (i.e., regulatory approval). Each reporting period, the Company will need to assess the expectation for achieving the condition.*
Changes in the value of awards	A Company grants 100 PSOs when the stock price is $10 with an exercise price of $20 (a premium option). If market share increases to a pre-defined percentage, then the exercise price will be reduced to $10 (an at-the-money option). *Note: This is a performance condition, since the value of the award is contingent on an internal goal (i.e., market share). Effectively, the Company has issued 2 awards that are mutually exclusive (i.e. an individual cannot earn both the option with the $20 exercise price and the option with the $10 exercise price). Each possible payout will have a distinct grant date fair value. Each reporting period, the Company will assess their expectation for achieving the goal. Further, the Company will need to record compensation accruals based on the fair value of the outcome that is assumed, and ultimately realized.*

10.3.3. The second category is awards with changes in the timing of vesting. A performance award can be designed with vesting contingent on when a goal is satisfied. The performance goal can be based on a performance condition or a market condition. Performance awards in this category will generally either require an assessment to determine an implicit service period or a calculation on the grant date to determine a derived service period, as discussed in paragraph 10.8.2. See Exhibit 10-2 for an example of an award where the timing of vesting changes. Some awards are structured such that a performance goal is evaluated for vesting at the end of a preliminary performance period. In the event that vesting does not occur at the initial completion of the performance period, the awards will have a "second-chance" for vesting at the end of another performance period. This form of secondary testing is another example of an award where the timing of vesting changes.

10.3.4. The third category is awards with changes in the value of awards. A performance award can be designed with internal goals that affect the terms of the award in the future. This type of award is not common. See Exhibit 10-2 for an example of an award where the value of an award changes.

10.4. Performance Awards with Graded Vesting.

10.4.5. For performance awards with graded vesting, each vesting tranche requires its own distinct valuation and requisite service period. For most performance awards, this will create expense recognition patterns where more compensation expense is recognized earlier in the performance period (sometimes described as "FIN 28 accounting"). For some performance awards with independent performance conditions where the service inception date has not occurred yet, expense recognition patterns can appear similar to straight-line accounting.

EXHIBIT 10-3 – INDEPENDENT/DEPENDENT GOALS		
Vesting	**Graded Vesting with Independent Goals**	**Graded Vesting with Dependent Goals**
Tranche 1 – 25%	Year 1 revenue equal to $10M	Vests when stock price = or > $10
Tranche 2 – 25%	Year 2 revenue equal to $11M	Vests when stock price = or > $11
Tranche 3 – 25%	Year 3 revenue equal to $12M	Vests when stock price = or > $12
Tranche 4 – 25%	Year 4 revenue equal to $13M	Vests when stock price = or > $13
	The goals of each vesting tranche are independent (i.e., Tranche 2, 3, or 4 can vest without any prior tranches vesting).	*The goals of each vesting tranche are dependent (i.e., Tranche 2 cannot vest unless Tranche 1 has vested).*

10.5. Independent / Dependent Goals.

10.5.1. Performance awards with graded vesting can be designed with goals for vesting tranches that are dependent on the vesting of prior tranches or are independent of the vesting of the prior tranches. The distinction is critical with respect to the service inception date, as discussed in subsection 10.7, and the requisite service period, as discussed in subsection 10.8. The applicable details are included in the terms of the Award Agreement as noted in paragraph 5.2.1. Exhibit 10-3 shows examples of independent and dependent goals.

10.6. Defining the Accounting Grant Date.

10.6.1. A grant date will generally not be established until the performance goals have been defined and a mutual understanding of the terms has been reached, assuming all other approvals have been achieved. A grant date has not occurred until all shareholder and Board approvals are obtained, unless such approval is essentially a foregone conclusion. For example, if management and Board members control enough votes to approve the plan, the vote would be considered a formality.

10.6.2. A mutual understanding of the key terms requires that the goals be communicated to an individual employee within a relatively short time period from the date of approval. A relatively short time period should consider all the facts and circumstances, but generally should be measured in days or weeks, not months.

