

DIAMOND HILL INVESTMENT GROUP INC

Form 10-Q

October 28, 2011

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**United States Securities and Exchange Commission  
Washington, D.C. 20549  
Form 10-Q  
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended September 30, 2011  
Commission file number 000-24498  
DIAMOND HILL INVESTMENT GROUP, INC.  
(Exact name of registrant as specified in its charter)**

Ohio

65-0190407

(State of incorporation)

(I.R.S. Employer Identification No.)

325 John H. McConnell Blvd, Suite 200, Columbus, Ohio 43215

(Address, including Zip Code, of principal executive offices)

(614) 255-3333

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. Yes:  No:

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes:  No:

The number of shares outstanding of the issuer's common stock, as of October 26, 2011, is 2,996,287 shares.

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**Table of Contents****PART I: FINANCIAL INFORMATION****ITEM 1: Consolidated Financial Statements****Diamond Hill Investment Group, Inc.****Consolidated Balance Sheets**

	9/30/2011 (Unaudited)	12/31/2010
<b>ASSETS</b>		
Cash and cash equivalents	\$ 22,920,367	\$ 5,775,526
Investment portfolio	9,252,870	11,527,060
Accounts receivable	8,608,934	8,695,103
Prepaid expenses	895,960	787,033
Furniture and equipment, net of depreciation, and other assets	887,451	907,670
Income tax receivable	301,007	
Deferred taxes	2,065,672	873,474
Total assets	\$ 44,932,261	\$ 28,565,866
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Liabilities		
Accounts payable and accrued expenses	\$ 3,580,615	\$ 4,101,079
Accrued incentive compensation	13,900,000	16,111,250
Income tax payable		855,285
Total liabilities	17,480,615	21,067,614
Commitments and contingencies		
Shareholders Equity		
Common stock, no par value 7,000,000 shares authorized; 2,995,235 issued and outstanding at September 30, 2011; 2,795,683 issued and outstanding at December 31, 2010	49,890,340	34,423,011
Preferred stock, undesignated, 1,000,000 shares authorized and unissued		
Deferred compensation	(12,551,515)	(7,137,729)
Retained earnings/(Accumulated deficit)	(9,887,179)	(19,787,030)
Total shareholders equity	27,451,646	7,498,252
Total liabilities and shareholders equity	\$ 44,932,261	\$ 28,565,866
Book value per share	\$ 9.17	\$ 2.68

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****Diamond Hill Investment Group, Inc.  
Consolidated Statements of Income (unaudited)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
<b>REVENUES:</b>				
Investment advisory	\$ 13,465,140	\$ 12,215,574	\$ 42,704,464	\$ 35,629,445
Mutual fund administration, net	1,904,733	1,827,426	5,942,680	5,558,699
Total revenue	15,369,873	14,043,000	48,647,144	41,188,144
<b>OPERATING EXPENSES:</b>				
Compensation and related costs	7,968,737	8,095,735	26,082,794	23,707,288
General and administrative	1,060,295	856,058	3,142,747	2,539,120
Sales and marketing	267,224	143,689	767,391	481,709
Third party distribution	180,226	238,890	661,208	756,546
Mutual fund administration	449,820	509,598	1,249,849	1,473,933
Total operating expenses	9,926,302	9,843,970	31,903,989	28,958,596
<b>NET OPERATING INCOME</b>	5,443,571	4,199,030	16,743,155	12,229,548
Investment return	(1,309,169)	1,169,916	(848,026)	231,130
<b>INCOME BEFORE TAXES</b>	4,134,402	5,368,946	15,895,129	12,460,678
Income tax provision	(1,595,174)	(1,930,540)	(5,995,278)	(4,522,093)
<b>NET INCOME</b>	\$ 2,539,228	\$ 3,438,406	\$ 9,899,851	\$ 7,938,585
Earnings per share				
Basic	\$ 0.84	\$ 1.24	\$ 3.37	\$ 2.88
Diluted	\$ 0.84	\$ 1.24	\$ 3.37	\$ 2.88
Weighted average shares outstanding				
Basic	3,005,504	2,779,345	2,937,403	2,757,539
Diluted	3,005,504	2,779,345	2,937,403	2,759,066

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****Diamond Hill Investment Group, Inc.  
Consolidated Statements of Cash Flows (unaudited)**

