Employer Sponsored Equity Incentive Plans

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American Payroll Association
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Linking the interests of senior management to shareholders

- Agenda
  - Executive compensation
  - Equity plan designs
  - Administrative issues
  - Accounting intersection
  - Payroll intersection
  - Legal and regulatory intersection
  - Shareholder's perspective
  - Communication
  - Third Parties

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Executive compensation

- Objective: determine the amount and mix of compensation
- Peer groups or market size to determine position e.g. median
  - Target Compensation amounts
  - Mix
    - fixed vs. variable
    - short term vs. long term
- Total Direct Compensation
  - Base Salary – fixed
  - Annual incentive – variable based on operating plan
  - Long term incentive – variable
    - based on share price appreciation
    - and possibly other longer term metrics

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Equity plan designs

- Vehicles
  - Stock options
    - Option to purchase a share of stock at a predetermined price (strike price) in the future
      - Value is the difference between the share price and the strike price when exercised
  - Full value share awards
    - Restricted stock
      - Participant holds the share but does not own it free and clear until vesting
    - Restricted stock units
      - Equivalent in value to a share of stock and is converted into a share of stock at vesting
  - Performance share awards
    - Full value share award but can increase (or decrease) based on operational metrics
- Typical vesting schedules
  - Ratable vesting e.g. 25% per year
  - Cliff vesting e.g. 100% after three years
  - Unexercised option will typically expire after a set period of time e.g. 10 years

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Administrative Issues

- Public traded companies must comply with a multitude of requirements to sponsor a plan
- Equity incentive plans are dilutive to shareholders
- Must by approved by shareholders
  - At least every five years or
  - When the allotment of shares will expire
- Requirements exist with
  - The SEC
  - The IRS
  - The NYSE

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Accounting intersection

- 1993 - Section 162m of the Internal Revenue Code eliminates the deductibility of non performance based compensation over $1 million per year
  - Use of performance based compensation plans increases
- 2005 - FAS Statement 123 (R) / ASC 718 – equity accounting rules, requires companies to expense the value of stock options and other forms of equity
  - Prior, $0 expense at the time of grant – free
  - Detrimental to shareholders – dilution
- Black Scholes valuation to estimate the value of an option at grant
- Full value shares expensed at the price on date of grant

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Payroll intersection

- Taxation of equity
  - Taxed as regular income at vest or exercise
    - Full value awards are taxed as regular income once vested
      - Taxable amount = fair market value on the date of vest
    - Proceeds of option exercises are taxed at the time of exercise
      - Taxable amount = difference between the share price at exercise and the share price at grant
  - Capital gains tax
    - When ultimately sold, shares will have capital gains tax
      - share price when sold less fair market value of the date of vest

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Option Exercise

- Strike Price = $22.67
- Current Price = $61.40

Exercise Type:	Cashless for Cash
Options Exercised:	535
Fair Market Value per Share:	$61.4000
Estimated Selling Price per Share:	$61.4000
Shares to be Sold:	535

Exercise Details		USD
Total Fair Market Value (Options Exercised x FMV):		32,849.0000
Total Option Cost (Options Exercised x Option Price):		12,128.4500
Taxable Income		20,720.5500
(Total FMV - Total Award Cost):		
Taxes:		
	Standard Federal Tax 1	5,180.14
	Standard State Tax 1 - OH	901.57
	Standard Local Tax 2 - Boa	414.41
	Standard FICA Social Security	1,284.67
	Standard FICA Medicare	300.45
Total Taxes:		8,081.24

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Legal and regulatory intersection

- Securities and Exchange Commission (SEC)
  - Form S8 – SEC filing requirement when stock is issued under an employee benefit plan
  - Regulation SK – covers disclosure requirements for the top five executives
  - Form 8-K requires filing of new contracts and plans when adopted
  - SEC Rule 16b requires director and officers to file statements
  - Form 144 must be filed with the SEC when an officer or director sells stock
- Dodd-Frank financial reform law
  - Resulting from the financial crisis of 2009 to provide more transparency to investors
  - Impact on Companies
    - Non binding Say on Pay vote
    - Independence of advisors to Compensation Committees
    - Clawback provisions

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Legal and regulatory intersection

- Internal Revenue Service
  - IRC Section 409A
  - Places restrictions and harsh penalties on the deviation of when deferred compensation is paid out.
- Exchange Listing Standards – New York Stock Exchange
  - Director independence
  - Equity grant restrictions

