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The Holy Grail of Employee Compensation

Performance Grants

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Introduction

This article provides an overview that explains performance grants, the ideal strategy of linking employee compensation to their performance while achieving all the other benefits of employee ownership. Performance Grants provide tremendous financial and HR benefits for companies, and these benefits far overweigh the accounting and administrative challenges associated with them.

The article starts with an explanation of performance grants and why all companies, both private and public, should have them. The article then talks about the accounting treatment of performance grants and the challenges associated with them. The article concludes with the steps that companies need to undertake to offer performance grants to their employees and a few examples of the accounting treatment of performance grants.

What are performance grants?

Performance grants are a special type of stock-based compensation in which the grant vesting is conditional on the fulfillment of certain performance criteria. The performance criteria can be attached to any of the following SBC instruments: Options, Restricted Shares, Share Appreciation Rights and Employee Share Purchase plans.

Performance conditions can be broken down into the following two categories:

(1) ***Individual conditions***, where the employee has significant control over the outcome of the conditions, for example, meeting the employee's sales targets.
(2) ***Corporate conditions***, where the employee has limited control over the outcome of these conditions, for example, meeting the overall company EPS targets.

An employee can receive multiple grants, each with a different condition, thereby encouraging the employs to focus on both their own goals together with the overall company goals.

Another dimension performance conditions is whether they are market based-condition or not. Individual conditions are always non-market conditions whereas corporate conditions can be either market or non-market conditions. The following table shows the difference between market-based conditions and non-market-based conditions:

	Market Conditions	**Non-Market Conditions**
Initial Valuation	Uses Monte Carlo Sinulatios	Uses management experience and discretion
Adjustment of Expected Fulfillment	Should not be done	Should be done
Actions at Vesting Time	No Adjustments	Review fulfillment conditions and true-up/true-down expenses

We will further discuss the differences between Market-based Conditions and Non-market-based Conditions later in this article.

The Benefits of Performance Grants

Performance grants provide all the financial and HR benefits of time-based stock-based compensation. Some of performance grant specific benefits include:

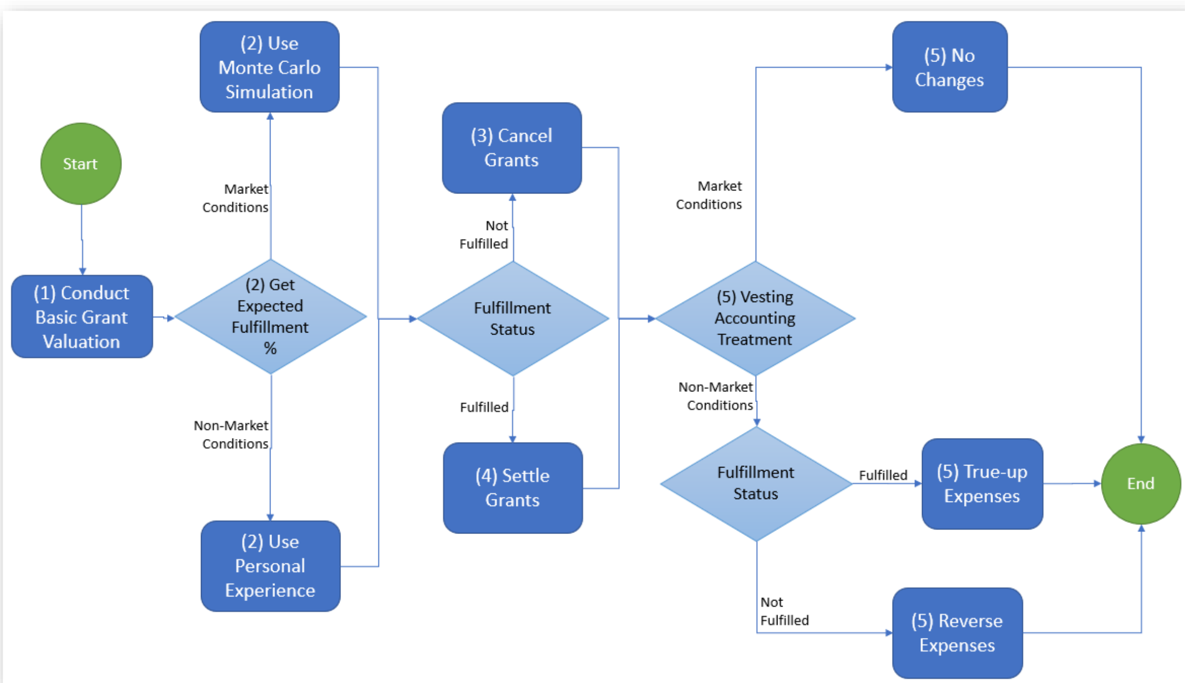
- **Link of Compensation to Objectives:** Performance grants are one of the unique methods of linking the employee compensation to their productivity and confirming the amount of compensation ahead of achieving the objectives.
- **Pruning Out Low Producers:** Star performers in the company would love performance grants while low producers would hate them. This may result in low

producers looking for opportunities in other companies that have less appreciation to high producing employees.

