

White Paper

Long-Term Incentives

By Rodney K.. Platt, WorldatWork
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Long-term incentives (LTIs) are an essential part of an organization's total rewards package that, if implemented correctly, can promote ownership and higher performance and ultimately higher shareholder return.

One definition of a long-term incentive plan is as follows: "Any incentive plan (usually limited to executives) that requires sustained performance of the firm for a period longer than one fiscal year for maximum benefit to the employee. Some plans are based on capital shares of the organization and may require investment by the employee, while others are based on financial performance."

Most HR professionals agree that there are five elements of total compensation: Salary, employee benefits, short-term incentives, long-term incentives and perquisites. Each element can be viewed in degree of importance versus the market lifecycle for a particular organization. When describing an industry, company or product, there are four stages in the market lifecycle: Threshold, growth, maturity and decline. The latter stage ends either in a turnaround, a buyout or going out of business.

Long-term incentives are of "high" importance during the developmental and growth phases, the former because of cash scarcity and the latter because of the need to establish strong, long-term market positions.

For most of its history, long-term incentives have long been a central feature of executive compensation programs. John D. Rockefeller's Standard Oil Trust and General Motors employed equity incentives back in the 1920s.

Stock options are the most popular form of long-term incentive. Stock compensation provides a strong link between compensation opportunities and shareholder value creation and has evolved into one of the most important elements in executive compensation pay packages. It represents not only the potential for significant financial reward, but also a powerful incentive for enhanced performance.

The advantages of stock options are well known:

- Direct alignment between compensation and shareholder gains
- An opportunity for the optionee to receive tax-advantaged appreciation with no up front capital commitment

- Simplicity
- Cash flow advantages for the company
- No charge to earnings for compensation expense for the majority of companies that use accounting treatment APB 25, although more stringent disclosure requirements are now required in financial statements.

A vast majority of the long-term incentive opportunities are provided to senior and middle management. LTIs are the single largest component in the total compensation package for senior management.

Retention is among the principal objectives of LTIs and is often cited as a key reason for granting stock options. The large increase in underwater stock options (i.e., options with strike prices greater than the current market price of the stock) across a variety of industries shows the fragility of the retention incentive offered by stock options.

With the renewed interest in making the adoption of FAS 123 a requirement, combined with the recent turbulence in the stock market and the general sluggishness in the economy, the debate has resurfaced over whether stock options are the optimal long-term incentive vehicle. Many employers are of the opinion that stock options granted at fair market value are losing their charm as effective tools for attracting, retaining and motivating employees.

Option Alternatives

Besides stock options, there are a variety of alternative long-term incentive vehicles that can augment stock option programs. These include:

- Restricted stock
- Discounted stock options
- Performance shares
- Cash-based long-term incentives based on operating performance.

Restricted Stock

Restricted stock is an outright reward of a company's common stock by an employer to an employee that has some strings – or restrictions – attached. Restrictions may include an employment or length-of-service restriction with vesting over a specified period (typically three to five years). An employee may not sell or transfer the shares until the restrictions lapse, i.e., working for a certain number of years or until specified corporate or individual performance goals have been met. The employee, however, also is typically granted voting rights and dividends during the restricted period, thus aligning him or her closely with the shareholders. Once the stated restrictions are lifted, the employee obtains full ownership of the unrestricted shares that may be sold or transferred. If the employee doesn't meet the requirements for restrictions to lapse, the shares are forfeited.

Restricted stock earned a reputation as a giveaway incentive during the late 1980s, arguably because of some high-profile grants made to CEOs during that period. When used appropriately, restricted stock continues to be a very useful long-term incentive tool. It offers a far more efficient and enduring retentive incentive than stock options, even in down markets, because recipients tend to value restricted stock much more closely to its “expected value” than they do stock options. With most restricted stock having time-based vesting, companies also benefit from restricted stock’s tax efficiency. The value of the shares at grant is recognized as an accounting expense, while the full value of the award when vested (presumably greater than the grant value) is deductible for corporate income tax purposes.

However, restricted stock results in an accounting charge as well as contributes to shareholder dilution. It also provides weaker performance leverage compared to stock options. Further, restricted stock does not afford the same tax advantages to recipients as stock options – specifically, the ability to defer taxes until exercise date.

