CEO

BEST PRACTICES FOR EQUITY COMPENSATION AND INCENTIVES

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The challenge for CEOs in today's fluid, and often volatile, market is finding stability through common sense efforts and creative solutions in attracting and retaining talent that propels your business to the next level. One practice is finding the best equity compensation and incentive program which best suits your business and satisfies your employees.

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Become A Destination Not A Stepping Stone

Attracting talent is one thing; retaining it is another. When developing equity compensation and incentive programs for your company, the idea is to create a package which attracts quality employees and keeps them motivated to stay. There are no blanket solutions, nor are there quick and dirty ways to incentivize your business model. This is not to say your only hope is throwing spaghetti at the wall and hope it sticks. There are key components which are universal through all business models if you know what to look for.

What is the purpose of equity incentive plans? "Incentive" is the key word. It's the motivation behind one's actions in order to generate a response. As the CEO, your main objective should be growth and sustainability. To do that you must have critical personnel who share your vision. Too many companies forego appropriate equity incentives. That is a pivotal error because when you deny your best people an opportunity to take ownership you hold them back from giving their all. Ask yourself: Do you want people to drive your business like a rental or their dream car?

Having a vested interest in the long-term viability of your business empowers your employees to work harder and strive for bigger, better things on a personal and professional level. The reward must justify the sweat-equity they put forth. In order to accomplish this, a stable, equally beneficial program must be put into place.

What is the difference between initial incentives and equity compensation? Who qualifies for it? Equity compensation offers non-cash opportunities for ownership and interest in your company, most commonly in the form of stock options. Initial incentives go beyond a regular paycheck geared more toward short-term rewards such as quarterly or annual bonuses based on company performance, and sign-on promotions when recruiting new talent.

It is important to remember that initial incentives and equity compensation programs are uniquely developed to push your business to the next level. Unfortunately, too many businesses mean well and have good intentions but wind up hurting their business and company morale. Take notice of what you have to offer, then look around and see if you are a destination or a stepping stone for top-tier employees.

Simplifying the Mechanics

Unless you are a corporate tax advisor, corporate financial planner, or stock options specialist, the subject of compensation plans, stock offerings, and protecting your assets can be overwhelming. The need to seek outside counsel and professional help in this matter cannot be stressed enough. There is no need to recreate the wheel when experts in compensation planning exist, but it is important to have a fundamental idea of what you will be providing. Offering equity compensation and incentives to your employees means you are committing a portion of your profits and ownership in the company. Do you really want to put your fiscal health at risk with guesswork?

KEY CONCEPTS

It is important to know if and when your stock is vested. Vested stock is when you can retain the real value of the stock even if the employer/employee relationship terminates. It is something they can take with them. This may be used as a "hook" to promote longevity in company.

There are tax consequences based on the fair market value of your stock. If you want to sell your stock to an outside entity, it is vital to know what the fair market share is worth after transaction fees and tax withholdings.

Early stage companies and start-ups have no history so their fair market value is undetermined. There simply hasn't been enough time to establish a per share value. They can use the public market as an indication of their estimated value but the tax implications should prompt you to tread carefully in uncharted waters.

STOCK GRANTS

As a CEO, stock grants may be awarded to employees, consultants, and members of your Board of Directors. There are special rules that apply when receiving these as incentive awards and even when there is an option to purchase stock.

Fully **vested** stock must be reported as compensation income which is equal to the value of the stock minus the amount that was paid into them. **Non-vested** stock may be treated as a taxable income and must be reported as income equal to the value of the stock at the time that it vests. When purchasing stock that is not vested, you have 30 days to declare its value. Not being a tax expert, it's highly recommended you speak with a tax consultant to help you navigate the waters and retain as much of the cash as possible.

NON-QUALIFIED STOCK OPTIONS

This is popular form of equity compensation, especially for early stage companies. If there is nothing to report at the time you receive these options, you report compensation income equal to the difference between what you received to what you had to pay at such time it becomes exercisable. As an employee this is subject to withholding. When selling these stock options, a capital gains and loss report must be filed. This includes any amount you pay for the actual compensation at the time it is exercised.

INCENTIVE STOCK OPTIONS (ISO)

This option is unique only by the fact that they are strictly for employees - no consultants, no board members, and no outsiders have this option. ISOs provide a real tax advantage for the employees but it creates a little bit of complexity for the company. This is important to note because with the tax advantages, you also take on a lot of the burden. If there is nothing to report by the time you receive these or the time you exercise them, there is an Alternative Minimum Tax that you must be aware of. There is a special holding period for ISOs because it allows the company to gain value over a period of time. If you sell the stock in the interim it is considered a disqualifying disposition and you must report compensation at the time of the sale.

Once again, it's important to seek out an accountant or tax advisor to see which direction best suits your company needs and objectives.

