**Aon Consulting**
Executive Compensation + Employee Benefits

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- **Driving Performance - Linking Equity Compensation Design with FAS 123(R) Valuation, Jeff Bacher and Terry Adamson, Aon Consulting**

November 6, 2006

# What's Important?

- Employers:
  - Accuracy in valuation
  - Consistency in reporting
  - Defensibility upon audit
  - Understandable results
- Auditors:
  - "Smell test" satisfaction
  - Auditability
  - Comprehensive disclosure of methodology,results, and data used

# Stock Option Valuation – Emerging Best Practice

- Data:
  - Historical exercise and cancellation activity
  - Separation from employment experience
  - Data used for projecting assumed activity of outstanding (i.e.unexercised) options
- Models: Service-based options
  - Binomial models becoming recognized as more accurate
    - 341 companies have now publicly disclosed (see handout)
    - Hazard rate models becoming the norm
    - Path dependency of stock is critical in valuation
    - Multiple drivers of exercise being modeled
  - Black-Scholes still used widely in spite of limitations and inaccuracy

# Stock Option Valuation – Emerging Best Practice

- Models: Service-based options
  - Aon has developed a new, more accurate version of Black-Scholes; **always** gives a lower fair value; better captures distribution of exercise behavior; easy audit review
- Models: Performance-based options
  - Performance-based options and share plans must use combination of binomial and Monte Carlo simulation
- Assumptions
  - Volatility is chosen based on combination of terms and types
  - Exercise behavior used to model life hazard rates, so "expected life" only needed for Black-Scholes
  - Separation from employment assumptions made at all points where option is underwater

# Stock Option Exercise Behavior – What We're Learning

- Important determinants of exercise behavior
  - Path-dependency in stock movement (Aon)
  - Recent vesting is an option tranche (Stanford Univ.)
  - Previous multi-week run-up of stock (Stanford Univ.)

- FAS 123(R) fair values can differ:
  - **Slightly** – Using different models with the same basic assumptions
  - **Slightly to Moderately** - Using the same (binomial) model with different assumptions for separation from employment
  - **Moderately to Greatly** – Using the same (any) model with different assumptions for exercise of outstanding options

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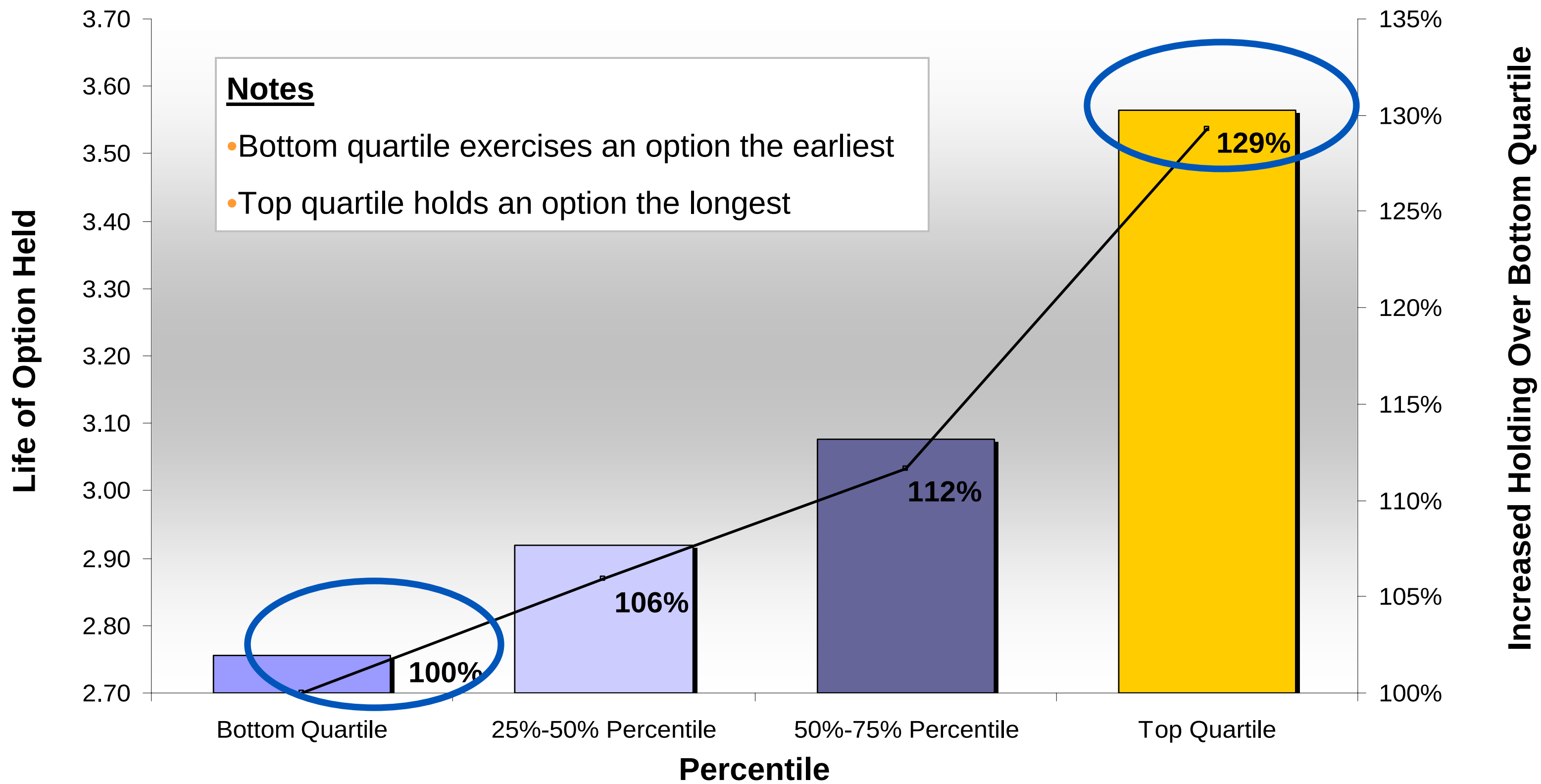
# Study of Exercise Behavior - Example

