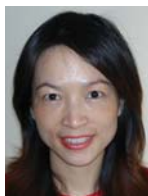


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The Changing Requirements for Equity Compensation



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Together with other accounting and tax rules and standards, the American Jobs Creation Act (AJCA) of 2004 and the Sarbanes-Oxley Act 2002, FAS123(R) ushered in a new era for equity compensation by invoking radical changes in equity-based compensation among employers. As a result, both public and nonpublic companies must understand the implications of these new rules and regulations for different types of equity compensation programs and proactively act to reconsider and restructure their existing equity compensation mix.

Key Provisions of New Accounting and Tax Rules

Under APB25 (Accounting Principles Board Opinion No. 25) adopted in 1972, no compensation expense exists for time-based vesting options granted at fair market value and for an employee stock purchase plan (ESPP) qualifying for favorable tax treatment under Section 423 of the Internal Revenue Code (the "Code") of 1986, as amended (Cooley Godward 2003). Also, in 1993, Congress enacted the Internal Revenue Code (IRC) Section 162(m), prohibiting companies from deducting certain forms of compensation for a company's five highest-paid executives on their tax returns. The exemption status from IRC Section 162(m) makes stock options granted with qualifying features an attractive vehicle

for companies delivering incremental compensation while maintaining the employer's tax deduction (PricewaterhouseCoopers 2005).

FAS123(R), issued in December 2004, requires a public entity to use a grant-date fair-value-based methodology to measure the cost of share-based payment awards received in exchange for employee services. That cost will be recognized during the period that an employee is required to provide service — the requisite service period (usually the vesting period). A public entity will initially measure the cost of share-based awards per its current fair value and remeasure the fair value of that award at each reporting date through the settlement date. Changes in fair value during the requisite service period will be recognized as

compensation cost during that period. Companies can choose “modified prospective application” (MPA) transition method or “modified retrospective application” (MRA) transition method for adopting the FAS123(R) standard.

On March 29, 2005, the Securities and Exchange Commission (SEC) released Staff Accounting Bulletin No. 107 (SAB107) to provide guidance on key provisions of FAS123(R), including the choice of one of several valuation methods such as a “lattice” (for example: binomial) or a “closed-form” (for example: Black-Scholes) valuation model as long as the method meets the requirements of the standard.

Figure 1 illustrates the principal differences between APB25 and FAS123(R).

FIGURE 1 The Principal Differences Between APB25 and FAS123(R).		
Key Provisions	APB25	FAS123(R)
Scope	Applies to instruments issued to employees	Applies to instruments issued to employees and nonemployees (except under ESOPs)
Measurement Method for Equity Awards and Liability Awards (Public Company)	Intrinsic value	Fair value
Recognition Period	Service period/vesting period	Requisite service period
Measurement Date	“Fixed Accounting” — Grant date; “Variable Accounting” or “Cash Settlement” — Deferred measurement usually until date of exercise/settlement or resolution of contingencies	“Equity-Classified” — Grant date; “Liability-Classified” — Measured at fair-value each reporting period until date of payment or settlement
Modifications	New measurement date established, potential for variable accounting	Incremental value of new award over old award, and unamortized compensation cost for old award during the remaining requisite service period
Option Pricing Model	Does not apply	No specific model preferred; closed-form model (for example, Black-Scholes), binomial and simulation models are acceptable
Option Pricing Inputs	Does not apply	Exercise price, current price, expected life, expected volatility, expected dividends, risk-free rate
Taxes	If the tax deduction exceeds book compensation cost, the resulting windfall tax benefit is credited to APIC. If the deduction is less than book compensation cost, the resulting shortfall is debited to APIC to the extent of the pool of previous windfall tax benefits. Otherwise the shortfall is charged to income tax expense. Since most awards did not generate book-compensation cost under APB25, shortfalls were rare (PricewaterhouseCoopers 2005).	Same as APB25 except that shortfalls more likely occur due to the charged compensation cost

Simultaneously, the American Jobs Creation Act of 2004 adds a new section to the Internal Revenue Code as Section 409A (Inclusion in Gross Income of Deferred Compensation under Nonqualified Deferred Compensation Plans). The new section is similar to the Sarbanes-Oxley rule in the tax world for nonqualified deferred compensation, which is now subject to tax when vested, unless a company meets specific requirements for timing of deferral elections, distribution and funding. The IRS indicated in Notice 2005-1 that incentive stock options, qualified ESPPs and restricted stock awards are exempt from the provisions of Section 409A. Most stock options granted at fair value subject to Code Section 83(b) and void of deferral features will be exempt from the IRS rules as well.