	Nine Months Ended September 30,	
	2011	2010
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net Income	\$ 9,899,851	\$ 7,938,585
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation on furniture and equipment	247,993	243,161
Stock-based compensation	3,086,851	1,947,623
(Increase) decrease in accounts receivable	86,169	1,827,304
Increase (decrease) in deferred income taxes	(1,203,598)	(449,201)
Investment gain/loss, net	866,697	706,745
Increase (decrease) in accrued liabilities	4,730,270	3,504,491
Other changes in assets and liabilities	(1,253,727)	(1,175,670)
Net cash provided by (used in) operating activities	16,460,506	14,543,038
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of furniture and equipment	(227,774)	(53,642)
Cost of investments purchased and other portfolio activity	(925,507)	(889,133)
Proceeds from sale of investments	2,333,000	3,050,000
Net cash provided by (used in) investing activities	1,179,719	2,107,225
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Payment for repurchase of common shares	(1,072,908)	
Payment of taxes withheld on employee stock transactions	(141,442)	(11,360)
Proceeds from common stock issuance	718,966	688,398
Net cash provided by (used in) financing activities	(495,384)	677,038
<b>CASH AND CASH EQUIVALENTS</b>		
Net change during the period	17,144,841	17,327,301
At beginning of period	5,775,526	11,513,194
At end of period	\$ 22,920,367	\$ 28,840,495
Supplemental cash flow information:		
Interest paid	\$	\$
Income taxes paid	8,343,676	6,088,700
Supplemental disclosure of non-cash transactions:		
Issuance of common stock as incentive compensation	7,461,984	5,003,146



Dividend Payable

36,263,591

The accompanying notes are an integral part of these consolidated financial statements.

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**Diamond Hill Investment Group, Inc.**

**Notes to Consolidated Financial Statements (unaudited)**

Note 1 **Business and Organization**

Diamond Hill Investment Group, Inc. (the Company) derives its consolidated revenues and net income primarily from investment advisory and fund administration services that it provides to individual and institutional investors. The Company has four operating subsidiaries.

Diamond Hill Capital Management, Inc. (DHCM), an Ohio corporation, is a wholly owned subsidiary of the Company and a registered investment adviser. DHCM is the investment adviser to the Diamond Hill Funds (the Funds), a series of open-end mutual funds, private investment funds (Private Funds), and also offers advisory services to institutional and individual investors.

Diamond Hill GP (Cayman) Ltd. (DHGP) was incorporated in the Cayman Islands as an exempted company on May 18, 2006 for the purpose of acting as the general partner of a Cayman Islands exempted limited partnership. This limited partnership acts as a master fund for Diamond Hill Offshore Ltd., a Cayman Islands exempted company; and Diamond Hill Investment Partners II, L.P., an Ohio limited partnership. DHGP has no operating activity.

Beacon Hill Fund Services, Inc. (BHFS), an Ohio corporation, is a wholly owned subsidiary of the Company incorporated on January 29, 2008. BHFS provides certain compliance, treasury, and fund administration services to mutual fund companies. BHIL Distributors, Inc. (BHIL), an Ohio corporation, is a wholly owned subsidiary of BHFS incorporated on February 19, 2008. BHIL provides underwriting and distribution services to mutual fund companies. BHFS and BHIL collectively operate as Beacon Hill.

Note 2 **Significant Accounting Policies**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses for the periods. Actual results could differ from those estimates. Certain prior period amounts and disclosures have been reclassified to conform to the current period financial presentation. Book value per share is computed by dividing total shareholders' equity by the number of shares issued and outstanding at the end of the measurement period. The following is a summary of the Company's significant accounting policies:

**Principles of Consolidation**

The accompanying consolidated financial statements include the operations of the Company and its subsidiaries. All material inter-company transactions and balances have been eliminated in consolidation.

**Segment Information**

Management has determined that the Company operates in one business segment, namely providing investment management and administration services to mutual funds, separate accounts, and private investment funds. Therefore, no disclosures relating to operating segments are required in annual or interim financial statements.

**Cash and Cash Equivalents**

Cash and cash equivalents include demand deposits and money market funds.

**Table of Contents**Note 2 Significant Accounting Policies (Continued)Accounts Receivable

Accounts receivable are recorded when they are due and are presented in the balance sheet, net of any allowance for doubtful accounts. Accounts receivable are written off when they are determined to be uncollectible. Any allowance for doubtful accounts is estimated based on the Company's historical losses, existing conditions in the industry, and the financial stability of those individuals or entities that owe the receivable. No allowance for doubtful accounts was deemed necessary at September 30, 2011 or December 31, 2010.