- **Grant and exercise practices for 20 companies were aggregated - involving more than 700 million option exercises**
- **Employees were categorized by the percent of the annual grant received and put into quartiles**



# Reporting of Valuation Results – What Auditors Want to See

- Well-documented process for:
  - Analysis of data
  - Selection of assumptions, including range of reasonable choices
- Technical support for range of assumptions presented
- Detailed explanation of the model(s) being used
- Charts of results with sensitivity analysis
- Disclosure of data used
- Explanation of changes in methodology or model and why changes are being proposed

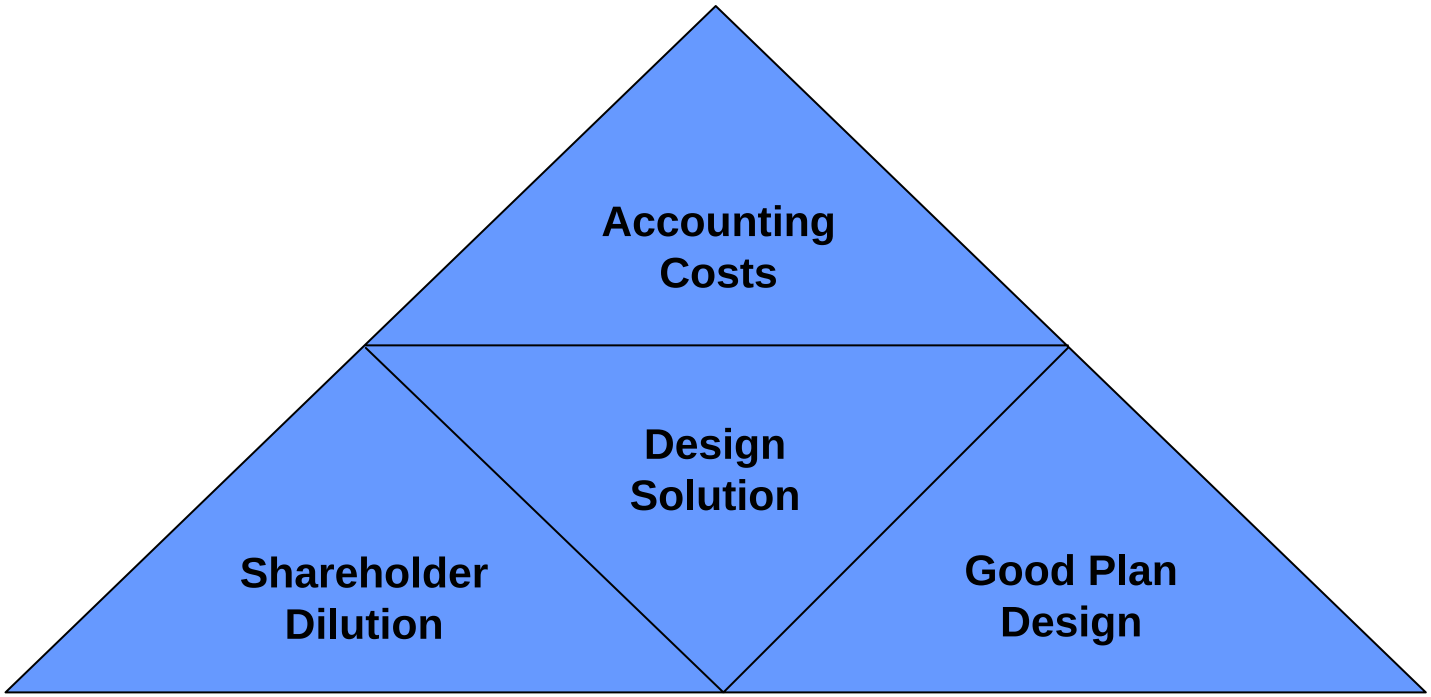
# Going Forward – Valuation Issues

- Expensing impact on the financial statement will take on more importance
- Industry- and/or company size-based FAS 123(R) assumptions will become the norm
- Performance-based cash compensation strategies will also be evaluated for their impact on earnings
- Study of data in understanding drivers of exercise behavior will become more important in designing plans