In addition, Sarbanes-Oxley Section 302 on financial reporting disclosure requires the company to characterize and document the new rules' impact on earnings due to the potential material effects on financial reporting incurred by FAS123(R) and the AJCA deferred compensation tax rules. In addition, Sarbanes-Oxley Section 404 requires an ongoing internal control system to address the use of valuation methods, recognition of share-based payment cost, identification of deferred tax assets and tax provisions, the data quality assurance process and the reward program administration procedures (Deloitte Consulting 2005(1)). If implemented or administered incorrectly, stock plans can result in internal controls violations due to improperly classified balance sheet, P&L and equity accounts, as well as costly correction measures and fines for tax, social insurance, securities currency exchange and data privacy noncompliance.

FAS123(R) and Other Rules Implications for Equity Compensation

Under FAS123(R), most rewards are classified as an equity award, except for the SARs settled in cash or cash unit plans and phantom stock, which are classified

as a *liability award*. The equity-classified award will be measured only once on the grant date and not remeasured unless the award is modified, while the liability-classified award will be remeasured at the end of each reporting period, at fair value, until settled.

Stock Options

A stock option is considered an equity appreciation value award under FAS123(R). Compensation cost is based on the award's fair value (on the grant date, estimated per a valuation model). The fair value equals the expected value on the grant date multiplied by the number of options expected to be vested. The number of options to be earned is revised each reporting period.

In terms of tax treatment, with incentive stock options (ISOs), the employee does not pay regular income taxes at the time of exercise, but needs to hold shares at least one year from the date of exercise and two years from the grant date to receive special tax treatment by treating the spread as an adjustment item for Alternative Minimum Tax purpose. With Non-Qualified Stock Options (NQSOs), the employee will be taxed on ordinary income earned that equals spread at exercise. The reason these options are called "non-qualified" is that they do not qualify for special treatment of ISOs. The employee must report ordinary income when the option is exercised.

Restricted Stock/Restricted Stock Unit (Settled in Shares)

Restricted stock or stock settled restricted stock units (RSUs) are considered an equity full-value award under FAS123(R), with compensation cost based on the common stock price of the underlying share on the grant date.

For service-based and performance-accelerated plans, the charge equals the fair value at the grant for the vesting period. For a performance-based plan, the charge equals the fair value at grant multiplied by the number of shares expected to be earned. The number of shares to be earned is revised each reporting period.

An employee receiving restricted stock awards is not taxed at the time of the award unless an election under Code Section 83(b) has been made to accelerate the tax paying upon receipt of restricted stock and avoid potential recognition of ordinary income when forfeiture restrictions lapse. Service-based and performance-accelerated restricted plans may be subject to Code Section 162(m) deductibility limitation. Performance-based restricted plans may qualify as performance-based compensation not subject to 162(m) deductibility limitation.

Stock Appreciation Rights (SARs) (Settled in Shares)

FAS123(R) implications and tax obligations for stock appreciation rights (SARs) settled in shares are similar to those for stock options.

Performance Share or Performance Unit (Settled in Shares)

Performance share plans are incentive plans in which shares of company stock are awarded to incentive participants only if certain companywide performance criteria are met, such as earnings-per-share targets. Performance unit plans use the current value of stock to develop a dollar allocation rather than a stock award based on the participants' contribution to company performance. The goal of performance shares or units is to provide an explicit incentive for employees to focus their efforts on maximizing shareholder value. FAS123(R) implications and tax obligations for a performance share or a performance unit are settled in shares and are similar to those for restricted stock or restricted stock units settled in shares.

Employee Stock Purchase Plan (ESPP)

Under an Employee Stock Purchase Plan, employees can purchase company stock at a discount to its fair market value. An ESPP is considered an equity full-value award under FAS123(R). Generally speaking,

an ESPP will not incur an accounting change to the company if the company provides a discount of 5 percent or less to employees, generally allows most employees qualify to participate and does not provide any option features, with the exception of two enrollment features.

With qualified Code Section 423 ESPPs, employees are not taxed at the time the shares are purchased, employees are taxed only when the shares are sold. Depending on if the shares were held for the required holding period, a portion of the gain may be taxed as capital gains or as ordinary income.

Stock Appreciation Rights (SARs) (Settled in Cash or Cash Unit Plans)

SARs settled in cash or cash unit plans are considered liability appreciation value awards under FAS123(R). The compensation cost is measured at the end of each quarterly reporting period using a variable fair-value accounting until final measurement of the liability at the "intrinsic" value is settled in cash.