10.7. Defining the Service Inception Date.

10.7.1. The service inception date is the date at which the requisite service period begins or when the employee begins rendering service to achieve a particular target. Usually, the service inception date is the grant date. However, the service inception date may differ from the grant date for certain performance awards.

10.7.2. Some awards have a service inception date prior to the grant date. This generally occurs in graded vesting awards when a company defines performance goals for later vesting tranches at a later time. In some circumstances, the service inception date can occur after the initial accounting grant date. This occurs when all terms are defined upon grant, the performance goals of each vesting tranche are independent, and the period of measurement has not begun.

10.7.3. Exhibit 10-4 summarizes alternative expense recognition patterns for awards with different possibilities of grant dates and service inception dates, with both dependent and independent vesting tranches. Note: Each of these performance awards has similar targets; however, they differ in the timing and method of communicating the goals. The accounting treatment is dramatically different in each situation.

10.8. Defining the Requisite Service Period.

10.8.1. The requisite service period is the period during which an employee is required to provide service in exchange for stock-based compensation. It defines the period of time that the expense of an award will be amortized. Generally, it should consider explicit, implicit, and derived service periods, depending on all of the terms of an award. Further, the requisite service period will define the period of time that compensation expense can be reversed, in the event of employee termination, as discussed in subsection 10.11.

EXHIBIT 10-4 - PERFORMANCE AWARDS WITH ALTERNATE EXPENSE RECOGNITION PATTERNS		
	Dependent Conditions	**Independent Conditions**
Grant Date Equal to Service Inception Date	FIN 28 expense recognition **Example:** Tranche 1: Year 1 revenue of $10M (target determined on Year 1 grant date) Tranche 2: Year 1 vests and Year 2 revenue of $11M (target determined on Year 1 grant date) Tranche 3: Year 2 vests and Year 3 revenue of $12M (target determined on Year 1 grant date) Tranche 4: Year 3 vests and Year 4 revenue of $13M (target determined on Year 1 grant date)	FIN 28 expense recognition **Example:*** Tranche 1: Year 1 revenue of $10M (target determined on Year 1 grant date) Tranche 2: Two-Year cumulative revenue of $21M (target determined on Year 1 grant date) Tranche 3: Three-Year cumulative revenue of $33M (target determined on Year 1 grant date) Tranche 4: Four-Year cumulative revenue of $46M (target determined on Year 1 grant date)
Grant Date Prior to Service Inception Date	Not Possible	Effectively straight-line expense recognition **Example:** Tranche 1: Year 1 revenue of $10M (target determined on Year 1 grant date) Tranche 2: Year 2 revenue of $11M (target determined on Year 1 grant date) Tranche 3: Year 3 revenue of $12M (target determined on Year 1 grant date) Tranche 4: Year 4 revenue of $13M (target determined on Year 1 grant date)
Grant Date After Service Inception Date	FIN 28 (subsequent vesting tranches are re-measured until grant date for tranche is fixed) **Example:** Tranche 1: Year 1 revenue of $10M (target determined on Year 1 grant date) Tranche 2: Year 1 Vests and Year 2 revenue of $11M (target determined immediately before Year 2) Tranche 3: Year 2 Vests and Year 3 revenue TBD (target determined immediately before Year 3) Tranche 4: Year 3 Vests and Year 4 revenue TBD (target determined immediately before Year 4) Since the performance targets have not been defined for Tranches 2-4 on the initial grant date, then the accounting grant date has not been established until the performance targets are set.	FIN 28 (subsequent vesting tranches are re-measured until grant date for tranche is fixed) **Example:** Tranche 1: Year 1 revenue of $10M (target determined on Year 1 grant date) Tranche 2: Two-Year cumulative revenue of $21M (target determined immediately before Year 2) Tranche 3: Three-Year cumulative revenue of $33M (target determined immediately before Year 3) Tranche 4: Four-Year cumulative revenue of $46M (target determined immediately before Year 4) Since the performance targets have not been defined for Tranches 2-4 on the initial grant date, then the accounting grant date has not been established until the performance targets are set.

*For grants with multiple tranches, each tranche may have a different grant date.