Discounted Stock Options

These are stock options granted at an exercise period less than 100 percent of fair market value on date of grant. For some reason, companies view at-the-money options and restricted stock as acceptable forms of long-term incentive, but view the hybrid, discounted stock option as an anathema. However, this form of long-term incentive combines some of the benefits of both stock options and restricted stock as follows:

- A far more durable retention incentive than an at-the-money or premium priced stock option (depending on the amount of the discount)
- Both tangible value to the employee (in the form of the spread at grant) as well as a leveraged upside relative to restricted stock
- Tax advantages of conventional stock options
- Accounting expense limited to the value of the spread at grant.

Discounted options represent an efficient way to strike a balance between the leverage and performance incentive of a conventional stock option and the retention incentive of restricted stock. However, discounted stock options still can dilute shareholders’ interests, and they don’t fully protect holders from future price fluctuations. Finally, as noted above, institutional investors have, in the past, expressed opposition to granting discounted options.

Performance Shares

The definition of performance shares is grants of actual shares of stock or stock units whose payment is contingent on performance as measured against predetermined objectives over a multi-year period ("cycle"); the value ultimately delivered to the participant is a function of performance against objectives and stock price performance during the cycle. These are shares or share equivalents

granted contingent upon the attainment of operating performance objectives and continued to be utilized frequently in long-term incentive plans. While performance shares introduce an element of operating performance that increases line of sight relative to stock options, the performance conditions in most plans are based on corporate measures, mitigating the benefits of this alternative for business unit participants. In addition, the use of performance criteria introduces issues related to how targets and thresholds are set – typically the weakest link in performance share plans. Companies can strengthen performance share plans in two ways:

- Introduce business unit performance measures for business unit participants (and still retain a corporate focus through the use of a corporate security)
- Set targets and thresholds objectively, by linking operating performance targets to investor expectations for value creation and by testing performance thresholds and sensitivities relative to historical volatility.

The biggest difficulty with performance shares is setting and sticking with goals over the multi-year performance period. This is an aspect of performance shares that will require more attention from compensation professionals and board compensation committees than current long-term incentive alternatives have required. The additional challenge presented by the goal-setting process will diminish as more companies get experience with the process. Starting with a rather broad bandwidth around target goals allows flexibility in goal measurement and minimizes the risk of extreme windfalls or penalties.

Cash/Operating Performance Plans

The long-term incentive plan that is perhaps most different from most corporate stock options are cash/operating performance plans. These plans provide cash payments based on the operating performance of a company or business unit over a multiyear period, and take the form of long-term performance cash plans and phantom stock plans. Operating performance plans are increasingly used at the business unit level to provide more targeted incentives and stronger line of sight. Such plans are less prevalent at the corporate level, but are being used selectively, either by companies with severe dilution constraints, or those with a desire to focus certain executives on operating performance, or both.

Effective cash/operating performance plans typically incorporate performance measures that capture value creation by recognizing both profitability and capital efficiency. Measures such as total business return and economic profit improvement are some examples that provide explicit incentives to maximize shareholder value, at the business unit or corporate level.

Cash/operating performance plans may have many of the same weaknesses as performance share plans (e.g., accounting expense, investor perceptions of performance targets and thresholds). While these plans, with cash-denominated

awards, do not affect voting or earning dilution, they have the weakness of being further-removed from stock price performance than other alternatives.

Participation Criteria

Companies typically use base salary level, position title and/or management discretion as criteria for participation in long-term incentive and stock compensation plans. Eligibility for stock option participation now typically extends to the manager and senior-salaried levels.

Today's Challenges

Major issues challenge stock compensation professionals today. With heightened scrutiny from regulators and economic pressures persisting into the foreseeable future, the spotlight is on CEOs, board compensation committees and compensation professionals to get it right.

Reviewing all pay programs to strengthen their retention capabilities is time well invested. Equally important is examining the overall volatility of your rewards strategy.

Create an ownership culture. Stock compensation is not enough to change behavior and drive performance. It needs to exist in an ownership culture. Several factors foster ownership. Financial ownership through incentives tied to organizational performance through real or simulated equity ownership is the basis of an ownership culture. Other contributors include establishing a clear connection between work and business strategy, employee involvement in strategic and operational decisions, performance feedback and career management.

Test the appropriateness of stock grants under various growth scenarios. Frequently, companies stop the grant-setting process once an option-pricing model yields the number of shares an executive will get. It has become necessary to reconcile the relationship between the size of grants and the corresponding compensation delivered with meaningful return to shareholders.