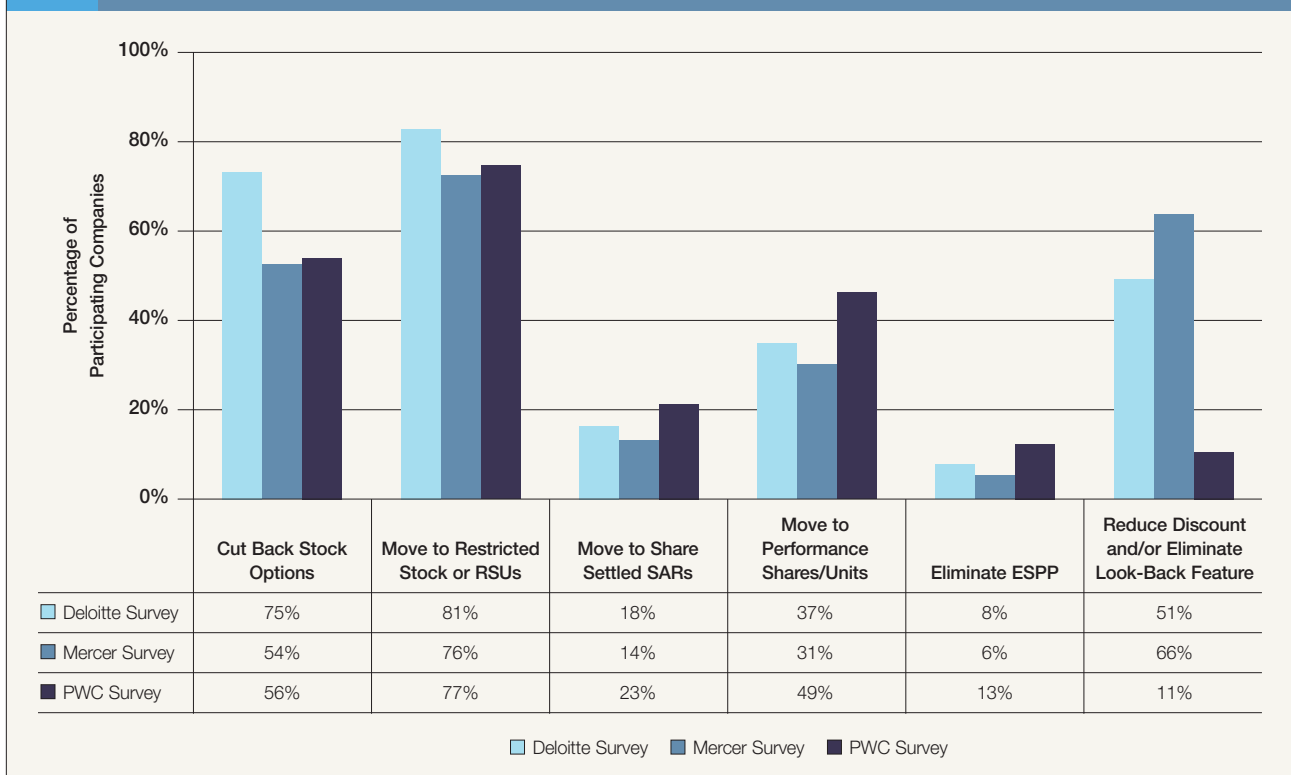
The tax obligation for the SARs is settled in cash or a cash unit plan and may require that cash payments received by employees be treated as ordinary income.

Emerging Trends in Equity Compensation

Various surveys reflect the emerging trends in equity compensation under this new FAS123(R) environment. The noticeable trends include the decline in the use of stock options, the more prevalent practice of restricted stock/unit plans and performance-based equity plans and more sophisticated usage of employee stock purchase plans. A majority of companies use a combination of equity vehicles such as the omnibus incentive plan, stock options and restricted stock and performance-based plans as primary long-term incentive plan tools.

Figure 2 on page 28 illustrates the key summary findings on the employer actions regarding equity

FIGURE 2 Employer Action on Equity Compensation per Survey Results



compensation programs (Deloitte Consulting 2005 (2), Mercer 2005 and PricewaterhouseCoopers 2005)

Broad-Level Stock Options Are Reduced

The most prevalent reaction to the mandatory stock options expensing requirements in the new accounting regulations is to scale back the grant level of the stock options. The Deloitte survey indicated that 75 percent of respondents are reducing the number of options granted. The Mercer survey indicated that 54 percent of U.S. publicly traded firms are changing eligibility, participation or award levels of broad-based stock options. Likewise, the PWC survey indicated that 56 percent of the total sample companies would reduce stock option grant levels.

