Understanding and Using Long-Term Incentives

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Abstract
Long-term incentives have played a role in the development and growth of businesses for generations. Yet in recent years they have become even more prevalent, both as a percentage of senior management’s pay and as a common form of additional compensation for rank-and-file employees. By the mid-1990s, many businesses had followed the high-technology industry’s lead of providing long-term incentives to all employees. This newly ubiquitous type of compensation created a new model for total direct compensation for the average U.S. employee. Although the “lottery ticket” mentality relating to stock options has subsided, it is still important for employers to understand the implications and alternatives of long-term incentive plans. This paper discusses the background of long-term compensation plans and the tax and accounting treatment of each type. It does not go into extensive detail on the new possibilities of Statement of Financial Accounting Standards No. 123.

Long-term incentives (LTIs) have become a critical component of employee compensation over the past decade. They are perhaps the most volatile, scrutinized, and visible components of compensation today.

Total direct compensation comprises base pay, short-term incentives, and long-term incentives. Each of these instruments has its own form and purpose.

Base pay is commonly defined as the salary or pay amount given to an employee for performing the daily duties of the defined job.

Short-term incentives—including annual incentives, bonuses, commissions, gainsharing, and the like—reward the individual employee for achieving certain goals over a short period. The measurement period for short-term incentives is most often quarterly, semi-annually, or annually. Short-term incentives can be measured based on the individual’s own performance, a group’s performance, or the company’s overall performance. This depends on the organization, the incentive plan, and the level of the individual within the organization’s hierarchy.

Long-term incentives—including restricted stock, stock options, phantom stock, stock appreciation rights, performance units, and the like—measure organization-wide performance, typically over several years. The intent of such plans is to provide incentives for employees to improve the overall performance of the organization by linking the employees’ long-term rewards to the organization’s long-term results.

Long-Term Incentive Plans
Long-term incentive plans reward participants (e.g., employees) for attaining results over a long measurement period. For this purpose, long-term generally means more than one year, and typically is between two and five years.

The form of payment from a long-term incentive plan is normally cash or equity. The reasons an employer would choose one or the other depend on the goals of the plan, the recipients of the awards, and the availability of cash or equity for payment.

Cash-Based Plans
Cash-based plans allow organizations to target specific performance levels over a long term. Organizations using such plans need to exercise caution to avoid confusion and complication that may result from implementing a long-term cash incentive plan that looks like the organization’s short-term incentive plan.

1 The reasons for choosing one form of payment over another are discussed later in this paper.
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Cash-based plans have their place. They are effective in rewarding employees, teams, groups, departments, and other entities for meeting or exceeding performance milestones that span more than one year. One of the benefits to the employer of using a cash-based plan is that the plan and its rewards can be very specifically tailored. For example, if the goal of the company is to increase market share for a particular product line from 10% to 33% over the next 39 months, the company can match a long-term incentive plan to that goal (presuming there is a reliable measure of market share for that product). Further, because the payments are made in cash and not equity, there is no need to introduce a second variable (e.g., stock price) that complicates and confuses the linkage between the performance and reward. That is, the value of the awards can be pinpointed the day the program is put in place because the currency does not change over time.

Cash-based plans are effective when:

- The target recipients are to be rewarded for performance that isn’t precisely correlated with stock performance.
- The stock price is not tracking properly with the company’s performance (e.g., the industry is out of favor).
- Stock is simply not available for the plan because the company is private, the shareholders haven’t approved a plan, or the plan has been depleted.
- Shareholder dilution is a concern.
- Broad-based employee groups are targeted for long-term incentives and they have shown strong preference for cash rather than stock. (Companies sometimes find it favorable to pay with cash rather than to pay with shares when they assume employees will sell any shares as soon as possible to convert them into cash.)
- Employee retention is critical.
- Award payments are designed to link with equity-based plans to help create the cash flow necessary to exercise stock purchases or option exercises.

Equity-Based Plans

Equity-based plans are the most common form of LTI; and stock option plans are perhaps the single most common form of LTI in use. Frederic W. Cook & Co., Inc. recently conducted a study of 250 large companies and discovered that more than 99% of those companies (all but one company) used stock options in 2001.