Communicate the value of stock compensation. Once companies determine appropriate grant levels in line with meaningful shareholder expectations, they need to communicate how stock compensation fits into the total pay and benefits picture. By communicating the value of stock compensation along with salary, target bonus levels, core benefits and retirement income, companies will create a more complete and better-understood program, and a powerful motivational tool.

Consider using relative performance measures to balance long-term incentive opportunities. A performance-based long-term incentive plan can help reduce the volatility of an overall pay program. A long-term performance plan using relative performance measures (i.e., performance vs. peers) in combination with incentives, such as stock options, restricted stock and annual incentives, can

focus management on the kind of performance that drives shareholder value long term. It also can be a powerful retention tool in a volatile market, since it rewards participants when the stock price is low but the company is outperforming its peers. However, the option component of long-term incentives should significantly outweigh other long-term opportunities.

Manage share dilution as both a key resource and critical constraint. Stock compensation is a powerful tool in rewarding and aligning management efforts. But market volatility has led to stagnant or declining stock prices. As companies increase share use to stay competitive, there is the potential for runaway dilution. For companies with underwater options, reigning in dilution may be even more complicated. Actions limiting dilution growth can include blending options with other long-term incentives, such as restricted stock, performance shares or long-term cash, reconsidered use of broad-based options, and shorter option terms.

Take a Fresh Look

Stock market volatility, changes in performance results and competitor practices have created the need for many companies to reassess their compensation strategies. Some programs simply need fine-tuning to preserve their pay-for-performance sensitivity; others may need a more complete overhauling. In either case, the aim should be to achieve balance and focus – balancing the need to improve current business performance with the need to create market confidence in the future, and focusing employee behaviors on actions that drive value.

Many companies have begun to re-examine their long-term incentive plans with an eye toward augmenting, and in some cases replacing, stock options with other long-term incentive vehicles, such as restricted stock, discounted stock, performance shares and cash/operating performance plans.

The Microsoft Effect

In July 2003, Microsoft announced that it would stop granting stock options and voluntarily adopted FAS 123, which raised a range of issues about equity restructuring that many companies should consider examining. It also struck another blow to the stock option's arguable position as king of equity compensation. At the same time, the company announced it would voluntarily adopt Financial Accounting Statement (FAS) No. 123 accounting treatment for its stock compensation awards, using the retroactive restatement transition method.

These decisions neither force companies to abandon stock options nor compel them to adopt FAS 123. But the decisions do provide a powerful reminder that stock compensation is changing drastically and quickly.

Microsoft's announcements raise a range of issues about equity restructuring that many companies should consider examining. Among these are the form of long-term incentive grants, grant expensing policies and the overall structure of annual and long-term incentive pay at the senior-management level.

Form of Long-term Incentive Grants

Microsoft will base future grants upon whole shares of company stock (mainly stock units). A whole-share stake conveys the concept of full economic "ownership" more effectively than the fractional claim created by an option grant. This may encourage decision-makers to assess business risks in a more balanced way. It also may address stability concerns within the pay structure.

Many option plans ran into trouble when the 1990s' bull market ended. Shares, share units and, for that matter, performance shares and discounted stock options, can be used to create award leverage and an effective stake that endures through the more typical range of ups and downs in business circumstance. This can help with executive retention and avoid the frustration that mounts when option grants go underwater.

Microsoft indicated that its top 600 executives would earn at least some shares based upon attaining certain business goals. If the new long-term incentive structure is substantially based upon clear, rigorous and complete goals, Microsoft will have more effective long-term incentives tied to specific results. Previous to the new plan, long-term incentives consisted mainly of time-vesting stock or stock unit grants whereas executives routinely could earn valuable awards for substandard results.

Microsoft has said it will track the number and satisfaction of Microsoft customers as part of its basis for issuing share grants. These are important indicators, to be sure, and it might behoove you to see if similar customer service measures could be incorporated into your company's long-term incentive plan(s).

Microsoft CEO Steve Ballmer cited potential effects of the new policy on a range of matters, including dividend policy. Regardless of whether all future grants at Microsoft are structured to include dividends, Ballmer raises an important question. Incentives can bias such financing decisions at companies in many ways, and the new U.S. rules equating low tax rates on capital gains and dividend income (encouraging capital formation and mobility) highlight one of the ways. The gain-only structure of stock options hampers those companies wanting to make greater taxable distributions as an alternative to share repurchases or debt pay-down.