Valuation of Investment Portfolio

Investments held by the Company are valued based upon the definition of Level 1 inputs and Level 2 inputs. Level 1 inputs are defined as fair values which use quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. Level 2 inputs are defined as quoted prices in markets that are not considered to be active for identical assets or liabilities, quoted prices in active markets for similar assets or liabilities and inputs other than quoted prices that are directly observable or indirectly through corroboration with observable market data. The following table summarizes the Company's investments valued based upon Level 1 and Level 2 inputs as of September 30, 2011 and December 31, 2010:

	September 30, 2011	December 31, 2010
Level 1 Inputs	\$ 1,137,421	\$ 1,265,998
Level 2 Inputs	8,115,449	10,261,062

Level 1 investments are all registered investment companies (mutual funds). Level 2 investments are all limited partnerships. There were no transfers in or out of the levels.

The changes in market values on the investments are recorded in the Consolidated Statements of Income as investment return.

Limited Partnership Interests

DHCM is the managing member of Diamond Hill General Partner, LLC, the General Partner of Diamond Hill Investment Partners, LP ( DHIP ), Diamond Hill Investment Partners II, LP ( DHIP II ), Diamond Hill Research Partners, LP ( DHRP ), and Diamond Hill Research Partners International, LP ( DHRPI ) collectively (the Partnerships) each a limited partnership whose underlying assets consist of marketable securities.

DHCM, in its role as managing member of the General Partner, has the power to direct the Partnerships' economic activities and the right to receive investment advisory and performance incentive fees that are significant to the Partnerships. The Partnerships are subject to investment company accounting and, as a result, they have not been consolidated in presenting the accompanying financial statements. DHCM's investments in these partnerships are reported as a component of the Company's investment portfolio, valued at DHCM's proportionate interest in the net asset value of the marketable securities held by the Partnerships. Gains and losses attributable to changes in the value of DHCM's interests in the Partnerships are included in the Company's reported investment return.

The Company's exposure to loss as a result of its involvement with the Partnerships is limited to the amount of its investments. DHCM is not obligated to provide financial or other support to the Partnerships, other than its investments to date and its contractually provided investment advisory responsibilities, and has not provided such support. The Company has not provided liquidity arrangements, guarantees or other commitments to support the Partnerships' operations, and the Partnerships' creditors and interest holders have no recourse to the general credit of the Company.

**Table of Contents**Note 2 **Significant Accounting Policies (Continued)****Limited Partnership Interests (Continued)**

Several board members, officers and employees of the Company invest in the Partnerships through Diamond Hill General Partner, LLC. These individuals receive no remuneration as a result of their personal investment in the Partnerships. The capital of Diamond Hill General Partner, LLC is not subject to a management fee or an incentive fee.

**Furniture and Equipment**

Furniture and equipment, consisting of computer equipment, furniture, and fixtures, are carried at cost less accumulated depreciation. Depreciation is calculated using the straight-line method over estimated lives of three to seven years.

**Revenue Recognition General**

The Company earns substantially all of its revenue from investment advisory, distribution, and fund administration services. Mutual fund investment advisory and administration fees, generally calculated as a percentage of assets under management, are recorded as revenue as services are performed. Managed account and private investment fund clients provide for monthly or quarterly management fees, in addition to quarterly or annual performance fees.

**Revenue Recognition Performance Incentive Revenue**

The Company's private investment funds and certain managed accounts provide for performance incentive fees. For management fees based on a formula, there are two methods by which incentive revenue may be recorded. Under Method 1, incentive fees are recorded at the end of the contract period; under Method 2, the incentive fees are recorded periodically and calculated as the amount that would be due under the formula at any point in time as if the contract was terminated at that date. Management has chosen Method 1, in which incentive fees are recorded at the end of the contract period for the specific client in which the incentive fee applies. The table below shows assets under management (AUM) subject to performance incentive fees and the performance incentive fees, as calculated under each of the above methods:

		As Of September 30,			
		2011		2010	
AUM	Contractual Period Ends Quarterly	\$	82,972,698	\$	105,112,498
AUM	Contractual Period Ends Annually		83,941,115		164,760,591
Total AUM Subject to Performance Incentive		\$	166,913,813	\$	269,873,089
		For The Three Months Ending Sept. 30,		For The Nine Months Ending Sept. 30,	
		2011		2010	
Performance Incentive Fees	Method 1	\$	3,934	\$	1,245
Performance Incentive Fees	Method 2	\$	37,823	\$	37,823