Equity plans are straightforward in that they provide a reward based on a market-driven equity. This means there are no cumbersome formulas nor are there subjective measures. The problem, however, is that the value of the equity is generally the only determinant of the value of the awards. This means that if the organization’s goal is to improve performance against a measurement other than market value, the LTI value may not be perfectly aligned with the stated goals.

A second difficulty with equity plans is determining the value of an award to a recipient. This value problem has come under great scrutiny recently. Stock options pose the most difficult problem for valuation because they arguably have no value at the date of grant but, as was seen repeatedly in the late 1990s, they can have extraordinarily high values in a short period of time.

Equity-based plans are effective when:

- The employer wants to create a strong link between the employees’ performance and the company’s performance.
- There is limited cash available for employee incentives. This is most prevalent among early-stage startups that are cash poor and therefore use equity for its high risk/high reward characteristics.
- It is desirable for employees to feel and act like owners.
- Retention is important—if the stock price has appreciated significantly.

Equity-based plans can take two forms: entire value, or appreciation only. Examples of the different forms will be discussed later, but the primary difference is that one form provides full value of the equity whereas the other measures only the increase in value of the same equity—typically measured from the equity’s value on the day of the original grant. Neither form is better than the other; each has its strengths and weaknesses. Plans with awards based on appreciation only are perceived to be stronger when the goal is to reward for future performance—that is, to reward for the increase in value from today. Plans with awards based on entire value provide a broader continuum of payments, allowing awards to be paid if the stock value drops below its current level. These plans provide more stability in payments and typically less volatility overall.

Hybrid Plans

There is some confusion about certain types of plans and whether they are equity-based or cash-based. The confusion typically results from the fact that the value of the plan is based on equity, but the payment is strictly in cash. The two most prevalent examples are phantom stock and stock appreciation rights (SARs).

Hybrid plans are normally used to approximate an equity-based plan when equity is not available or advisable, but the other aspects of an equity plan are desirable.

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2 The specific terminology and parameters of stock options is discussed later.

3 Phantom stock is a promise to pay cash equal in value to one share of stock. It looks and acts like a regular stock plan but the recipient is not free to sell the stock to anyone on the open market, rather the employee must return the shares to the company in exchange for cash. Phantom stock is discussed in more detail later.

4 An SAR is like a phantom stock option. An SAR behaves exactly the same as a stock option except that the recipient does not receive a share of stock upon exercise of the SAR. Rather, the employee receives the cash value of the stock appreciation from the date of the grant to the date of exercise. SARs are discussed in more detail later.

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Summary of Plan Types
The following is a summary of the most common types of long-term incentive plans. Within each description is a summary of the type of plan, its features, various regulatory requirements, tax and accounting implications for the employer, and tax implications for the recipient. Each section also includes commentary on the uses of each type of plan.

Restricted Stock
Restricted stock is company stock that carries some limitations. Essentially, the recipient (e.g., employee, director, independent contractor) receives full shares of company stock that are forfeitable until certain terms and conditions are met. The most typical restriction on the shares is continued employment, that is, a time-based vesting schedule. Common vesting schedules include pro-rata vesting over three to five years.

Within some plans, recipients are required to purchase their shares of restricted stock. However, this practice tends to be much more common in the context of another type of vehicle. That is, variants of stock purchase plans or deferred compensation plans may use restricted stock purchases as a feature within the plan. Normally in these plans, the recipient purchases shares of restricted stock at a discount using cash or deferred income. The discount is provided to make the purchase beneficial to the recipient—otherwise, an open-market purchase would be better because there would be no restrictions. In an ordinary restricted stock plan, however, the recipient normally does not pay anything for the restricted shares.

The key terms that define a restricted stock grant are:

- Number of shares
- Purchase price, if any
- Grant price
- Vesting schedule

Section 83 of the Internal Revenue Code addresses the taxation of property transferred in connection with performance of services. The general rule—Section 83(a)—states:

“If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.”