- **Management Discipline:** The linking of the annual review process for employees to stock-based compensation via performance grants will instill a high level of management discipline in defining the individual and corporate goals.
- **Focus of Employees on Objectives:** Throughout the period of the performance grant, the employees would focus on their set objectives. Knowing what's on the line employees would do everything in their power to achieve their objectives so that they do not "lose" the grants that they received.
- **Lower Expenses:** From a financial perspective, the expenses recognized as a result of issuing performance grants are gnerally lower than the expense resulting from time-based grants for the same number of units.
- **Reduced Dilution:** The number of settled units for performance grants would normally be less than their equivalent for time-based grants.

The Accounting Treatment of Performance Grants

The accounting treatment of performance grants depends on whether the grant criteria are based on market conditions (stock price, for example) or non-market conditions. The following flow chart attempts to summarize the accounting treatment, and the explanation that follows will elaborate on the intricacies of different accounting treatments:



Source: Created by Author

(1) **Conduct Basic Grant Valuation:** This is similar to other stock-based compensation grants. The valuation is usually done using the Black-Scholes valuation model, and in some cases a Binomial valuation model is used for the valuation.

(2) **Calculate the Expected Fulfillment:** The basic valuation assumes that there are no performance conditions associated with the grant. As we introduce performance conditions, the expenses incurred for the grant would drop by a percentage equal to the expected fulfillment of the performance conditions.

   The calculation of the expected fulfillment depends on whether the performance conditions are market conditions (e.g. stock price) or non-market conditions (e.g. revenue targets).

   Market conditions expect a solid mathematical justification for the expected fulfillment percentage; this justification is usually done through a Monte Carlo simulation of a binomial model.

   On the other hand, the expected fulfillment percentage for non-market conditions are left to management discretion without a need for mathematical justifications.

   There are two reasons for the need of mathematical justification for market condition expected fulfillment:

   a. Market conditions valuation can be calculated with a relatively high accuracy.
   b. Expenses associated with market conditions are neither reversed or trued-up at the vesting time, whereas non-market conditions are either trued-up or reversed at the vesting time depending on whether the performance conditions are fulfilled or not.

(3) **Grant Cancellation:** At vesting, if the fulfillment conditions are not met, the grants would be cancelled.

(4) **Grant Vesting:** At vesting, if the performance conditions are met, the grants are vested. In the case of restricted shares, the vesting will imply a settlement of the shares.