Restricted Stocks or Share-Settled Restricted Stock Units (RSUs) Become More Popular

The Deloitte survey indicated that 81 percent of the responding companies who are considering an alternative

equity-based compensation plan use either time-based restricted stock/units (45 percent) or performance-vested restricted stock/units (36 percent). The Mercer survey showed that 76 percent of the responding companies made changes or planned to change to restricted stock in the last two years, with 40 percent of the companies opting for service-based restricted stock and 36 percent of the companies opting for performance-based restricted stock. Similarly, the PWC survey revealed that 77 percent of the survey participating companies planned to move to either restricted stock plans (37 percent) or restricted stock unit plans (40 percent).

SARs Settled in Shares Are Expected to Increase

Historically, stock appreciation rights (SARs) rarely were granted due to their unfavorable accounting treatment under APB25. The use of stock-settled SARs is expected to increase because fewer shares will be issued and more shares will remain in the plan's share reserve, available

for future issuance. The Deloitte survey showed that 18 percent of the responding companies planned to move to share-settled SARs. The Mercer survey indicated that 14 percent of the participating companies made changes or planned to change to share-settled SARs in the last two years. The PWC survey showed that 23 percent of the surveyed companies planned to move to stock-settled SARs. In addition, the Frederic W. Cook & Co's 2005 Top 250 Long-Term Incentive Grant Practices for Executive Survey tracked the increased use of SARs at FAS 123 companies (10 percent), that voluntarily implemented "fair value" accounting for share-based grants versus non-FAS123 companies (1 percent). It serves as a clear sign for the future direction of SARs usage by employers under the FAS123(R) environment.

Performance-Based Long-Term Incentive Plans Have Become More Prevalent

Many companies will incorporate a performance element into option plans. Thus, performance, contingent stock options and performance-accelerated stock options emerge as alternative options. Performance-based restricted stock and performance shares or performance units settled in shares will increase as well. The Deloitte survey said that 37 percent of respondents were changing to performance-granted stock plans, with 24 percent to performance-granted restricted stock/units and 13 percent to performance-granted stock opportunity. The Mercer survey showed that 31 percent of the participating companies made changes or planned to change to performance shares/units plans in the last two years. The PWC survey said that 49 percent of the surveyed companies considered moving to performance-based equity plans.

Employee Stock Purchase Plans (ESPPs) Will Scale Back Slightly, with Revised Features

Although most current ESPPs will incur compensatory cost, various survey results indicate that only a small

percentage of responding companies plan to eliminate them (8 percent per Deloitte, 6 percent per Mercer and 13 percent per PWC). Most employers choose to reduce the discount and/or eliminate the ESPPs' look-back feature (51 percent per Deloitte, 66 percent per Mercer and 11 percent per PWC). As long as employee stock purchase plans are modified with a lower discount rate and by eliminating a look-back feature to avoid compensatory cost, they continue to serve as popular equity compensation programs since many employers cut stock option grants to lower-level employees.

In summary, Figure 3 on pages 30 and 31 illustrates a primer for equity compensation, with a description of the various types of share-based compensation plans addressed by how they are structured, the FAS123(R) treatment for their compensation cost, the U.S. taxation implications, the pros and cons of each type and the predicted trend of their prevalence in the foreseeable future.

Employers' To-Do List

Transitioning to the Share-Based Payment Standard FAS123(R)

Most companies need to understand the new disclosure requirements under FAS No. 123(R) and estimate the FAS123(R) fair-value and compensation cost associated with each equity compensation plan. In response to the latest regulatory changes and shareholders, companies need to

- ▶ Choose a proper measurement method.
- ▶ Distinguish liability presentation from equity presentation of the share-based payments.
- ▶ Make changes not only in plan design but also in the actual language of plans and grant agreements.