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## Note 2 Significant Accounting Policies (Continued)

Revenue Recognition – Mutual Fund Administration

DHCM has an administrative and transfer agency services agreement with the Funds, under which DHCM performs certain services for each fund. These services include mutual fund administration, transfer agency and other related functions. For performing these services, each fund compensates DHCM a fee, which is calculated using the following annual rates times the average daily net assets of each respective series and share class:

	Prior to February 28, 2011	After February 28, 2011
Class A and Class C	0.30%	0.26%
Class I	0.19%	0.24%

The Funds have selected and contractually engaged certain vendors to fulfill various services to benefit the Funds shareholders or to satisfy regulatory requirements of the Funds. These services include, among others, required fund shareholder mailings, federal and state registrations, and legal and audit services. DHCM, in fulfilling a portion of its role under the administration agreement with the Funds, acts as agent to pay these obligations of the Funds. Each vendor is independently responsible for fulfillment of the services it has been engaged to provide and negotiates fees and terms with the management and board of trustees of the Funds. The fee that the Funds pay to DHCM is reviewed annually by the Funds' board of trustees and specifically takes into account the contractual expenses that DHCM pays on behalf of the Funds. As a result, DHCM is not involved in the delivery or pricing of these services and bears no risk related to these services. Revenue has been recorded net of these Fund related expenses, in accordance with the appropriate accounting treatment for this agency relationship. In addition, DHCM finances the upfront commissions which are paid by the Fund's principal underwriter to brokers who sell Class C shares of the Funds. As financier, DHCM advances to the underwriter the commission amount to be paid to the selling broker at the time of sale. These advances are capitalized and amortized over 12 months to correspond with the repayments DHCM receives from the principal underwriter to recoup this commission advancement.

Beacon Hill has underwriting and administrative service agreements with certain clients, including registered mutual funds. The fee arrangements vary from client to client based upon services provided and are recorded as revenue under Mutual Fund Administration on the Consolidated Statements of Income. Part of Beacon Hill's role as underwriter is to act as an agent on behalf of its mutual fund clients to receive 12b-1/service fees and commission revenue and facilitate the payment of those fees and commissions to third parties who provide services to the funds and their shareholders. The amount of 12b-1/service fees and commissions are determined by each mutual fund client and Beacon Hill bears no financial risk related to these services. As a result, 12b-1/service fees and commission revenue has been recorded net of the expense payments to third parties, in accordance with the appropriate accounting treatment for this agency relationship.

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## Note 2 Significant Accounting Policies (Continued)

Revenue Recognition – Mutual Fund Administration (Continued)

Mutual fund administration gross and net revenue are summarized below:

	Three Months Ended Sept. 30, 2011	Sept. 30, 2010	Nine Months Ended Sept. 30, 2011	Sept. 30, 2010
Mutual fund administration:				
Administration revenue, gross	\$ 2,829,944	\$ 2,618,017	\$ 8,802,865	\$ 8,180,583
12b-1/service fees and commission revenue received from fund clients	1,663,549	1,903,486	5,437,354	6,223,147
12b-1/service fees and commission expense payments to third parties	(1,663,549)	(1,903,486)	(5,437,354)	(6,223,147)
Fund related expense	(934,701)	(824,032)	(2,892,596)	(2,700,106)
Revenue, net of fund related expenses	1,895,243	1,793,985	5,910,269	5,480,477
DHCM C-Share financing:				
Broker commission advance repayments	79,780	179,531	286,890	500,895
Broker commission amortization	(70,290)	(146,090)	(254,479)	(422,673)
Financing activity, net	9,490	33,441	32,411	78,222
Mutual fund administration revenue, net	\$ 1,904,733	\$ 1,827,426	\$ 5,942,680	\$ 5,558,699

Third Party Distribution Expense

Third party distribution expenses are earned by various third party financial services firms based on sales and/or assets of the Company's investment products generated by the respective firms. Expenses recognized represent actual payments made to the third party firms and are recorded in the period earned based on the terms of the various contracts.

Income Taxes

The Company accounts for income taxes through an asset and liability approach. A net deferred tax asset or liability is determined based on the tax effects of the various temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

The Company has analyzed its tax positions taken on federal income tax returns for all open tax years (tax years ended December 31, 2007 through 2010) to determine any uncertainty in income taxes and has recognized no adjustment in the net asset or liability.

Earnings Per Share

Basic earnings per share (EPS) excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution of EPS that could occur if outstanding warrants were exercised. At September 30, 2011, there were no warrants outstanding.