Incentive Restructuring

Microsoft's actions may have accomplished the company's objectives fully. Many companies may benefit from not only rebalancing their stock-based pay, but also restructuring their incentives more generally in any of several ways.

Making Better Use of 'Operating' Incentive Plans

Basing incentive pay – particularly long-term incentives – more heavily on the business results that drive the stock price (separate from the uncontrollable part

of stock movement) improves the sense of influence and degree of line-of-sight in the incentive structure. This makes incentive pay much more compelling and effective as a performance device. The best way incentives can align the interests of executives with those of shareholders is the proactive way – actively encouraging better business results – rather than simply connecting them to pay after the fact.

Improving Efficacy of Annual Incentive Plans

Most long-term incentive plan participants don't have much impact on the stock price, so stock or options by themselves aren't really a performance "incentive" in a direct sense. Annual incentive plans do link rewards with financial results that senior management can affect, so these plans should be seen as the working end of the typical company's incentive structure.

The short-term nature of annual incentive plans, combined with the fact that their terms and targets may be re-negotiated, means that they create no real stake in the longer-term financial results that are critical to shareholder value creation. Often, they actually reward what can be poor business decisions, create a destructive preoccupation with the short-term, and encourage executives to manage expectations and results into a modest, narrow range each year. With more stable and complete methods for measurement and target setting, these plans can make a much greater contribution to long-term success and value creation.

Creating a Real Stake in Long-term Results of Business Units

The bulk of the value of corporations, and many of the business decisions they might hope to improve with incentive plans, are found in business units, such as groups, divisions, profit centers and joint ventures. Most of these are separate enough to warrant having incentive pay based upon their results. Indeed, most companies base at least a portion of the bonus plan upon business unit results now. But, the financial stakes typically based on business unit success need to be concentrated and made longer-term in nature.

Well-designed performance share, stock unit and performance unit plans, for example, can be useful in creating a strong incentive to improve long-term performance. Better methods exist for target setting and measurement than the negotiated, incomplete procedures in place at many companies now.

Companies should look at their overall incentive structures now as part of the changes they are considering in response to the new option accounting rules and other forces. The stakes are high, and typical problems with company incentive plans can contribute to short-term bias, excessive risk aversion, sandbagging and income management. Problems in plan design can discourage many good business decisions and reward many bad ones. Incentive structures typically attach weak accountability for capital usage and long-term results, so they often have a hand in encouraging the low-yielding business acquisitions, investments

and initiatives that really destroy long-term shareholder wealth. They can encourage high debt levels, discourage dividends and otherwise bias company decisions about capital structure.

Stock options don't actively discourage these things, any more than they specifically encourage business decisions that create value. Market stock valuation is efficient in the long run, but also is uncertain, unclear and mostly unrelated to business results during the time frame over which most incentive awards vest or pay out.

Making a Commitment

A long-term commitment to stock-based pay can be very helpful to a company's overall structure of rewards and the messages it is meant to convey. But options and stock by themselves do not provide clarity or directive power at levels connoted by the term "incentive," particularly for grant recipients outside of the top few officers. It is the "performance" part of a performance share plan, for example, that holds greater promise to improve company results.

Companies should evaluate the specific benefits of each element of the incentive mix. However, a typical company should not shift its mix from stock option grants to other types of incentives without first remedying the problems that beset measurement and target setting in such plans. The biggest part of the executive incentive structure is in its long-term incentive elements rather than the bonus plan. If an all-option company changed over to performance shares, as some are considering doing, it would quickly triple or quadruple that part of senior management's incentive pay that depends upon formal performance goals and ranges. Any problems with incentive plan terms would then become all the more troublesome. Arguing for less ambitious goals, for example, could become a much more rewarding tactic. So could the many types of acquisitions that increase revenue and income while destroying value.

Microsoft's strategic business decision does not create a generalized road map for redesign, but it does expose many of the relevant themes driving change in the incentive arena. Most companies soon will amend their incentive structures, changing how they use incentives in response to factors like those affecting Microsoft – and they would be smart to take this opportunity to revamp the overall structure of executive incentives so that it consistently encourages the best business results.

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