This means the recipient pays taxes only when the shares become vested. There is no taxation at the time of the restricted stock grant, unless some shares are immediately vested. Upon vesting, the recipient is subject to ordinary income tax on the difference between the fair market value of the stock as of the vesting date and the amount paid for the stock, if any. The gain from vesting to the ultimate sale of the security can be subject to either ordinary income tax or long-term capital gains tax, depending on how long the recipient holds the shares.

When discussing the individual’s taxation, note that Section 83 also allows recipients voluntarily to accelerate the taxation of the property transferred into the year of the transfer—that is, in this case, to pay all the taxes upon receipt of the restricted stock. Section 83(b) is the “Election to include in gross income in year of transfer” and specifically states:

“(1) In general
Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income for the taxable year in which such property is transferred, the excess of (A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over (B) the amount (if any) paid for such property. If such election is made, subsection (a) shall not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.

(2) Election
An election under paragraph (1) with respect to any transfer of property shall be made in such manner as the Secretary prescribes and shall be made not later than 30 days after the date of such transfer. Such election may not be revoked except with the consent of the Secretary.”

This election, often referred to as an 83(b) election, should be exercised by the recipient only in consultation with a qualified financial planner. The election must be made within

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In the future.

The expense is "fixed" at the date of the award and is not remeasured and conditions to receive some of that stock, the recipient will have paid taxes on stock he or she never received.

There are also tax and accounting implications for the company. The company must take a charge to earnings equal to the spread between the stock’s fair market value at grant and the amount, if any, that the recipient paid for the stock. This amount is determined once, at the time of the grant, but the expense is spread out over the vesting period. As the shares vest, the company receives a tax deduction equal to the amount of income recognized by the recipient—the spread between the fair market value at vesting and the amount paid by the recipient, if any. Interestingly, even though there are annual expenses and deductions associated with restricted stock grants, the company’s deduction does not equal the expense because they are measured based on the fair market value of the stock at the different points in time.

Companies listed on the big boards and companies wishing to comply with the SEC’s exemption from Federal “insider trading” rules must obtain shareholder approval for restricted stock plans.

Incentive Stock Options

There are several varieties of stock options, all of which share some basic characteristics. A stock option is a right to purchase a share of stock in the future at a price determined at the grant (or based on a formula defined at the grant). Most stock options are granted with a vesting schedule similar to the ones described under “Restricted Stock” above.

The key terms that define a stock option grant are:

- Number of shares under option
- Grant date
- Grant price
- Exercise price
- Vesting schedule
- Term or expiration date

Incentive Stock Options (ISOs) are a special subset of stock options that satisfy certain criteria promulgated by the Internal Revenue Service and discussed in Internal Revenue Code Section 422. Subsection (b) defines ISOs:

“For purposes of this part, the term "incentive stock option" means an option granted to an individual for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but only if:

1. the option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under options and the employees (or class of employees) eligible to receive options, and which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted;

2. such option is granted within 10 years from the date such plan is adopted, or the date such plan is approved by the stockholders, whichever is earlier;

3. such option by its terms is not exercisable after the expiration of 10 years from the date such option is granted;

4. the option price is not less than the fair market value of the stock at the time such option is granted;

5. such option by its terms is not transferable by such individual otherwise than by will or the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

6. such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation.

Such term shall not include any option if (as of the time the option is granted) the terms of such option provide that it will not be treated as an incentive stock option.”

One of the primary restrictions in the preamble of the definition is that an ISO can only be granted to an employee—ISOs cannot be granted to outside directors, independent contractors, consultants, nor any other nonemployees. ISOs are the only LTI vehicle discussed in this paper with such a restriction on eligibility. Also, the recipient must exercise the ISO within three months of terminating employment.

The Code includes a special ISO provision that allows the “10 percent owner” to receive an ISO. However, the exercise price of the ISO must be at least 110% of the fair market value of the stock at the time of the grant and the option must expire within five years following grant, rather than the 10 years normally allowed.

In addition to the above, the Code continues in Section 422(d) to impose a $100,000 per year limitation on any grants to be considered incentive stock options. The

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8 This type of accounting is referred to as “fixed accounting” because the expense is “fixed” at the date of the award and is not remeasured in the future.

9 IRC §422(c)(5)

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These changes have not yet happened.