10.8.2. The explicit service period is stated in the terms of the award. The implicit service period is inferred from the terms of a performance award and can generally be seen in performance awards with performance conditions that affect the timing of vesting. The derived service period is calculated from the same valuation techniques used to determine fair value, as discussed in paragraph 10.10.2 and can generally be seen in performance awards with market conditions that affect the timing of vesting. From the valuation model, the derived service period represents the duration of the median of the distribution of share price paths on which the market condition is satisfied.

10.9. Multiple Conditions.

10.9.1. Awards with multiple market, performance, or service conditions may have terms that specify multiple service periods. Multiple conditions may be referred to as "And/Or conditions." For accounting purposes, an award can only have one requisite service period (per vesting tranche).

10.9.2. An award that requires all conditions be satisfied prior to vesting is classified as an "And" condition award. It is critical to thoroughly understand the interrelation of multiple conditions as it directly impacts the amortization of the compensation expense. Generally, the requisite service period for an "And" condition equals the longest of possible service periods. An award that requires only a single condition be satisfied prior to vesting is classified as an "Or" condition. Generally, the requisite service period for an "Or" condition equals the shortest of possible service periods.

10.10. Valuation of Performance Awards.

10.10.1. The effect of a performance condition is not reflected in the grant date fair value. For awards with performance conditions, generally the fair value will be equal to the stock price on the grant date (absent any reductions for the lack of dividends or dividend equivalents).

10.10.2. The effect of a market condition is reflected in the grant date fair value. Awards with market conditions frequently have path-dependent features (such as an averaging period on the calculation of TSR), as well as complex features (such as vesting contingent relative to the TSR of peers). As a result, more advanced valuation techniques, such as Monte Carlo simulations, are the most common approach for valuing these awards. The fair value determined using a Monte Carlo simulation will represent the present value of all potential stock price outcomes.

10.11. Treatment of Forfeitures.

10.11.1. A pre-vesting forfeiture describes when an award is forfeited due to a change of employment status prior to the completion of the requisite service period. If an award is forfeited prior to the requisite service period, then any prior accruals of compensation expense will be reversed. If an individual terminates after the requisite service period, then no compensation expense will be reversed.

10.11.2. Consider an example of a termination prior to the requisite service period. A company grants 100 PSUs when the stock price is $10. Vesting occurs at the earlier of achieving a stock price of $20 or on the 4th anniversary of the grant date. Through a valuation model, the Company determines that the award has a derived service period from the stock price performance goal of three years. Further, the award has an explicit service period of four years. Since the award would vest at the earlier of the service condition or market condition, then the requisite service period would represent the minimum of the service periods, or three years. If termination occurs prior to three years and the award is forfeited, then all prior accruals of associated compensation expense would be reversed, without regard to the satisfaction of the market condition. If termination occurs after three years, then all compensation expense would be recorded for the award, regardless of the satisfaction of the market condition.

10.12. Interim Changes in Expense Amortization.

10.12.1. Estimating the change in expense may be challenging, depending on the interrelationships of different performance goals. When changes in the quantity, timing, or the value of performance awards occur, different expense recognition patterns result.

10.12.2. The impact of changes in the quantity, timing, or value of performance conditions is summarized in Exhibit 10-5. The impact of changes in market conditions is summarized in Exhibit 10-6.

EXHIBIT 10-5 – EXPENSE RECOGNITION PATTERNS FOR PERFORMANCE CONDITIONS

	Impact on Expense	Example
Changes in Quantity	Cumulative Effect	A company grants 100 PSUs with a three-year cliff performance period. The payout can range from 0-200% of target based on EBITDA targets. Initially, the Company expects to pay out at 100% and amortizes the expense over the three-year period. At the end of Year 2, the Company revises the assessment to 150%. The Company takes a cumulative charge to reflect for the additional shares expected to vest.
Changes in Timing	Prospective Change	A company grants 100 PSUs such that vesting will occur when the Company receives regulatory approval to market a new product offering. Initially, the Company assumes that regulatory approval will occur in 3 years. At the end of Year 1, the Company revises the assumption to assume that regulatory approval occurs in 5 years. The Company will prospectively amortize any unrecognized compensation cost over the new requisite service period of 5 years (no adjustment for the cumulative effect).
Changes in Fair Value	Cumulative Effect	A company grants 100 PSOs with a four-year explicit service period when the stock price is $10 with an exercise price of $20 (with a fair value of $2). If product market share increases to a certain percentage, then the exercise price will be reduced to $10 (with a fair value of $5). Initially, the Company assesses that the performance goal will not be met, and the Company amortizes $2 over the four-year service period. At Year 2, the Company assesses that the performance goal will be met. The Company takes a cumulative charge to reflect for the additional value based on the new exercise price.