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Shareholder's perspective

- Institutional shareholder's perspective
  - Focus on executive pay
  - Granting equity to management is dilutive
  - Many of the reforms driven by the shareholders

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Communication

- Significant portion of senior management's compensation
- Do they understand how operational performance leads to better earnings leads to share price appreciation leads to more compensation?
- Equity compensation is not easily understood
- Education and communication is key
- Leaders need to understand the direct connection between their performance and their leadership to the success of the company and the reward to shareholders and their rewards

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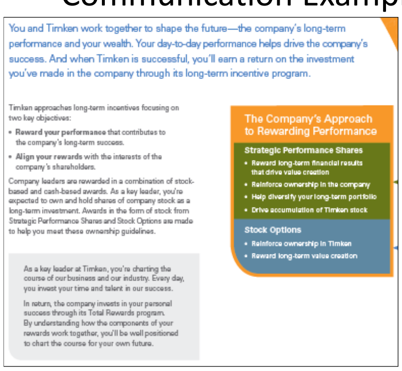
Communication Examples



You and Timken work together to shape the future—the company's long-term performance and your wealth. Your day-to-day performance helps drive the company's success. And when Timken is successful, you'll earn a return on the investment you've made in the company through its long-term incentive program.

Timken approaches long-term incentives focusing on two key objectives:

- **Reward your performance** that contributes to the company's long-term success.
- **Align your rewards** with the interests of the company's shareholders.

Company leaders are rewarded in a combination of stock-based and cash-based awards. As a key leader, you're expected to own and hold shares of company stock as a long-term investment. Awards in the form of stock from Strategic Performance Shares and Stock Options are made to help you meet these ownership guidelines.

As a key leader at Timken, you're charting the course of our business and our industry. Every day, you invest your time and talent in our success.

In return, the company invests in your personal success through its Total Rewards program. By understanding how the components of your rewards work together, you'll be well positioned to chart the course for your own future.

The Company's Approach to Rewarding Performance

Strategic Performance Shares
- Reward long-term financial results that drive value creation
- Reinforce ownership in the company
- Help diversify your long-term portfolio
- Drive accumulation of Timken stock

Stock Options
- Reinforce ownership in Timken
- Reward long-term value creation

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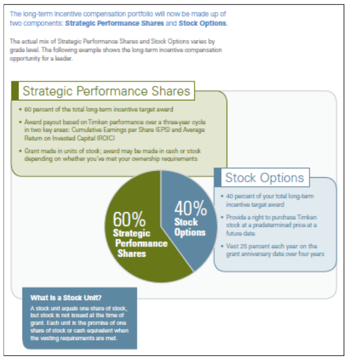

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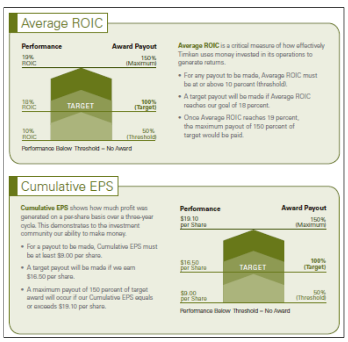

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Communication Examples

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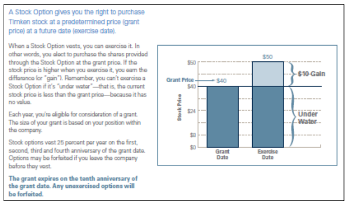
Communication Examples



A Stock Option gives you the right to purchase Timken stock at a predetermined price (grant price) at a future date (exercise date).

When a Stock Option vests, you can exercise it. In other words, you elect to purchase the shares provided through the Stock Option at the grant price. If the stock price is higher when you exercise it, you earn the difference (or "gain"). Remember, you can't exercise a Stock Option if it's "under water"—that is, the current stock price is less than the grant price—because it has no value.

Each year, you're eligible for consideration of a grant. The size of your grant is based on your position within the company.

Stock options vest 25 percent per year on the first, second, third and fourth anniversary of the grant date. Options may be forfeited if you leave the company before they vest.

The grant expires on the tenth anniversary of the grant date. Any unexercised options will be forfeited.

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Third Parties

- Record keepers
  - Outstanding equity
  - Vesting Schedules
  - Tax withholding and reporting
- Open market transactions
  - Broker affected option exercises
  - Dividend reinvestment
- Customer service
  - SEC reporting (Form 144)
- Financial reporting

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Questions and Discussion

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