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Conference Board, and numerous shareholder activist groups to

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intrinsic value (the positive difference, if any, between the fair market

Technically, they do have an expense, but that expense is equal to the

situations like this, this provision of the Code has come under

significant scrutiny and may be changed but has not been changed as

of this writing.

ISOs, along with other stock options, also have significant

benefits for the employers. For example, there is no expense

recognized for ISOs. The company, however, does not

receive a tax deduction for an ISO unless the recipient

does sell the shares before the end of the holding period, that

is considered a disqualifying event and the ISOs are then

treated like nonqualified stock options (see below).

ISOs, along with other stock options, also have significant

benefits for the recipients. Namely, there is no tax at grant,

no tax at vesting, and no tax at exercise (although there is

some potential exposure to the Alternative Minimum Tax

(AMT)). ISOs were conceived to allow the recipient to take

advantage of capital gains rates so long as the recipient meets

the holding requirements. The holding requirements are that

the recipient cannot sell the stock gained through an ISO

exercise earlier than the later of two years following the ISO

grant, and one year following the exercise. If the recipient

does sell the shares before the end of the holding period, that

is considered a disqualifying event and the ISOs are then

treated like nonqualified stock options (see below).

11 ISOs may be subject to Alternative Minimum Tax at exercise based on

the spread between the exercise price and the fair market value of

the stock at the date of exercise. This AMT treatment has recently

posed significant tax liabilities for recipients who exercised pre-IPO

options when the stock was trading at a very high, post-IPO price. In

some cases these people paid AMT on the spread and then held the

stock only to see the share price plummet, leaving them with stock

worth considerably less than the amount they paid the IRS. Because of

situations like this, this provision of the Code has come under

significant scrutiny and may be changed but has not been changed as

of this writing.

12 As a technical note, stock options with exercise price at or above

the fair market value at grant are considered to have “no expense.”

Technically, they do have an expense, but that expense is equal to the

intrinsic value (the positive difference, if any, between the fair market

value at grant and the exercise price), which is $0 for options with

exercise prices at or above the fair market value. This favorable

expense treatment of stock options (ISOs and nonqualified stock

options) is under great scrutiny. There is a push from Congress, The

Conference Board, and numerous shareholder activist groups to

change the way options are expensed to replace the intrinsic value

with something more resembling a fair market value of the option.

These changes have not yet happened.

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Non Qualified Stock Options

A nonqualified stock option (NQSO) is broadly any stock option that does not comply with all the requirements for

incentive stock options. A stock option is a right to purchase

a share of stock in the future at a price determined at the

grant (or based on a formula defined at the grant). Most stock

options are granted with a vesting schedule similar to the

ones described under “restricted stock” above.

The key terms that define any stock option grant are:

• Number of shares under option

• Grant date

• Grant price

• Exercise price

• Vesting schedule

• Term or expiration date

It is perhaps best to enumerate the variations of NQSOs that differ from those of ISOs. For example:

• NQSOs may be granted to nonemployees. Outside

  directors, contractors, and other nonemployees may

  receive NQSOs but not ISOs.

• NQSOs are not limited by the $100,000 cap.

• NQSOs may have an exercise price less than the fair

  market value of the stock on the date of the grant—

  these are called discounted stock options.

• NQSOs are not restricted to a 10-year expiration,

  although most companies do limit NQSOs to 10 years

  or less.

• NQSOs are not limited to any specific exercise period

  following termination of employment (if recipient is an

  employee).

Nonqualified stock options are not quite as tax-advantaged as

ISOs, but they do have some favorable tax benefits. NQSOs

have no tax at grant and no tax at vesting. Unlike ISOs,

however, NQSOs are subject to ordinary income tax at

exercise, on the spread between the fair market value at that

date and the exercise price. The appreciation from the

exercise date until the ultimate sale is treated the same as if

the recipient had purchased the shares on the open market—

that is, capital gains if the security is held more than one year

following the exercise; otherwise the appreciation is treated

as ordinary income.

Like ISOs, NQSOs have significant benefits for the

employee. Currently, there is no expense recognized for

NQSOs that have an exercise price at or above the fair

market value on the date of the grant. If the NQSO has an

exercise price below the fair market value on the date of the

grant, the employer must recognize an expense equal to the

amount of the discount. The expense is determined at the date

of the grant and spread over the vesting period.