# Long-term Incentive Design Considerations

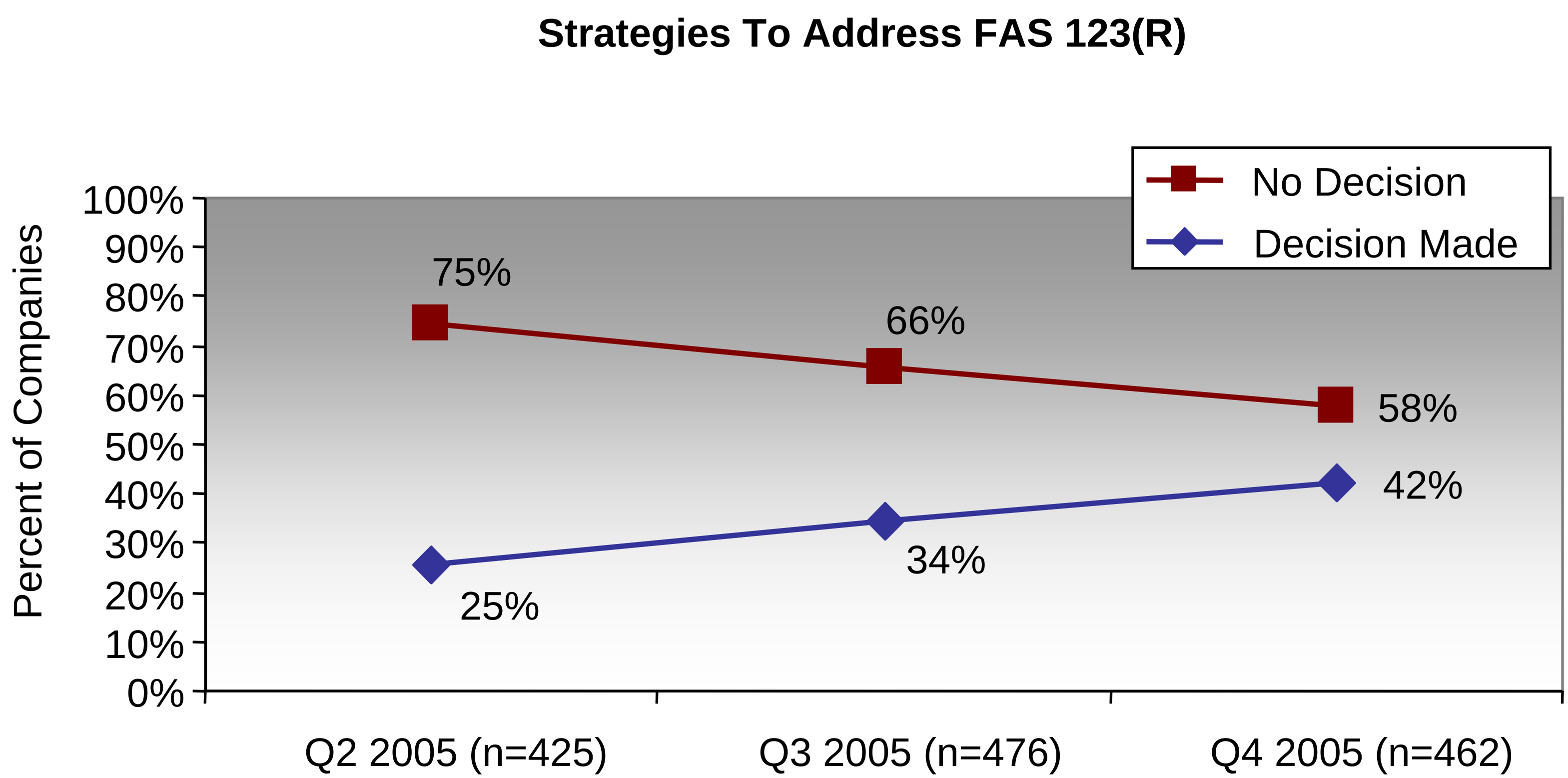
## The Critical Question

**In the post-stock option expensing world, what drives long-term incentive design – accounting costs, shareholder dilution or good plan design…?**




