

**Employer Sponsored Equity
Incentive Plans**

Presented to: Hall of Fame Chapter
American Payroll Association
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May 1, 2014

**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
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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 be 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):	32,849.9000
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 - Bca	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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Communication Examples

The long term incentive compensation portfolio will now be made up of two components: **Strategic Performance Shares** and **Stock Options**.

The actual mix of Strategic Performance Shares and Stock Options varies by grade level. The following example shows the long term incentive compensation opportunity for a leader.

Strategic Performance Shares

- 40 percent of the total long term incentive target award
- Award payout based on Temken performance over a three-year cycle in two key areas: Cumulative Earnings per Share (EPS) and Average Return on Invested Capital (ROIC)
- Grant made in units of stock; award may be made in cash or stock depending on whether you've met your ownership requirements

Stock Options

- 40 percent of your total long term incentive target award
- Provides a right to purchase Temken stock at a predetermined price at a future date
- Vest 25 percent each year on the grant anniversary date over four years

What is a Stock Limit?

A stock unit equals one share of stock, but stock is not awarded in this form of grant. Each unit is the purchase of one share of stock at your appointment when the vesting requirements are met.

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Communication Examples

Average ROIC

Performance	Award Payout
100% (ROIC)	100% (Maximum)
85% (Target)	50% (Threshold)
50% (Threshold)	0%

Average ROIC is a critical measure of how effectively Temken uses money invested in its operations to generate returns.

- For any payout to be made, Average ROIC must be at or above 50 percent (Threshold).
- A target payout will be made if Average ROIC reaches our goal of 85 percent.
- Once Average ROIC reaches 10 percent, the maximum payout of 100 percent of target would be paid.

Performance Below Threshold - No Award

Cumulative EPS

Performance	Award Payout
\$10.10 per Share	100% (Maximum)
\$10.00 per Share (Target)	50% (Threshold)
\$9.90 per Share	0%

Cumulative EPS shows how much profit was generated on a per share basis over a three-year cycle. This demonstrates to the investment community our ability to make money.

- For a payout to be made, Cumulative EPS must be at least \$9.90 per share.
- A target payout will be made if we earn \$10.00 per share.
- A maximum payout of 100 percent of target award will occur if our Cumulative EPS equals or exceeds \$10.10 per share.

Performance Below Threshold - No Award

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Communication Examples

Reaching Your Individual Award

Strategic Performance Shares awards are made at the end of each three-year performance cycle. The number of Strategic Performance Shares you receive can range from 50 percent to 100 percent of your target award, depending on results.

Take Action:

- There are also when you receive your award. If your award is paid in cash, you'll need to pay taxes on the value of your award.
- If your award is in the form of Temken stock, you can pay taxes on the value of the shares as you can sell them or your shares to pay taxes.
- Talk to your financial planner about what your choices mean for your finances.

Your Award Potential

Your award potential comes from two areas: Temken performance over the three-year cycle as well as a potential increase in Temken stock price over the same cycle.

- While your target award represents what you'd receive if a target level of performance is achieved, you have the potential to earn much more. If actual company performance is above or below target, your award may increase or decrease. You can earn up to 100 percent of your target award if company performance exceeds target.
- Because a Strategic Performance Share is awarded in value in a share of Temken stock, your award will increase or decrease in value based on the performance of Temken stock over the three-year performance cycle. Your award can increase through additional shares as well as the value of each share.

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Communication Examples

A Stock Option gives you the right to purchase "In-the-Money" 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 for "free". Sometimes you call this 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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