EXHIBIT 10-6 – EXPENSE RECOGNITION PATTERNS FOR MARKET CONDITIONS

	Impact on Expense	Example
Changes in Quantity	None	A company grants 100 PSUs such that 0%-200% will vest dependent on the TSR over a three-year period relative to a peer group. Using a valuation model, the Company determines on the grant date the fair value of the awards is $13. The Company initially amortizes $1,300 (100 x $13) over three years. At the end of Year 1, the Company determines that it is most likely that 200% will be paid out. Despite the assessment that 200% will be paid out, there will be no changes in prior, current, or future expense recognition.
Changes in Timing	None; acceleration of unrecognized expense if vesting occurs	A company grants 100 PSUs when the stock price is $10. Vesting occurs at the earlier of achieving a stock price of $20 or on the 4th anniversary of the grant date. Through a valuation model, the Company determines that the award has a derived service period from the stock price performance goal of three years. The Company initially amortizes over the three-year requisite service period. If the Company achieves a stock price of $20 during Year 1, the Company will immediately accelerate any unrecognized compensation expense.
Changes in Fair Value	None	A company grants 100 PSOs with a four-year explicit service period when the stock price is $10 with a strike price of $20 (with a fair value of $2 per). If Company TSR increases to a certain percentage, then the exercise price will be reduced to $10. , The economic impact of this market condition is considered in the valuation model. The single fair value produced by the model is then expensed over the requisite service period.

10.13. Earnings per Share Requirements.

10.13.1. Performance awards are considered a contingency in applying the guidance in ASC Topic 260 – Earnings per Share. At the end of each reporting period, the Company is required to measure the quantity of awards paid out as if the performance period had ended. The Company applies the Treasury Stock method to the shares considered issuable based on that measurement.

10.13.2. A company may need to calculate a different quantity of awards expected to vest under ASC Topic 260 than what is used for recognition of compensation expense under ASC Topic 718. For example, a company issues 100 PSUs that vest when annual revenues exceed $10,000,000. Even though the Company is recognizing compensation expense at target for ASC Topic 718 (which represents what the Company ultimately expects to vest), under the contingent share provisions of Topic 260, the incremental awards would not be included until the Company revenue exceeds $10,000,000 (which represents what would vest if the performance period ended today).

10.14. Plan Design Challenges.

10.14.1. Small changes in plan design or communication can sometimes yield large changes in financial reporting. Exhibit 10-4, paragraph 10.7.3, summarizes examples of expense recognition for performance awards with only minimal changes in the goals and the timing of communication. In those examples the accounting ramifications were dramatically different. Exhibit 10-4 underscores the importance of a close integration between Financial Reporting and plan design.

10.14.2. As a result of ASC Topic 718, it is increasingly important that companies expand the role of Legal and Finance on the plan design team and encourage a greater degree of participation and coordination among team members. Many of these same personnel will also be involved in documentation and testing the Company's internal controls over stock-based compensation.

10.15. Quarter-End Checklist.

10.15.1. At the end of each fiscal reporting period, several steps need to occur for the financial reporting process. Close coordination is required between Equity Compensation, Human Resources, Finance, Corporate Tax, and third-party providers. The financial reporting process at many companies involves many disparate internal and external systems, the involvement of many departments, and significant manual intervention. Robust internal controls are necessary to ensure the validity of the financial reporting process. Some of the required steps for quarterly financial reporting include –

- Reconcile awards forfeited and cancelled prior to the end of the requisite service period to the expense amortization schedule
- Assess the probability of payout for awards with vesting contingencies
- Assess the timing of vesting for all performance awards
- Determine the appropriate payout multiplier for purposes of determining "contingently issuable shares" under ASC Topic 260
- Compute the cumulative effect adjustment (or prospective adjustment, if appropriate) of any changes in payout multiplier and/or vesting timing assumptions
- Interface with the Corporate Tax department to ensure the roll-forward of the deferred tax asset matches changes in the expense amortization schedule
- Ensure a multi-layer review occurs, with a particular focus on any manual spreadsheets driving the calculations
- Reconcile final current period expense to forecasted expense of prior reporting periods

See Exhibit 10-7 for internal controls associated with financial reporting.