**Most would say all three.**

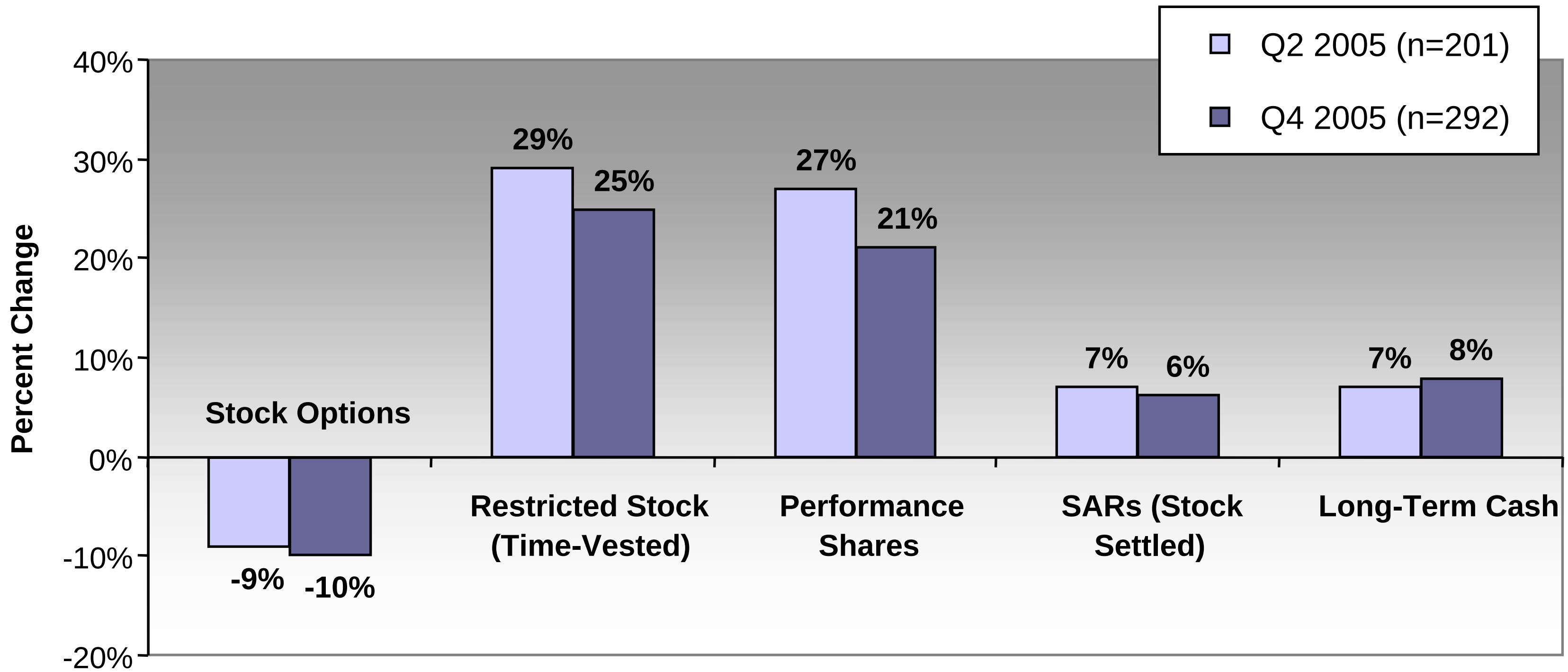
# 2005 & 2006: A Time of Preparation




*Data Sources: Radford Quarterly Summary of Industry Trends, Q2-Q4 2005 – Tech and Biotech Editions Combined*