**Table of Contents****Note 3 Investment Portfolio**

As of September 30, 2011, the Company held investments worth \$9.3 million and an estimated cost basis of \$7.2 million. The following table summarizes the market value of these investments as of September 30, 2011 and December 31, 2010:

	September 30, 2011	December 31, 2010
Diamond Hill Small Cap Fund	\$ 178,318	\$ 211,301
Diamond Hill Small-Mid Cap Fund	186,982	217,915
Diamond Hill Large Cap Fund	189,684	210,413
Diamond Hill Select Fund	195,080	221,491
Diamond Hill Long-Short Fund	193,370	206,312
Diamond Hill Strategic Income Fund	193,987	198,566
Diamond Hill Investment Partners, L.P.	970,612	1,177,098
Diamond Hill Investment Partners II, L.P.	947,772	1,155,022
Diamond Hill Research Partners, L.P.	5,291,354	7,928,942
Diamond Hill Research Partners International, L.P.	905,711	
<b>Total Investment Portfolio</b>	<b>\$ 9,252,870</b>	<b>\$ 11,527,060</b>

DHCM is the managing member of the Diamond Hill General Partner LLC, which is the General Partner of the Partnerships. The underlying assets of the Partnerships are cash and marketable equity securities. Summary financial information, including the Company's carrying value and income from the Partnerships is as follows:

	September 30, 2011	As of December 31, 2010
Total partnership assets	\$ 124,827,628	\$ 173,007,238
Total partnership liabilities	22,556,955	32,855,190
Net partnership assets	\$ 102,270,673	\$ 140,152,048
DHCM's portion of net assets	\$ 8,115,449	\$ 10,261,062

	For the Nine Months Ended September 30, 2011	For the Year Ended December 31, 2010
Net partnership income	\$ (21,107,125)	\$ 4,486,719
DHCM's portion of net income	\$ (737,615)	\$ 939,265

DHCM's income from the Partnerships includes its pro-rata capital allocation and its share of an incentive allocation, if any, from the limited partners.

**Note 4 Capital Stock****Common Shares**

The Company has only one class of securities, Common Shares.

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Note 4 Capital Stock (Continued)

Authorization of Preferred Shares

The Company's Articles of Incorporation authorize the issuance of 1,000,000 shares of blank check preferred shares with such designations, rights and preferences, as may be determined from time to time by the Company's Board of Directors. The Board of Directors is authorized, without shareholder approval, to issue preferred stock with dividend, liquidation, conversion, voting, or other rights, which could adversely affect the voting or other rights of the holders of the Common Shares. There were no shares of preferred stock issued or outstanding at September 30, 2011 or December 31, 2010.

Note 5 Stock-Based Compensation

Equity Incentive Plans

*2011 Equity and Cash Incentive Plan*

At the Company's annual shareholder meeting on April 26, 2011, shareholders approved the 2011 Equity and Cash Incentive Plan ( 2011 Plan ). The 2011 Plan is intended to facilitate the Company's ability to attract and retain staff, provide additional incentive to employees, directors and consultants, and promote the success of the Company's business. The 2011 Plan authorizes the issuance of 600,000 Common Shares of the Company in various forms of equity awards. As of September 30, 2011, there were 494,625 Common Shares available for issuance under the 2011 Plan. The 2011 Plan provides that the Board of Directors, or a committee appointed by the Board, may grant awards and otherwise administer the 2011 Plan. Restricted stock grants issued under the 2011 Plan, which vest over time, are recorded as deferred compensation in the equity section of the balance sheet on the grant date and then recognized as compensation expense based on the grant date price over the vesting period of the respective grant.

*2005 Employee and Director Equity Incentive Plan*

At the Company's annual shareholder meeting on May 12, 2005, shareholders approved the 2005 Employee and Director Equity Incentive Plan ( 2005 Plan ). With the approval of the 2011 Plan, there are no longer any Common Shares available for future issuance under the 2005 Plan. Outstanding grants under the 2005 Plan are unaffected and remain issued and outstanding. Restricted stock grants issued under the 2005 Plan, which vest over time, are recorded as deferred compensation in the equity section of the balance sheet on the grant date and then recognized as compensation expense based on the grant date price over the vesting period of the respective grant.

*Restricted Stock Grant Transactions*

The following table represents a roll-forward of outstanding restricted stock grants issued pursuant to the 2011 and 2005 Plans and r