Long Term Incentive Plan

Overview

This, the fourth in a series will address the elements of a long-term incentive plan. Over the past few years the predominant reward vehicle for long-term performance was the stock option. With the Financial Accounting Standards Board (FASB) requiring that stock options be shown as an expense, the playing field is changing. What I hope to do in this article is to discuss some of the alternative vehicles, including the pros and cons of each.

Compensation is not only a major expense; it is the best tool companies have to focus the employee's behavior or performance. For that reason compensation strategy must be strongly and irrevocably tied to the overall business strategy's short and longer-term objectives.

In order to achieve the desired mix of compensation elements, the Company should set annual as well as long-term goals, and incorporate them into the compensation plan's company performance measures, individual/team measures, and competitive benchmarks

- Measures used to fund and allocate payments under the annual incentive plan support short-term business results
- Measures tied to overall Company or Business Unit success and shareholder value drive the long-term plan.

As we discussed in the last issue, a company should select short-term performance measures for the annual incentive plan, however, it should also tie into the long-term strategy. The expected performance levels of the short-term measures should be consistent with the annual portion of the long-term plan.

Long-term incentives (LTI) link financial rewards to the Company's longer-term performance. Over the past number of years most companies use the stock option (either non-qualified stock options or Incentive Stock Options) as rewards that reflected long term performance.

Recent public scandals have resulted in increased scrutiny of executive compensation, which has led to the requirement that options be expensed on the financial statements. This has removed the advantages of using stock options as a reward for long-term performance. It has also put the other reward vehicles on an equal footing in rewarding employees for long-term company performance. A long-term incentive plan is necessary to maintain an appropriate mix of short and long-term incentives.

In addition to cash payments companies are now adding other reward vehicles that for long-term performance that include the following among others. I also included non-qualified stock options and Incentive Stock options in order to compare the full menu of long-term incentive awards.

1. **Non-Qualified Stock Options (NQSO):** The right to purchase shares of stock during a defined period of time at a price that is typically specified in the option. This price is

normally the fair market value on the date of grant. Options usually cannot be exercised immediately when they are granted but on a later specified date. Typically the right to exercise the option or some part of the option is spread over some period of time. For example if an employee is given an option to purchase 5,000 shares of stock, they may vest over a five-year period of time. This means that at the end of each year the employee can purchase 1,000 shares of stock at the specified price, regardless of the market price on the date of purchase.

- Pro:
    - Align employees interest with shareholder interest
    - Company receives tax deduction
    - No limit on the amount that may be exercised
    - Offers potential for long-term tax deferred appreciation as company grows
    - Deliver competitive total compensation in order to recruit a qualified, diverse workforce
    - Serves as a retention tool
    - The Company gets cash upon exercise
- Con:
    - Investment is required on the part of the participant
    - Participant incurs tax liability at exercise
    - Dilutes EPS through common stock equivalents
    - Starting in 2005 the company is required to expense options, which will create reduced earnings
    - There is no benefit from dividends

2. **Incentive stock Options (ISO):** This is similar to the non-qualified option in that it is a right to purchase shares of stock during a defined period of time at a specified price. It has a number of other features as well. The tax effect of the exercise of the option can be different in that the executive can postpone the tax liability for the value derived from these options until the stock is sold, instead of incurring it when the option is exercised, and may take advantage of the more favorable treatment of long term capital gains tax instead of ordinary income tax. In order to use the long-term tax treatment, the employee is subject to certain restrictions. These restrictions include a minimum exercise price, limits on exercisability after termination of employment, the need to hold underlying shares for a minimum period after the option is exercised, and the employee must consider the benefits derived from the option in the calculation of their alternative minimum tax.
    - Pro:
        - Align employees interest with shareholder interest
        - Participant's tax liability is deferred until stock sold
        - Deliver competitive total compensation in order to recruit a qualified, diverse workforce
        - Long exercise period allows participant flexibility and can be retentive
        - Participant may defer taxes or may sell the stock earlier in a disqualifying disposition
    - Con:

- Company loses tax deduction
- Participant investment is required
- Spread at exercise is considered tax preference item for purposes of computing alternative minimum tax
- No benefit from dividends
- The rules of an ISO are confusing to the participant

3. **Restricted Stock:** An outright grant of shares to participants with restrictions as to sale, transfer and pledging. Participant receives dividends during restriction period. Restrictions lapse over a period of time. As the restrictions lapse, the participant has unrestricted shares which he or she may sell, transfer, or pledge. If participant terminates employment, all unvested shares are forfeited.
   - Pro:
     - No participant investment required
     - Promotes immediate stock ownership
     - Charge to earnings is fixed at time of grant
     - If stock appreciates, company's tax deduction exceeds fixed charge to earnings
     - Aligns participant's interest with shareholders
     - Vesting can be tied to performance
     - Serves as a retention tool (stronger retention than Options)
     - Offers participant potentially long-term appreciation as company grows
     - Participant gets benefit of dividends
   - Con:
     - Charge to earnings
     - Uses stock, so immediate dilution to EPS
     - Participant may incur tax liability before shares are sold
     - If stock depreciates, company's fixed-earnings charge exceeds tax deduction
     - May provide value to employee without a corresponding increase in stock value