13 Ibid.

14 Referring to ISOs as “restricted stock options.”
Unlike with ISOs, the company does receive a tax deduction for an NQSO. The deduction is equal to the income recognized by the recipient upon exercise of the NQSO.

Nonqualified stock options are very attractive to employers because they carry a tax deduction without a corresponding charge to earnings. In effect, the only “cost” is in shareholder dilution. The combination of these features has caused considerable debate on the merits of the accounting and tax treatment of all options. Before implementing any option program, employers should consult with their advisors to ensure the plans are in compliance with any new regulations while supporting the company’s goals.

Stock Appreciation Rights

A stock appreciation right (SAR) measures the increase in the fair market value of the stock over a specified period. In one form, the SAR operates the same as a stock option except the ultimate reward is paid in cash equal to the value of the spread rather than in the underlying security.

The key terms that define any SAR grant are:

- Equivalent number of shares for which appreciation will be awarded
- Grant date
- Grant price
- Exercise price
- Vesting schedule
- Term or expiration date
- Form of payment (cash or stock)

For the recipient, SARs are similar to the NQSOs. The recipient does not pay tax at either grant or vesting. The spread at the exercise of the SAR is subject to ordinary income tax, whether the ultimate award is paid in cash or stock. There is no specific future tax associated with the SAR payment that is settled in cash. If the SAR payment is settled with company stock, the sale of that stock triggers a taxable event—either ordinary income or capital gains, depending on whether the recipient held the stock for more than one year from the date of the SAR exercise.

Companies that cannot issue shares to employees sometimes use SARs. Employers whose stock is not publicly traded also use SARs as a way to provide an option-like award for their employees and other interested parties.

Although an SAR appears similar to a stock option from the employees and other interested parties. However, the key differences are:

- The SAR grant is settled with company stock, so the recipient pays no tax on the stock until the stock is sold.
- The SAR is subject to taxation in the year of the grant.
- The SAR grant is subject to change or extension based on the employee’s exercise date.

Variable accounting raises significant concerns in the CFO’s office in most public companies. Under variable accounting, an employer using SARs must recognize a charge to earnings each year, from grant until exercise, based on the year-over-year spread. This is sometimes referred to as “mark to market” accounting. Unlike its cousin the stock option, the SAR carries an expense that is adjusted every year to equal the change in value of the award and the charges continue each year until the recipient exercises the SAR (regardless of vesting).

Let’s look at two employees of the same employer. Employee O receives 1,000 stock options with an exercise price of $10 per share (the fair market value on the day of the grant); the same day Employee S receives 1,000 SARs, also with an exercise price of $10 per share (the fair market value on the day of the grant). Both the shares and the SARs are fully vested after one year. At the end of the first year the share price is $17 and at the end of the second year, the share price is $35. Both employees exercise at the end of the second year, and Employee O sells the stock gained on exercise of the options. Both employees end up with $25,000 pretax gain; however, the company’s expense treatment of the two differs greatly. For Employee O, the company expenses $0 in the first year, because options are expensed with fixed accounting spread over the vesting period. But because Employee S received SARs, the expense is subject to variable accounting. The expense for the first year for the 1,000 SARs is $7,000 (the expense for the second year (even though the SARs are already vested) is an additional $18,000). The total expense for Employee O’s SARs over the 2 years is $25,000, which, not coincidentally, is the same as the ultimate cash payment to Employee S.

Variable accounting is problematic because it is subject to the variability in the stock price and the decision of the employee regarding when to exercise the SARs. If Employee O held on to those SARs for 10 years, the company would have to recognize the change in value of those SARs each year until they were finally exercised, whereas if Employee O decided not to exercise the options for the full 10 years, there still would be no expense.

Even in the case of discounted options or restricted stock (both of which have an expense), the value of the expense is known at the time of the grant and is spread only over the vesting period. The expense impact is clear and known and is not subject to change or extension based on the employee’s exercise date.

Explanatory note on variable accounting. The net expense for an SAR plan, or any other plan for which variable accounting applies, cannot be less than $0. Even if the underlying stock price drops below the grant price, the expense does not become a credit (i.e., negative expense).