# Decline in Option Use in Favor of Full-Value Awards

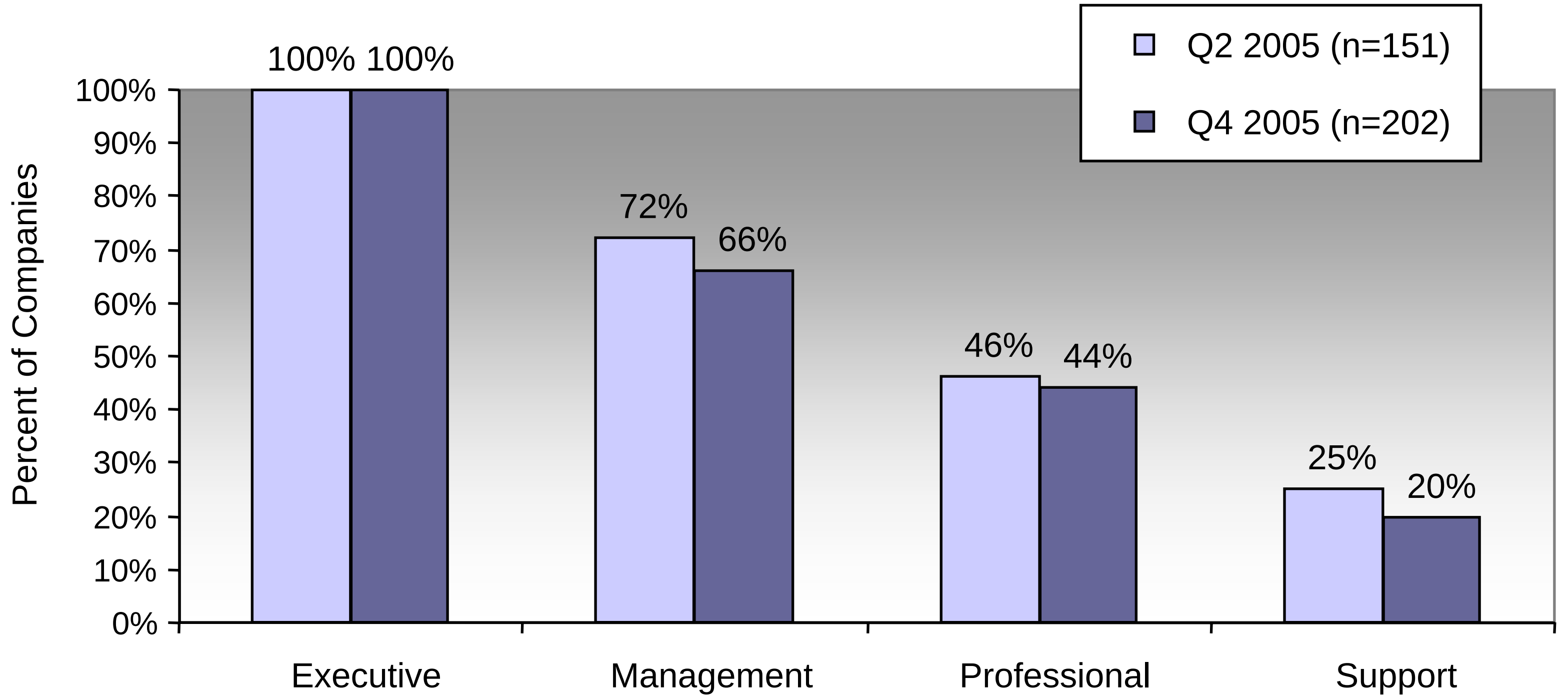
**Change in Percent of Companies Using Each Vehicle After FAS 123(R) Implementation**