4. **Phantom Stock:** Participants receive appreciation in market price, book value or formula value of a specified number of shares over a set period (3 – 10 Years). Value earned is dependent upon performance level achieved over same time frame. Reward can be paid in stock or cash.
   - Pro
     - Align participant interest with stockholders
     - Does not dilute stock ownership (when paid in cash)
     - No participant investment required
     - Company receives tax deduction
     - Can be retentive if values increase
   - Con
     - Unpredictable charge to earnings
     - May result in substantial cash outflow if paid in cash
     - Does not lead to direct stock ownership unless paid in stock
     - Less flexibility since valuation date is set in advance

5. **Performance Shares:** Participant receives contingent share units at the beginning of the performance period. At the end of the period, participant earns a portion or multiple of the contingent share units originally granted dependent upon the extent to which performance targets are met, payable in stock or cash.
   - Pro
     - No cash outlay.
     - Vesting can be tied to performance criteria.
     - Serves as a retention tool.
     - Can be aligned with shareholder interests.
     - Can typically grant restricted stock units with same intrinsic value as an option grant with fewer shares than under an option grant, causing less dilution.
     - Encourages employee ownership.
     - If award is forfeited, Company can reverse expense in current period.
   - Con
     - Uses stock.
     - Increases dilution.
     - Shares will need to be registered with the SEC and listed with NASDAQ.
     - Shareholder approval will be required under proposed NASDAQ rules.
     - Upon vesting and receipt of shares, taxes are due.
     - May provide value to employee without increase in stock price.
     - Variable accounting (quarterly profit & loss fluctuations and less predictability)

6. **Performance Units:** Contingent units are granted at the beginning of each performance period. These units have an absolute dollar value (i.e., $25 per unit). At the end of the period, the value of the unit earned will depend upon the extent to which performance targets are met. Payment is made in cash or stock contingent upon meeting stated performance targets over a specified period.
   - Pro
     - No participant investment required
     - Company receives tax deduction
     - Performance oriented
     - Potential maximum charge to earnings is fixed at grant
     - Participant's tax liability can be paid out of award
     - No dilution of shares outstanding unless paid in stock
   - Con
     - Charge to earnings
     - Difficulty in setting performance targets

7. **Stock Appreciation Rights (SAR):** SAR units are granted with a specific base price, typically fair market value (FMV) on grant date. Upon completion of time and/or performance-based vesting restrictions, the holder is entitled to the spread between the FMV of the stock price and the base price. Payment can be made in cash. stock, or combination.
   - **Pro**

    - Vesting can be tied to performance criteria.
    - Serves as a retention tool.
    - Aligned with shareholder interests. (Unlike restricted stock, there is only value if the stock price increases after the grant date).
    - It provides for cash payout, no stock will be issued upon exercise, no registration is required, the award will not result in stockholder dilution, and no stockholder approval of a plan is required unless company would like award to qualify as "performance-based compensation" under the Internal Revenue Tax Code Section 162(m).
- Con
    - Uses stock
    - Increases dilution.
    - Shares will need to be registered with the SEC and listed with NASDAQ.
    - Shareholder approval will be required under proposed NASDAQ rules.
    - Upon vesting and receipt of shares, taxes are due.
    - May provide value to employee without increase in stock price.
    - If time-vested or TARSAP, does not qualify as "performance- based compensation" for 162m purposes.
    - If only performance-based, then variable accounting (quarterly Profit & Loss fluctuations and less predictability).

Once the vehicle is selected there are a number of other issues that must be resolved. The following are some of those items:

Plan design:

1. **Develop and set performance metrics:** The performance metric that will focus the behavior of the participants on the company strategy that is desired should be selected. There are many and will vary by industry, the performance desired and may vary by the performance period.
    a. **Potential Key Metrics**:
        i. Maintenance or increase in Market Share
        ii. Operating profit vs. Industry competitors
        iii. Share price growth
        iv. Earnings Per Share
        v. Return on Equity
        vi. Earnings before interest, taxes, depreciation, and amortization (EBITDA)
        vii. 3 year compound growth in any of the above financial metrics
        viii. Return on Invested Capital
        ix. Etc.

2. **Set the level of expected or target performance for the metric chosen.**
    a. Should it be at the business plan?
    b. Should it be above or below the business plan?
3. **Set the level of target payout**

a. What is the payout target if expected performance level is achieved?
b. What is the upside and downside if the target performance is not met or if it is exceeded? For example, is the payout greater for an equal increase in performance above the target performance that it is below the target?

4. **What is the threshold performance**
   a. What is the minimum level of performance that must be achieved before making any incentive payment?
   b. If targets are not met at a minimum or threshold level, the units are forfeited or the cash is not paid.
5. **Who are the participation**
   a. Officers
   b. Other Key Employees
6. **What is the performance Period**
   a. Most companies will have a three-year plan. This may include overlapping performance periods. In order to do this a new three-year performance period is started each year with different performance levels.
7. **Form of Award**
   a. Cash, stock, or combination

When the issues are decided and plan participation agreed to, a good communications plan must be developed. Each participant must understand their role in the performance necessary to hit the target performance and what their reward will be if the target is achieved. Without this understanding the motivation is lost.

In summary, a long-term incentive plan has primarily two objectives: one, to focus the work behavior of the covered employees on the performance that is desired. Two, is to assist in the retention of executives and other key employees.