EXHIBIT 10-7 - INTERNAL CONTROLS ASSOCIATED WITH FINANCIAL REPORTING		
	Illustrative Controls	**Illustrative Test of Controls**
1	Summarize each report used for the valuation and accrual. Define the purposes of the report. Define each field and how each number is calculated. Enumerate what is included and excluded. All individuals that generate the report or use the report should sign off the report summary. Review and update the summary after each update of the stock plan system.	Confirm that there were no changes in the reports used for the period. If the report has changed, confirm that all appropriate people have signed off the revised report description.
2	Develop and implement a procedure to assess the probability of the attainment of the goal and communicate the probability and any changes in the probability to appropriate parties as necessary.	Confirm that the process is followed.
3	Develop and implement a procedure to validate the information included in each report. Document that the validation procedure is followed prior to releasing the information to the group responsible for the valuation.	Confirm that the validation procedure is followed.
4	Prepare a quarterly audit narrative to document the process used for financial reporting, including the assumptions used and the decisions made.	Review the audit narrative on quarterly basis.

10.16. Outsourcing.

10.16.1. The Company may outsource certain aspects of performance awards for financial reporting purposes such as valuing the award, calculating the period expense, and tracking performance for diluted EPS purposes. Multiple vendors may be used for valuing the awards and handling ASC 718 reporting. If these functions are outsourced, clearly define responsibilities for maintaining and validating data. Close coordination is required between the Company and a third-party to ensure a clear understanding of responsibilities of each party and the source of required data. In addition, the parameters of all reports must be described in detail to minimize misunderstandings and inconsistencies.

10.16.2. Many administrative and software platforms have the capability to effectively meet the requirements of ASC Topic 718 for some types of performance awards. Given the complexity of accounting guidelines and the significant potential for unique design features in performance awards, standard capabilities should be carefully evaluated to determine suitability.

10.16.3. The valuation of performance awards with market conditions under ASC Topic 718 generally requires a Monte Carlo simulation to determine fair value. Many companies require the use of an outside specialist for the Monte Carlo simulation.

Appendix A – Acknowledgements

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The 2018 update to this publication was completed by Dan Kapinos of Aon Equity Services and Steve Tamsula of The PNC Financial Services Group, Inc.

2010 Technical Oversight Board

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Fred Whittlesley, CEP	Hay Group

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As an independent, academic organization the CEPI is proud to respond to the needs of the equity compensation industry by providing guidance on performance awards.

Additionally, the CEPI is fortunate to have a dedicated and supportive Advisory Board. The Advisory Board initially recommended that the CEPI pursue independent research projects, and the Advisory Board has been actively involved throughout the project.

Appendix B: Common Equity Compensation Terms

Accepted Terminology	Equivalent
ASC Topic 718	Accounting Standards Codification on stock compensation incorporating FAS 123R
Award Agreement	Employee stock agreement; Grant Agreement; Agreement
Blackout Period	Period of time in which designated individuals cannot trade securities of a corporation
Board	Board of Directors
Book Entry	Electronic recording of stock ownership where no certificate is given to securities broker
Broker	Brokerage Firm; Securities Dealer; Registered Broker; Stock Broker
Cancellation	The annulment of a performance award as a result of nonattainment of a performance goal; An accounting term
Cash- Settled	An award which pays out in cash rather than in stock
Ceiling	A maximum payout regardless of additional, incremental performance
Certification	Validation of achievement of performance goals, typically by the Board of Directors or a sub-committee of the Board
Clawback	Contractual right to recover gains from equity compensation in certain circumstances
Cliff Vest	Entire award vests in full on a single date
Common Stock	Capital stock; Securities
Compensation Expense	Expense; Compensation cost
Compensation Income	Income; Compensation
Deferral	An optional or mandatory election to delay payout of an award beyond vest date to a later date