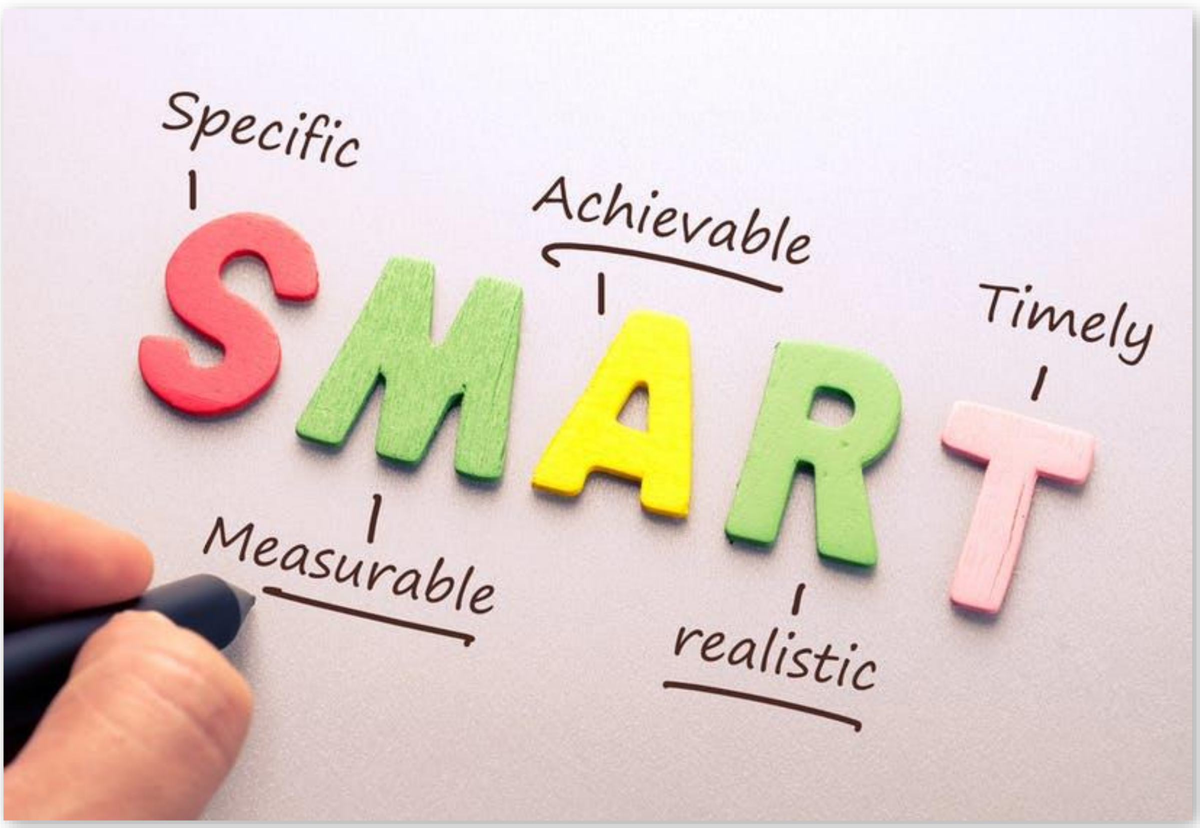
(5) **Vesting Accounting Treatment:** Upon vesting, one of three scenarios will take place related to the grant

   a. If the condition is a market condition, no change will happen.
   b. If the condition is an individual/corporate condition and the performance conditions are fulfilled, the expenses are trued-up. An additional expense would be incurred to cancel out expense discounts resulting from the expected fulfillment condition.
   c. If the condition is an individual/corporate condition and the performance conditions are NOT fulfilled, the expenses incurred associated with this grant are fully reversed.

How can a company offer performance grants to its employees?

To introduce performance grants to its employees, the company needs to take the following steps:

(1) Determine the performance criteria for every individual; the criteria can be individual and/or corporate criteria. Most companies already do that as part of the annual performance review for employees. The criteria set need to be SMART ones:
   a. Specific
   b. Measurable
   c. Achievable
   d. Relevant
   e. Timely



Source: ClearReview, [Which SMART Objectives definition should I use?]

(2) Determine the expected fulfillment of the performance criteria. For non-market conditions, a 50% starting point should be o.k. as long as there are plans to review this number periodically.
(3) Select a software product to manage the performance grants.

(4) Train the management team on how to communicate the performance grants and the criteria to employees.
(5) Deliver the performance grants to the employees; these performance grants should be offered via a grant letter.
(6) Monitor the fulfillment of the criteria and reflect the changes in the expected fulfillment on the system. If a criterion is met, the expected fulfillment is set to 100%; the company may then choose to accelerate the vesting for the performance grant.
(7) At the vesting date, set the expected fulfillment to either 0% or 100%. Grants with criteria that are not met are then cancelled.
(8) Prepare for the next performance grant round and repeat the above steps.

Why do some companies still use time-based grants instead of performance grants?

I personally believe that time-based grants should not be used as long as there is an opportunity to use performance grants. Based on my experience I found that companies do not use performance grants for the following reasons:

- The company management is not aware of the benefits of performance grants.
- The company management does not want to exert the effort associated with setting up and monitoring the grants.
- The company is not using a system that supports performance grants and does not want to use a spreadsheet for the accounting and administration.

Final Points to Consider

Following are some points that need to be taken into consideration while introducing performance grants to your company:

- Offering the performance grants needs to be done in conjunction with the annual review process.
- The ideal vesting period for the performance grants is one year.
- When offering performance grants, offer a higher number than what you would have offered for time-based grants thereby giving a a higher perception of compensation, especially for “high-producing” employees.
- Modifications of the expected fulfillment of the performance criteria are applicable only for non-market conditions.
- Introducing performance grants for the first time needs to be done on a pilot basis to a limited number of employees.
- If the company does not have an annual review process for its employees, then introduce this process together with introducing performance grants.

- Make sure that the software you are using handles all the accounting and administrative features of performance grants.