Expensing Stock Options via Option Pricing Model

To deal with the regulatory impact of the new rules on the stock options, companies need to make sound

FIGURE 3 The Changing Requirements for Equity Compensation

	At-the-Money Stock Options (Nonqualified) with Service Condition	Incentive Stock Options (Qualified)	Discounted Stock Options	Premium Options	Restricted Stock or Stock-Settled RSUs
Description	Options with exercise price equal to stock price at grant date; vests based on continuous employment over specified time period	Same as nonqualified at-the-money stock option except for special tax treatment if the option complies with IRC requirements	Stock options with exercise price less than stock price at grant date	Options with exercise price set higher than grant-date stock price	Grant of shares (restricted stock) or promise to issue shares (RSUs) upon completion of service condition
Classification	Equity	Equity	Equity	Equity	Equity
Award Type	Appreciation	Appreciation	Appreciation	Appreciation	Full-Value
FAS123(R) Treatment	Expense based on fair value at grant and number of options that vest, recognized over vesting period	Same as nonqualified at-the-money stock option	Same as nonqualified at-the-money stock option; fair value higher than at-the-money option but generally increase is less than discount amount	Same as nonqualified at-the-money stock option except lower grant-date fair value	Expense based on grant-date fair value of stock and number of shares that vest, recognized over vesting period
U.S. Taxation	(1) Employee: taxed ordinary income tax on exercise equal to spread; (2) Employer: Deduction equal to employee's income	(1) Employee: ISO holders do not pay regular income taxes at the time of exercise if no disqualifying disposition occurs; subject to capital gains tax at sale of shares; (2) Employer: No deduction unless disqualifying disposition	(1) Employee: Taxed at vesting because discounted options are treated as deferred compensation under IRC Section 409A; (2) Employer: Deduction equal to employee's income	Same as nonqualified at-the-money stock option	(1) Employee: Subject to tax at vesting based on stock price on that date; may elect under IRC Section 83 (b) to be taxed at grant date; (2) Employer: Deduction equal to employee's income when taxed
Pros	(1) Employees may receive substantial gain from well-timed exercise without shareholder gains; (2) easily qualifies for IRC Section 162(m); (3) can be issued to employees and directors	Same as nonqualified at-the-money option except employee may receive capital gains treatment instead of being taxed as ordinary income	Same as at-the-money option except provides rewards even if stock price declines; employee may perceive that discount has more value than increase in fair value measured for FAS 123(R)	No value to employee unless stock price rises above premium; increases motivation; reduces FAS 123(R)'s fair value	(1) Employees share upside and downside of share price (2) receive dividends; (3) dilution not as great as options
Cons	(1) Employees do not share the downside risk; (2) overhang and dilution issues; (3) FAS123(R) accounting remove its previous advantages; (4) little retentive effect in falling market	(1) Same as nonqualified at-the-money stock options; (2) employer generally has not tax deduction unless disqualifying disposition; (3) can only be issued to employees	Unfavorable tax treatment for employee under IRC Section 409A	Employee may demand more options to make up for perceived reduction in value	(1) Employees realize value even if stock price declines; (2) not deductible under 162(m) unless performance-based; (3) may be viewed as giveaway by shareholders
Trend Predicted	Decrease	Decrease	Decrease	Flat	Increase

	Stock-Settled SARs	Performance Shares/Units with Performance Conditions	Performance Shares/Units with Market Conditions	Employee Stock Purchase Plans (ESPPs)	SARs (Settled in Cash or Cash Unit Plans)
	Employee receives stock equal to intrinsic value at exercise; otherwise identical to nonqualified stock option	Restricted stock or units that vest based on time-based vesting plus attainment of non-stock-price-related performance conditions (e.g., revenue or EPS)	Same as performance shares with performance conditions except with targets related to stock price increases or tying stock price to an index	A program that allows employees to purchase company stock at a discount to its fair market value	Same as stock-settled SARs except intrinsic value at exercise paid in cash
	Equity	Equity	Equity	Equity	Liability
	Appreciation	Full-Value	Full-Value	Full-Value	Appreciation
	Same as nonqualified options	Same as restricted stock except recognize compensation cost over the period when targets will probably be attained and true-up for actual vesting	Fair value at grant date reflects market condition using lattice model; expense recognized over derived requisite service period and not reversed if targets are not attained	Measured on the grant date (fixed accounting)	Considered liability award with mark-to-market fair value (using an option-pricing model); total expense equals cash paid to employee
	Same as nonqualified stock option	Same as restricted stock	Same as restricted stock	Not taxed at the time the shares are purchased, only when they are sold. A portion of the gain may be taxed as long-term capital gains if the shares are held for the required holding period.	Same as nonqualified stock option
	(1) Same as nonqualified stock option plus exercise does not require tendering of an exercise price; (2) reduces dilution compared to broker-assisted exercise; (3) exempt from section 409(A) under AJCA	No FAS123(R) expense unless performance target attained; employee motivated to reach targets; shareholders also benefit if targets reached	Employee directly motivated to increase stock price; fair value per share generally lower than stock price at grant	Encourage saving and investing	Same pros as stock-settled SARs except for accounting under FAS123(R)
	Same as nonqualified stock options	(1) Hard to set up proper performance criteria; (2) stock price may decline even though performance criteria are met	(1) FAS123(R) expense not reversed if targets not attained; (2) lattice model required to measure fair value	The potential compensatory cost incurred if the plan has a discount rate is more than 5% or provides a look-back feature	Same as nonqualified stock options except (1) Mark-to-market variable accounting under FAS123R; (2) subject to 409(A) under AJCA
	Increase	Increase	Increase	Slightly Decrease	Decrease