Accepted Terminology	Equivalent
Derivative Security	For Section 16 reporting, awards that have a value derived solely from the value of an equity security
Director	Member of the Board of Directors; Board member
Dividend	A distribution of profits paid to owners of company stock
Dividend Equivalent	A payment to holders of unvested stock units that mimics a dividend paid stockholders
Employee Trading Restrictions	Restrictions for employees on trading company stock
Exchange Control	Restrictions on inbound and outbound transfer of local currency
Exercise	To implement the rights of an option to purchase shares at a predetermined price
Fair Market Value	FMV
FAS 123(R)	Statement of Financial Accounting Standards No. 123(revised 2004); FAS 123(R)
Floor	A minimum payout on a performance award, regardless of the level of performance achieved
Forfeiture	The annulment of a performance award which never vests as a result of a change of employment status; An accounting term
Fungible Share Pool	A reserve of shares in a plan used to settle different types of awards granted under the plan; Different types of awards may be counted differently against the reserve
Graded Vesting	Incremental schedule over which vesting requirements are met
Grant	Award
Grant Date	Date of grant; Option date
Insider	Affiliate
IRC	Internal Revenue Code
IRC Section 83(b) Election	US tax election to include the FMV of property received (less any amount paid for the property) in the year of transfer

Accepted Terminology	Equivalent
Issuer	Company that "issues" stock, may be privately held or publicly traded
Market Condition	A performance goal that is related to company stock price
Modification	A change to the terms of the award; An accounting term
Net Exercise	An exercise of an option where the Company withholds some of the underlying shares to cover the option price
Non-Derivative Security	For Section 16 reporting, awards that have a value NOT derived solely from the value of an equity security
Payout	The process of determining the amount to be paid on the award; Sometimes refers to the release of shares, as well as the payout of the award
Peer Group	An identified list of companies to be used as a reference point for compensation and performance
Performance Award	Performance stock unit; Performance stock award; Performance stock option
Performance Condition	A performance goal that is NOT related to company stock price
Performance Goal	A particular level of attainment on a performance measure
Performance Measure	The basis for the assessment of a performance goal
Performance Stock Award	Shares awarded for no cost contingent upon achieving associated performance goals and meeting the requisite service period
Performance Stock Option	A stock option granted with vesting or price contingent on achieving associated performance goals and service requirements
Performance Stock Unit	A promise to award shares for no cost in the future contingent on achieving associated performance goals and meeting the requisite service period
Plan	Employee stock option plan
Release	Transfer of shares to the employee
Restricted Stock Award	RSA; Equity award in which stock is issued, usually at no cost, subject to vesting restrictions
Restricted Stock Unit	RSU; Equity award in which a promise is made to issue stock, usually at no cost, when vesting restrictions have been met.

Accepted Terminology	Equivalent
Same-Day-Sale	SDS; Exercise of an option and simultaneous sale of shares through a broker
SEC	Commission; Securities and Exchange Commission
Second-Chance Shares	Awards that have a secondary chance to vest when the original goal was not achieved
Sell-to-Cover	Shares sold from award to cover tax obligation
Service Period	The time over which an employee earns the award
Settlement	Transfer of unrestricted ownership of an award through payment of cash or stock
Shares	Stock
Share Reserves	The pool of shares that has been authorized for issuance under a stock plan; Share pool
Stock-Settled	An award which pays out in stock rather than in cash
Stock Option	Equity award in which the right to purchase stock at a fixed price for a fixed period of time is granted, may be subject to vesting restrictions.
Stock Plan Brokerage Account	Brokerage account established specifically for company stock plan transactions
Target	Expected level of performance
Tax Withholding	Withholding
Threshold	Minimum level of performance required for any payout
Total Shareholder Return	Return on investment of stock in a company, including stock appreciation and dividends; TSR
Variable Payout	A sliding scale of payout that is adjusted for varying levels of performance
Vest	Award no longer subject to substantial risk of forfeiture
Withhold-to-Cover	Shares withheld from award to cover tax obligation

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