*Data Sources: Radford Quarterly Summary of Industry Trends, Q2-Q4 2005 – Tech and Biotech Editions Combined*

# Full Value Vehicles Focused at the Top

**Percent of Companies Granting Each Level, Among Those Using Full Value Stock**




*Data Sources: Radford Quarterly Summary of Industry Trends, Q2-Q4 2005 – Tech and Biotech Editions Combined*

# Participation and Award Size Expected To Be Impacted

| Changes to Ongoing Option Programs | Percent of Companies Q2 2005 (n=201) | Percent of Companies Q4 2005 (n=291) | Change From Q2 to Q4 |
|---|---|---|---|
| No change to option participation or award size | 31% | 27% | **-4% pt** |
| Decreasing both option participation and award size | 19% | 24% | **4% pt** |
| Decreasing option participation, maintaining award size | 8% | 10% | **2% pt** |
| Maintaining participation, decreasing award size | 11% | 11% | **-1% pt** |
| Moving toward a mix of options and full value | 19% | 16% | **-3% pt** |
| Abandoning traditional options entirely | 10% | 12% | **2% pt** |

*Data Sources: Radford Quarterly Summary of Industry Trends, Q2-Q4 2005 – Tech and Biotech Editions Combined*

# Reductions in Award Size Occurring Across the Board

| | Change in Ongoing Award Size | | |
|---|---|---|---|
| Organizational Level | Q2 2005 (n=42) | Q4 2005 (n=67) | Change From Q2 to Q4 |
| Executive | -23% | -22% | **1% pt** |
| Management | -30% | -29% | **1% pt** |
| Professional | -33% | -34% | **-1% pt** |
| Support | -33% | -27% | **6% pt** |

*Data Sources: Radford Quarterly Summary of Industry Trends, Q2-Q4 2005 – Tech and Biotech Editions Combined*

# No “Make-Up” for Majority

| Make-Up Alternatives for Option Cuts | Percent of Companies: Q2 2005 (n=85) | Percent of Companies: Q4 2005 (n=140) | Change From Q2 to Q4 |
|---|---|---|---|
| No make-up | 69% | 64% | **-6% pt** |
| Other LTI vehicles | 15% | 18% | **3% pt** |
| Increase bonus participation | 7% | 11% | **4% pt** |
| Increase bonus payouts | 9% | 8% | **-2% pt** |
| Increased retirement benefits | 5% | 4% | **0% pt** |
| Increase health & welfare | 1% | 1% | **0% pt** |
| Base salary increase | 1% | 3% | **2% pt** |

*Data Sources: Radford Quarterly Summary of Industry Trends, Q2-Q4 2005 – Tech and Biotech Editions Combined*

# So What Are Companies To Do?

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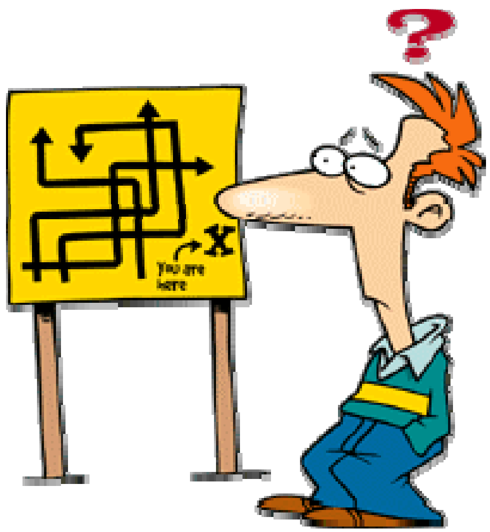

## The same old path is no longer available

# Set an Executive Compensation Framework which Rewards Performance

**Salaries**

- Set at market median

**Annual Incentives**

- Set target at market median
- Establish actual awards based on performance which truly reward for results (below and above plan)
- Increase bonus opportunity if reduced equity grants impact middle management

**Long-term Incentive Philosophy**

- Consider mandatory deferrals that tie in with long-term incentive plan
- Create a pool of equity shares based on an appropriate burn rate, not by levels established by jobs in compensation surveys
- Balance equity design taking into account:
  - Accounting costs
  - Shareholder dilution
  - Corporate governance concerns
  - Pay with performance alignment
  - Proxy disclosure