assumptions about the expected term and volatility — the two most difficult inputs to determine — and the most significant drivers of option value. They need to make these assumptions regardless of the option pricing model companies choose.

Reducing/Eliminating/Accelerating Stock Options or Modifying Stock Options Terms

Companies' options include:

- ▶ Choose to reduce or eliminate stock option participation or the number of shares granted.
- ▶ Accelerate unvested underwater option or shorten option term, or
- ▶ Modify the terms of the existing stock option plans to reduce FAS123(R)-incurred compensation cost.

Adopting Restricted Stock/Restricted Stock Unit (Settled in Shares) Program

Companies should follow the practices of leading companies to move from stock options to restricted stock or performance-based restricted stock units. These two types of full-value awards help companies better manage share usage and plan dilution.

Implementing a Broad-Based Share-Settled SAR Program

The use of stock-settled SARs is expected to increase as stock-settled SARs offer many advantages to companies using fewer shares and leaving more shares in the plan's share reserve, available for future issuance. Thus, under FAS 123(R), stock-settled SARs are an attractive alternative to stock options. Companies could consider adopting a new cashless exercise by exchanging existing stock options for stock-settled SARs.

Adding Performance Share or Performance Unit (Settled in Shares) Program

The FAS 123(R) makes performance-based restricted stock awards or share-settled performance unit plans more popular. The performance plan design's critical

elements are the right participation levels and the performance criteria. Companies should introduce the proper performance targets in equity compensation plans, particularly for senior executives, and assess the implications of market versus performance conditions.

Modifying The Employee Stock Purchase Plan

Companies do not have to eliminate the employee stock purchase plans entirely, partly because companies already scale back the stock option grants to lower-level employees. Nevertheless, companies do need to modify their plans to make the plans less expensive by reducing the discount and eliminating the look-back feature.

Reducing or Eliminating Cash-Settled SARs, Cash-Settled RSUs or Cash-Settled Performance Units

Due to the variable cost calculation under FAS123(R) and the 409(A) election requirement for deferral feature, companies should reduce or eliminate granting of SARs settled in cash, cash-settled RSUs or cash-settled performance unit plans.

Developing a Holistic Mix of Long-Term Incentive Plans (LTIPs)

Companies must grasp the pros and cons of each equity compensation type under the FAS123(R) environment and re-evaluate the total compensation mix, including the cash and equity compensation. They must take this step to:


- ▶ Optimize value for total compensation cost,
- ▶ Explore the emerging long-term incentive plan alternatives including SARs (whether settled in stock or in cash), various forms of stock options (ISOs, NQSOs, discounted options and premium options), performance awards, restricted stock and RSUs, ESPPs with no look-back feature, phantom stock plans, etc.,
- ▶ Develop a holistic retentive long-term incentive plan mix that links pay to performance.

Launching Communication and Education for Implementing New Equity Plans

The various challenges involved in program design and implementation are:

- ▶ Employee communication and education,
 - ▶ Stock award administration including systems and international and technical considerations for tax, accounting and securities laws, Section 409A and Sarbanes-Oxley compliance and
 - ▶ The tangible steps to take to implement new plans.
- Companies must determine and design transition and communication strategies and plans for rolling out new types of equity compensation plans within the organization.

Conclusion

Back to the bottom line, now is the time for employers to embrace the new rules and regulations (such as FAS123(R), the AJCA section 409(A) and Sarbanes-Oxley). Employers must take a fresh look at the impact of these rules and regulations on the existing equity-based compensation programs and explore new holistic mixes of long-term incentive plans. Ideally such newly revamped equity plans and long-term incentive plans would comply with the new rules and regulations and drive corporate performance and shareholder value at the same time. There is no simple formula for a so-called “perfect” long-term incentive plan model. Each employer needs to go through its own growing pains to create its own “unique” rather than “perfect” model. 

Resources Plus

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