Accounting for Performance Plans

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Classifications of Performance Goals

- There are two accounting classifications of Performance Goals:
  - Performance Conditions - a condition that is based on the internal operations or activities of the company or relative companies, and requires the employee to provide services for a specified period of time. The condition may relate to the performance of the entire company, a division, or an individual employee.

  - Market Conditions - a performance metric that is tied to a stock price, either on an absolute basis or on a relative basis against comparable companies.

Performance Conditions
- EPS
- Revenue Target
- Market Share
- A Change-In-Control Drug approval

Market Conditions
- Relative TSR
- Stock Price
- Absolute TSR
- Market Stock Units
- Internal Rate of Return (private companies)
Categories of Performance Goals

- Three categories of Performance Goals that change the:
  - Number of Awards that Vest - (Most common)
  - Timing of Vesting – (Common)
  - The Value of Awards – (Least Common)
Defining the Grant Date

- Mutual understanding of terms and goals
  - Performance targets must be defined
  - Sometimes hurdles for future vesting tranches aren’t defined until later (i.e. 2012 revenue goals are defined at the end of 2011)

- Board approval
  - Grant date can’t occur until Board approval (unless Board approval is a foregone conclusion)
Grant Date vs. Service Inception Date

- Grant Date and Service Inception Date usually the same, but frequently not
  - Grant Date same as Service Inception Date
    - Example: 4-year graded performance period with each tranche based on annualized TSR growth (each tranche is dependent of each other)
  - Grant Date prior to Service Inception Date
    - Example: 4-Year graded performance period with each tranche based on pre-defined EBITDA targets for each fiscal year (all independent of each other)
  - Grant Date after Service Inception Date
    - Example: 4-year graded performance period with each tranche EBITDA target defined at the beginning of the vesting tranche year

- When do you start the clock on measuring performance?
Expense Amortization and the Service Inception Date

- Graded vesting awards with performance conditions require each vesting tranche to be amortized on their own

- For most awards, this requires frontloaded expense accrual where each tranche is amortized from the grant date.

NOTE: However, since the service inception date has not occurred yet for graded performance awards with independent and pre-defined goals, the expense recognition looks like straight-line amortization. See the comparison example on the next slide.
### Expense Recognition for Performance Plans

#### Dependent Goals

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tranche 1</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Tranche 2</td>
<td></td>
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<tr>
<td>Tranche 3</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tranche 4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>52.08%</td>
<td>27.08%</td>
<td>14.58%</td>
<td>6.25%</td>
</tr>
</tbody>
</table>

**NOTE:** Note how the Grant Date and the Service Inception Date for each vesting tranche occurs on Year 1.

#### Independent Pre-Defined Goals

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tranche 1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tranche 2</td>
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<tr>
<td>Tranche 3</td>
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<td></td>
</tr>
<tr>
<td>Tranche 4</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>25.00%</td>
<td>25.00%</td>
<td>25.00%</td>
<td>25.00%</td>
</tr>
</tbody>
</table>

**NOTE:** Note how the Service Inception Date doesn’t begin until the beginning of that year.

### Versus
Requisite Service Period

- Depending on the terms of the performance award, a requisite service period may consist of one or more:
  - Explicit Service Period (service conditions)
  - Implicit Service Period (internal performance conditions – must be assessed every reporting period)
  - Derived Service Period (market conditions – calculated once at the Grant Date as an output of a valuation model)
Requisite Service Period – Example 1

Company ABC issues 1000 Units of stock at $10.00 that cliff vest on the 5th anniversary of the Grant Date. If at any point during the five year vesting period the 20-day average stock price equals $20.00, then the vesting will accelerate.

What is the requisite service period of this award?
Question #1: What is the requisite service period of this award?

Answer #1: Company ABC issued an award with 2 conditions. The first condition is an explicit service condition of 5 years. The second condition is a derived service period which was calculated to be 3 years (and is calculated as an output of a valuation model). Since it vests at the earlier of the two conditions, then this would be an “Or” condition, and the expense should be recognized over the shorter of the derived service period and explicit service period, or 3 years in this case.
Requisite Service Period – Q&A

Question #2: In 2 years, Company ABC has appreciated to over $20.00, and the award has fully vested. What are accounting ramifications?

Answer #2: Accelerate recognition of all unamortized expense.