15 Although there is no specific taxable event following a cash distribution from an SAR plan, one should not infer this is the best payment alternative. If the recipient chooses to invest that cash, the recipient will then be subject to tax on the appreciation of that investment. If the recipient were to buy company stock with the cash distribution, that stock would ultimately be taxed exactly the same way as if the SAR settled in stock upon exercise.

16 $25,000 = 1,000 shares X ($35 - $10).

17 $7,000 = 1,000 SARs X ($17 - $10).

18 $18,000 = 1,000 SARs X ($35 - $17).
This is logical since the value to the recipient will never be less than $0 either.

**Phantom Stock**

Phantom stock is a right granted by an employer to a recipient—an employee or not—to receive an award with a value equal to the value of a share of stock or the appreciation in the value of a share of stock. Phantom stock that pays only appreciation is the same as a standalone SAR. This paper therefore treats that vehicle in the SAR section; only full-value phantom stock is discussed in this section.

Phantom stock plans are based on “phantom” or “hypothetical” shares of stock. At a publicly traded company, the phantom shares are typically cash equivalents of shares of the publicly traded stock. In private companies, however, the share value is typically based on a calculated or formula value, such as book value, or some multiple of earnings.

The tax and accounting treatments are similar to those for SARs. The recipient does not bear any tax liability at either grant or vesting of the phantom stock awards. At the time of exercise or payout, the recipient is liable for ordinary income tax on the total realized gain (i.e., the amount of the payment). Phantom stock plans may include dividend payments throughout the holding period, or accrued and paid at the exercise date. In either event, those dividend payments are also treated as ordinary income as of the date they are actually paid to the recipient.

As with SARs, the company must recognize an expense as a charge to earnings each year from the grant until the exercise of the phantom stock. This variable accounting charge recognizes the increase (or decrease) in value from year to year. When the award is ultimately paid to the recipient, the employer receives a tax deduction equal to the total value of the payment—which is also the total value of the charges to earnings over the life of the award.

Phantom stock is most common among organizations that are unable or unwilling to grant actual shares of stock to employees or others. By using phantom stock, organizations can provide awards in keeping with the competitive practices of their industry or other recruiting peer organizations. As such, phantom stock is most common among privately held companies, mutual savings and loan associations, hospitals, and not-for-profit organizations.

**Performance Units and Performance Shares**

Performance unit plans and performance share plans are similar; the primary difference is the ultimate payment or payment measure. Both types of plans provide an award that is tied to some formula or schedule over a specified period. Either the number of “units” or the value of a “unit” varies with performance over time.

For example, an employer may implement a performance unit plan for which the number of units delivered at the end of a period of time is a function of the company’s cumulative earnings per share (EPS) over that same period. In this example, the number of units paid to a recipient might be described by the table below.

<table>
<thead>
<tr>
<th>Cumulative EPS</th>
<th>Units Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0.00 - $0.75</td>
<td>0</td>
</tr>
<tr>
<td>$0.76 - $1.50</td>
<td>500</td>
</tr>
<tr>
<td>$1.51 - $3.00</td>
<td>750</td>
</tr>
<tr>
<td>$3.01 - $5.00</td>
<td>1,000</td>
</tr>
<tr>
<td>$5.01 - $7.50</td>
<td>1,500</td>
</tr>
<tr>
<td>$7.51 +</td>
<td>2,500</td>
</tr>
</tbody>
</table>

Based on this example, the number of units the employee would receive is based on the cumulative EPS over the measurement period. An interesting feature is that the units can also have a formulaic value—that is, a second level of performance measurement and reward. Each performance unit could have a value equal to the price of one share of stock, or a formula based on the book value of the company, or any other multiple that makes sense for the organization. The resulting payout could be designed to be either cash or company stock, or a combination of the two. Typically, if the payout is in stock, the “units paid” would simply be denominated in “shares.”

The plan structure and measures can change as the organization’s needs change. This gives plan designers the flexibility to create incentives and rewards that closely tie to the needs of the evolving business.