About the Author

Ramy Taraboulsi is the CEO of VeritableSoft Innovations Inc., the parent of LoyaltyOptions (https://LoyaltyOptions.com), the software product that manages all aspects of administration and accounting of stock-based compensation and employee ownership plans, including performance grants.

Prior to founding VeritableSoft, Ramy held different executive positions including Chairman and CEO at SyncBASE, CIO at Insurance Bureau of Canada, VP - Internet Strategy and Development at Fidelity Investments, VP - Internet Strategy at Merrill Lynch and Chief Systems Architect at Mercer Human Resources Consulting. Ramy has also held and is currently holding various directorship positions.

Ramy is a Professional Engineer who holds an M.Sc. in Computer Science, MBA and he is a Chartered Financial Analyst (CFA). Ramy has been practicing different forms of martial arts for 40 years, and is currently actively practicing Karate. He also plays music and enjoys reading, writing and traveling around the world.

Appendices

Appendix-1: Examples of Performance Grants Accounting Transactions

This section is written for accountants and financial professionals.

Example-1: Market Condition Performance Grant, Fulfilled or Not Fulfilled at Vesting

Grant Offering:

- Robert L. received a grant of 1,200 Restricted Shares
- Vesting is in one year
- Vesting performance condition: the stock price remains above $120 for 30 days before the vesting date.
- Current stock price: $100

Valuation:

- Basic valuation: $100 per share (stock price as this is an RSU)
- Expected fulfillment (based on a Monte Carlo simulation): 60%

Accounting Transactions:

- Total expenses: (the valuation per share) * (number of shares) * (expected fulfillment of the condition) = $100 * 1,200 * 60% = $72,000
- This amount would be amortized over 12 months for $6,000 monthly expenses.
- At the vesting time, there will be no adjustments.

Example-2: Corporate Condition Performance Grant, Fulfilled at Vesting

Grant Offering:

- Chris T. received 2,400 options
- Vesting is in one year
- Expiry is after 3 years.
- Current price of the stock is $100
- Option strike price is $100.
- Vesting performance condition: exceeding the personal sales target by 20%.

Valuation:

- Option basic valuation: $10 per unit (based on Black Scholes model)
- Initial expected fulfillment: 60%
- 6-month review expected fulfillment: 70%
- Final assessment: Performance conditions are met

Accounting Transactions:

- Base monthly expense (no performance criteria): (number of options) * (option valuation) / 12 = 2,400 * $10 / 12 = $2,000.
- With the 60% expected fulfillment monthly expenses are $1,200.
- 6-month true-up adjustment: (number of months) * (base monthly expense) * ((new expected fulfillment percent) – (old expected fulfillment percent)) = 6 * $2,000 * (70% - 60%) = $1,200.
- Vesting date true-up (removal of the impact of expected fulfillment): (number of months) * (base monthly expense) * (100% – (last expected fulfillment percent)) = 12 * $2,000 * (100% - 70%) = $7,200.

Example-3: Corporate Condition Performance Grant, Not Fulfilled at Vesting

Grant Offering:

- Ned H. got the same grant as the one above for Chris

Valuation:

- Same as above except that the vesting condition was not met

Accounting Transactions:

- Same as above until vesting where prior expenses are reversed

- Vesting date reversal: (number of units) * (base valuation) * (last expected fulfillment percent) = 2,400 * $10 * 70% = $16,800.

Appendix-2: Examples of Performance Criteria

This section is written for HR and general management

Following is a list of examples of non-market SMART performance criteria. The conditions can be either Corporate Conditions or Individual Conditions; Some conditions are applicable to both.

- Developing and implementing an employee recognition program
- Implement an HRIS system
- Complete the internal control audit report with an unqualified opinion
- Achieve sales goals of $930K for year 2023
- Achieving 2022 net operating income per Board approved budget
- Complete 1st round of equity financing prior to 12/31/2022
- The EPS exceeds 0.25 for three consecutive months.
- 2022 sales exceed 2021 sales by 50%
- Met or exceed agreed to sales goal of $2,800,000 for 2000.
- Developing and implementing a comprehensive safety program that passes the audit
- EPS is a minimum of $0.55 between the period of July 1,2022 and June 30, 2023

The following are examples of market conditions. By default, market conditions are corporate conditions.

- Share price has to exceed $2.151 per share for 20 consecutive trading days that have above average trading volume in the 2022 fiscal year
- Market price equals or exceeds $4.50 for at least 15 consecutive trading days on or before December 31st, 2022