# "Stock Options Are Not Evil."

***Jeff Bacher, November 6, 2006***

**Reward for value created…**

# Long Term Incentive Designs

- Introduce alternative equity-based compensation programs:
  - Performance accelerated options/full-value shares
  - Performance contingent options/full-value shares
  - Stock-settled stock appreciation rights
  - Performance share plans
- We believe the next Long Term Incentive design trend will be the use of equity awards with the use of market conditions

# Common Types of Performance Plans with Market Conditions

- Absolute Performance Plans
  - Contingent Vesting
    - At the service period, if market condition is achieved at or before the service period
    - At the later of achieving the market condition and a specified service period
    - At the earlier of achieving the market condition and a specified service period
- Relative Performance Plans
  - Relative Vesting (based on percentile rank of Index)
  - Indexed Exercise Price

# Absolute Performance Plan - Example

A company grants stock options to employees with the following market condition in place:

*"Options will vest if the company's share price increases by 10% annual Total Shareholder Return ("TSR") from the grant date, any time over the next five-year period."*

The following slide shows the difference in valuation between a traditional time vested stock option and a single absolute performance hurdle stock option

# Sample Valuations of Absolute Performance with Contingent Vesting

- Vesting is at the service period, if market condition is achieved at or before the service period

| Vesting Occurs Only if Hurdle is Met - Cliff Vesting - Expected Volatility of 20% | | | | | | |
|---|---|---|---|---|---|---|
| | | 1-Year | 2-Years | 3-Years | 4-Years | 5-Years |
| Black-Scholes Value [1] | | 26.40% | 28.20% | 30.03% | 31.83% | 33.49% |
| | | Reduction in Valuation from Traditional Service Based Options | | | | |
| Vesting Hurdle (Total Annual TSR) | 2.00% | -9.02% | -8.56% | -7.04% | -5.07% | -3.10% |
| | 4.00% | -13.70% | -13.21% | -12.71% | -9.98% | -7.96% |
| | 6.00% | -24.20% | -22.22% | -19.91% | -17.21% | -15.42% |
| | 8.00% | -28.95% | -27.75% | -26.63% | -25.75% | -25.26% |
| | 10.00% | -37.20% | -35.80% | -35.94% | -34.60% | -34.95% |

[1] Assumes a Black-Scholes valuation with an expected life equal to the midpoint of the service period and the contractual term (for example, a 1-year service period and a 10 year contractual term would yield an expected life of 5.50 years), a volatility of 20%, no dividend yield, and a Risk-Free Rate commensurate with the expected life.

# Relative Performance Plans

- Stock indices such as the S&P 500 Index are commonly used as performance benchmarks
  - Shares vest if company performance ranks within a pre-defined percentile of the S&P 500 over a future period of time
  - Number of shares granted varies due to future performance relative to the index

- An example of a Relative Performance Plan would be the following: **Company B** grants restricted shares to employees with the following market condition in place:

*"The number of shares that vest is dependent on the TSR of Company B as compared to the TSR of each individual equity in the S&P 500 index at the end of three years. At the 50th percentile rank, 100% of the targeted award will vest. For each percentile rank above or below the median, an additional +/-2% of shares will vest."*

# Relative Performance Plan (continued)

- This plan does not necessarily create a discounted value

Pros

- Compensation tied to Shareholder Returns
- Fixed Accounting
- Create a competitive compensation framework

Cons

- TSR is not always correlated to actual performance
- Challenging to determine representative peer companies

- However a relative performance plan rewards executives for performance – it doesn't allow for Super Bowl rewards for a losing season performance. Conversely, it rewards very well for better managing in the down cycles versus the peers.

# Market Conditions - Considerations

- Since expense will not be reversed if market conditions are not met, it is in a company's best interest to accurately discount equity instrument fair value to reflect the effects of market conditions
- Plans containing market conditions are enjoying popularity in the marketplace as companies
  - Align shareholder and employee interests
  - Strive to reduce the effect of FAS 123(R) expense on the P&L

# Summary

- FAS 123(R) has impacted the long term incentive landscape
- However, long term incentive design needs to follow company business strategy, not the accounting policy
- We believe that long term awards need to be based on performance –
- … and stock options and restricted can reward for that performance using market performance conditions

# Contact Information

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