This plan only triggers a taxable event upon payment to the recipient, at which time the payment is treated as ordinary income. It is common within performance unit plans for executives to include a deferral provision to allow the executive to defer income into a nonqualified deferred income account. This deferral election puts off the tax moment until the payment is delivered, but the tax deferral comes as the result of “substantial risk of forfeiture.”

The employer receives a tax deduction at the time and in the amount of the employee’s taxable event. The employer’s expense associated with performance share plans and performance unit plans is somewhat more complicated. The organization must expense the anticipated payment over the performance period. Ultimately the total charge to earnings equals the total amount paid at the end of the performance period (or deferred at that time), but the accumulation of those charges is slightly subjective.

FASB requires that the organization recognize the expected payments over the total performance period. Calculating the expected payment from one of these plans is an art, but in the end, the final number is clear. During the interim years, the employer estimates the total anticipated payment and from that calculates the difference between (1) the cumulative prorata portion that should be expensed by that year, and (2) the cumulative amount that has been expensed already. The difference is the current year’s charge to earnings. This process repeats each year throughout the performance period.

There are three differences between this expense treatment for SARs or phantom stock plans and the expense treatment

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19 The Financial Accounting Standards Board.
for performance unit plans or performance share plans. The first is that the period is fixed by the plan’s performance period, so the employer knows the duration of the expense rather than it being subject to the actions of each recipient. The second difference is that the actual expense amounts each year are based on estimates of the ultimate payout rather than the full value accumulated to date each year. The third difference is that the expense is spread over the full measurement period, so each year the charge to earnings represents a pro-rata portion of the total expense. This has the effect of smoothing the expense of a volatile program vis-à-vis the expense associated with SARs or phantom stock.

**Misellaneous LTI Terms and Concepts**

A number of other terms come into play when managing long-term incentives. Some of the more common terms are described below for reference.

**Performance-accelerated vesting** is the concept of providing a vesting schedule tied to performance as an additional means of incorporating performance measures into the LTI reward scheme. The vesting normally is structured by starting with a time-based vesting schedule (e.g., seven-year cliff vesting) and then adding a vesting accelerator onto that (e.g., each year the company hits certain revenue targets, 25% will vest). Strict performance-based vesting schemes trigger variable accounting and are therefore more rare than performance-accelerated vesting.

**SARs** or **phantom stock** represent a pro-rata portion of the total expense. This has the effect of smoothing the expense of a volatile program vis-à-vis the expense associated with SARs or phantom stock.

**Indexed stock options** are stock options whose exercise price is determined based on a market index, rather than the normal fixed dollar amount at the grant date. Indexed options are appealing to stock option critics because the indexing, in theory, eliminates the broad stock market movement from the individual company’s stock price performance in determining the stock option gain at any point in time. Indexed stock options are not common or popular because they are subject to variable accounting; they have an unpredictable expense amount and duration as opposed to traditional stock options that currently have no expense at all. Also, in an up-market, indexed stock options reduce the value delivered to the recipient while adding the same dilution and a lot more expense than the traditional options.

**Underwater options** are stock options that have an exercise price higher than the stock’s fair market value. Underwater options have no intrinsic value but may have a fair value (or present value) that represents the possibility that the fair market value of the stock may some time exceed the exercise price before the expiration of the option.

**In-the-money options** are stock options that do have an intrinsic value. That is, they are options for which the fair market value of the underlying stock is more than the exercise price for the option.

The **Black-Scholes option pricing model** is a mathematical model developed in the 1970s to estimate a fair value of a stock option. This model has become the primary method used to value employee stock options. The model estimates the value of an option based on six variables:

- Current stock price
- Exercise price of the option
- Expected life of the option
- Expected volatility of the underlying stock
- Expected dividends on the underlying stock
- Risk-free interest rate during the expected option term

These assumptions plus some mathematics create a formula for the value of a stock option. The Black-Scholes formula is the most commonly used valuation methodology for FAS 123. The formula normally results in an option value at grant equal to 20% to 70% of the underlying stock’s fair market value.

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20 Strict performance-based vesting schemes are those that only vest upon achievement of performance targets, and if the targets are not met the awards are forfeited.

21 The **binomial model** is another mathematical model used for valuing stock options based on the same variables.