Question #3: In 2 years, Company ABC has depreciated to $1.00? What are the accounting ramifications?

Answer #3: None
Requisite Service Period – Q&A

Question #4: In 2 years, Employee 1 terminates and the award is cancelled. What are the accounting ramifications?
Answer #4: Since Employee 1 terminated prior to the requisite service period, then all expense accruals should stop for this award, and any prior recognized expense should be reversed.

Question #5: In 4 years, Employee 1 terminates and the award is cancelled. What are the accounting ramifications?
Answer #5: The total compensation expense will be fully accrued at the end of 3 years. Since Employee 1 terminates after the requisite service period, then no compensation expense should be credited.
Question #6: What if the award doesn’t vest on the earlier of the 2 conditions, and instead vesting was contingent on both conditions being achieved? What are the accounting ramifications?

Answer #6: Company ABC issued an award with 2 conditions. The first condition is an explicit service condition of 5 years. The second condition is a derived service period which was calculated to be 3 years (and is calculated as an output of a valuation model). Since it vests at the later of the two conditions, then this would be an “And” condition, and the expense should be recognized over the longer of the derived service period and explicit service period, or 5 years in this case.
Changes in Expense Amortization

- Performance Condition - Number of Awards that Vest (i.e. Payouts range from 0% to 200% dependent on EBITDA)
  - Example: Company ABC grants 100 awards with a 3-year cliff vesting at a FMV of $30. The payout can range from 0-200% of target based on EBITDA targets. Company ABC initially expects to pay out at 100% and amortizes accordingly.
  - Company revises assessment to 150% at the end of Year 2.
  - Retroactive change - Company takes cumulative charge to reflect for additional shares expected to vest

<table>
<thead>
<tr>
<th>Grant Date</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assumption (EOY)</td>
<td>100%</td>
<td>100%</td>
<td>150%</td>
</tr>
<tr>
<td>Total Expense Required</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$4,500</td>
</tr>
<tr>
<td>Proportion To Recognize</td>
<td>33.3%</td>
<td>66.7%</td>
<td>100.0%</td>
</tr>
<tr>
<td>Annual Expense Accrual</td>
<td>$1,000</td>
<td>$2,000</td>
<td>$1,500</td>
</tr>
<tr>
<td>Cumulative Expense Accrual</td>
<td>$1,000</td>
<td>$3,000</td>
<td>$4,500</td>
</tr>
</tbody>
</table>
Changes in Expense Amortization

- Performance Condition: Timing of Vesting (i.e. Payout occurs if FDA approval)
  - *Example:* Company ABC grants 100 awards at a fair market value of $30 that vest upon receiving FDA approval of a drug. Company ABC initially expects FDA approval to occur in 3 years.
  - At end of year 2, Company ABC now assesses that drug approval will occur in 5 years.
  - **Prospective change** - Company prospectively re-amortizes unamortized expense over new requisite service period (longer implicit service period).

<table>
<thead>
<tr>
<th>Grant Date</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Expense Required</td>
<td>$3,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Original Annual Expense Accrual (3 Years)</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Annual Expense Accrual (5 Years)</td>
<td></td>
<td>$1,000</td>
<td>$500</td>
<td>$500</td>
<td>$500</td>
</tr>
</tbody>
</table>
Changes in Expense Amortization

- Performance Condition: The Value of Awards
  - *Example:* Company ABC grants 100 awards at $30 with the following payout dependent on both stock price and EPS. Awards have 3 year cliff vesting.

<table>
<thead>
<tr>
<th>Stock Price</th>
<th>EPS Condition</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$40</td>
<td>$3 or above</td>
<td>100%</td>
</tr>
<tr>
<td>$40</td>
<td>&lt;$3</td>
<td>150%</td>
</tr>
<tr>
<td>$30</td>
<td>$3 or above</td>
<td>25%</td>
</tr>
<tr>
<td>$30</td>
<td>&lt;$3</td>
<td>100%</td>
</tr>
</tbody>
</table>

- Company ABC determines a grant date fair value for each of the possible payouts due to the EPS performance condition. If $3.00 EPS is achieved, then the fair value is $36. If <$3.00 EPS is achieved, then the fair value is $18.

- Company ABC initially assesses that they will achieve over $3 EPS, and therefore initially recognizes compensation expense using a fair value of $36.
Changes in Expense Amortization

- Performance Condition: The Value of Awards (continued)

- Company ABC ultimately does not achieve the performance target of $3.00 EPS nor the $40 stock price, but achieves the $30 stock price. Therefore, 25% ultimately vests.

<table>
<thead>
<tr>
<th>Grant Date</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Satisfy EPS? (EOY)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Total Expense Required</td>
<td>$3,600</td>
<td>$3,600</td>
<td>$3,600</td>
</tr>
<tr>
<td>Annual Expense Accrual</td>
<td>$1,200</td>
<td>$1,200</td>
<td>($600)</td>
</tr>
</tbody>
</table>

- Note the total expense recognized is $1,800. This is higher than 25% of the 100 awards at $30 ($750).
Changes in Expense Amortization

- Market Condition - Number of Awards that Vest (i.e. Payouts range from 0% to 200% dependent on TSR Relative to Peers)
  - *Example:* Company ABC grants 100 awards with a 3-year cliff vesting at a FMV of $30. The payout can range from 0-200% of target based on relative TSR targets versus an Index. Company ABC determines that the fair value of the award is $39.
  - Ultimately, the company outperforms the Index and 200% is paid out
- **Change in Expense Amortization** - Nothing, as probability of 200% payout was included in the grant date Fair Value

<table>
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<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Expense Required</td>
<td>$3,900</td>
<td>$3,900</td>
<td>$3,900</td>
</tr>
<tr>
<td>Annual Expense Accrual</td>
<td>$1,300</td>
<td>$1,300</td>
<td>$1,300</td>
</tr>
</tbody>
</table>
Changes in Expense Amortization

- Market Condition - Timing of vesting (i.e. Accelerate vesting based upon achieving a defined stock price)
  - *Example:* Company ABC grants 100 awards with a 3-year cliff vesting at a FMV of $30. Awards accelerate vesting if $40 stock price is achieved. Company initially expects stock price to be achieved over 4 years, calculated as an output of a Monte Carlo simulation, therefore amortizes over the shorter of the explicit and derived service period (3 years). At year 2, awards vest due to stock price target being achieved.

- Action: Accelerate recognition to reflect that awards are now vested

<table>
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<tbody>
<tr>
<td>Total Expense Required</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Annual Expense Accrual</td>
<td>$1,000</td>
<td>$2,000</td>
<td>$0</td>
<td></td>
</tr>
</tbody>
</table>
Earnings Per Share

- Considered contingency for purposes of applying EPS guidance in ASC 260
- Determine if the shares are contingently issuable
  - Measure performance at the end of the reporting period and determine how many shares would be issued if the performance period ended
  - If condition met (or partially met), include those shares as of beginning of the reporting period or grant date if later
- Apply the Treasury Stock Method to the shares considered issuable (ASC 260-10-45-55)
Diluted EPS – Market Condition

- Target Awards: 5.0M (weighted average during period)
- Assumed percentage: 150% (at the end of reporting period)
- Remaining expense: $10.0M (weighted average outstanding during period)
- Average stock price: $6 (simple average during period)
- Fair Value: $8 (original grant date FV)

Potentially diluted awards: 5.0M x 150% = 7.5M shares
Proceeds to buy-back shares:
   $10.0M expense + ($6x7.5M shares - $8 FVx5.0M shares) x 40% = $12.0M
Shares repurchased: 12.0M / $6 = 2.0M shares
Dilutive shares: 5.0M x 150% - 2.0M = 5.5M shares
Diluted EPS – Performance Condition

- The number of shares contingently issuable is often different than the number assumed to vest for expense accrual purposes
  - Companies accrue expense based on the number of awards expected to vest at the end of the performance period
  - Contingently issuable shares based on actual performance through the end of the reporting period
- A company may record expense during the performance period without recognizing any shares in the denominator of the diluted EPS until they are issued
Additional Resources

- Performance Plans Portal on NASPP.com
  (www.naspp.com/members/Portal/Performance.asp?path_info=/members/Portal/Performance.asp)

- NASPP Webcasts:
  - “Performance Vested Stock Options: The Next Big Trend?” (Sept 2008)
  - “A Closer Look at Leading-Edge Performance-Based Plans” (Mar 2010)

- Radford’s Relative TSR web portal: www.RelativeTSR.com
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