Compensation and Incentive Trends

A company called Equilar does an annual Equity Trends Report and supplies really interesting information on high level equity vehicles for an effective compensation strategy. This is for key individual contributors who are company makers or breakers but may also be offered to rank and file employees. This gives them ownership opportunities in your company. Here are some trends they gathered from researching the S&P 1500 Index in equity rewards for fiscal years 2007 through 2012. Note: These trends are not quarterly findings. They are based on multiple-year performance. Companies are shifting away from options and placing greater focus on granting full value shares. Restrictive stocks are at an all-time high

Performance based equity is gaining in popularity

Equity grant rates increased

Dilution rates fell dramatically

More stability versus volatile shifts

EQUILAR

Making Your Compensation Plan Scorecards Work

Planning. Anyone can build a compensation package. Winston Churchill said, *"Plans are of little importance, but planning is essential."* One size does not fit all. What works for one company might not work for yours so gear back on comparisons even with companies in a similar market. Don't let their problems become yours. Creating a scorecard is insight for where you are as a company at any given point in time. Let's preface this with saying there is no such thing as a perfect scorecard. It is fluid and always asking questions that bear answering. Where are we today? What's competitive in our industry? How can we grow? Where should we direct our focus? Where are we going tomorrow? These questions guide your compensation plan, which then drives employee behavior to get your business moving forward and upward.

Farmer or Hunter. You cannot lose sight that compensation plans are what drive behavior. Now consider the type of behavior you need. Do you need farmers who maintain and harvest what you have, or are you looking for hunters who beat the bushes, throw a wider net, and uncover new opportunities in the market? Those are two very different types of behavior. Your farmer is more steady-as-she-goes. Their job is to build long-standing relationships based on trust, commitment, and stability. Your hunter is scrappy and more transactional. They are the grab-them-get-them-who's-next type. Neither is right or wrong. In fact, you may need farmers and hunters but remember they are inherently different in personality and skill set.

Communication. Trickle-down conversations about compensation plans are often projected as force-feeding your lower ranking employees, which may be compounded by misunderstanding the nuances or a breakdown in communication. A strategic HR conversation is ideal in such cases.

Evolution. The compensation plan that you develop right now must also evolve with your company. Allow yourself corrective actions to protect your business. Make sure your best practices are relevant in maintaining and growing your business.

Compensation Drivers. If good employees are leaving then your compensation drivers are moving in the wrong direction. You must be aware of their value to your business while keeping an eye on the market and your competitive peers.

The overall purpose of offering equity compensation and incentives is to attract and retain good employees. Most successful professionals are financially motivated, but the real savvy ones are weighing job function against incentive packages. What you have to offer determines if they are going to kick the tires, use you as a stepping stone until the next best offer appears, or become vested in your company.

Is your compensation plan enough to make them stay? Is it competitive in the market? Are you attracting punch cards or leaders and owners?

Your business is not a democracy. There is no political polling. The decisions you make affect everyone under your banner. Keep an eye on your business scorecard and review it every six (6) months. Make definitive plans but be agile enough to make course corrections as necessary, preferably in advance of the next fiscal year.

Sample Compensation Plan Scorecard

Best Practice	0 *Satisfactory; no action required*	1 *Potential area targeted for improvement*	2 *Immediate action required*
1. The compensation plan attracts and retains the best people.			
2. The compensation plan is competitive in the market.			
3. The current plan rewards performance.			
4. The plan motivates a sufficient quantity of desired sales activities.			
5. Salespeople understand the plan.			
6. The plan drives customer results.			
7. The plan cost is reasonable.			
8. Performance measures are linked to the organization's goals.			
9. Salespeople believe they can meet performance standards.			
10. The organization gives salespeople the resources they need to meet their goals.			
Individual Column Totals (Number of checks)			
Multiply number of checks by:	x0	x1	x2
	0		

Compensation Plan Score (Sum of Columns 1+2+3)

Scoring and Interpretation

0 – 5 .... Congratulations! You have put a good sales compensation plan in place. Minimal corrective action is needed at this time.

6 – 20 .... You have a functional plan. Addressing some of the areas needing improvement could provide you with higher performance from your salespeople.

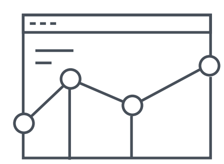
20+ .... You have a marginal plan with serious weaknesses that need to be corrected immediately. Making those adjustments can have a material impact on performance.

Ten Reasons Why Incentive Compensation Plans Fail

There's a saying: "The road to hell is paved with good intentions." No one wants to put their efforts into launching and building a business only to turn around and sabotage it. It is very exciting when you've gotten to the next echelon where you can now consider incentive compensation but let's preface this by stating two major hurdles: 1. Top line revenue payouts without paying attention to profitability is short-sighted, and 2. Incentivizing people without a clear plan for next-level growth will affect your bottom line.

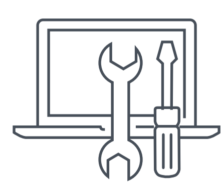
1. Who is accountable? Nothing is more deflating to company morale than a compensation plan based on something they have no control over. For example: Your sales reps have no control over how effectively you manage your warehouse or inventory. Be consistent, clear and concise about your company goals and the specific roles your employees play. Be sure to communicate your goals. Specificity drives credibility.

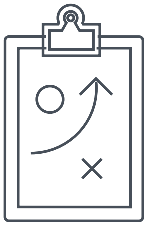
2. Am I being realistic? It is really nice to have an incentive program but not very functional when you dangle an impossible goal like a carrot on an unattainable string. It's demoralizing in the long-run. If your compensation plans are counterintuitive to the business objectives and strategies then you are setting yourself up to fail your people and your business.



3. Are my resources being allocated appropriately? Blanket compensation plans risk unnecessary stress and division among your people if there isn't a clear and concise way to distribute it. Be cognizant of what their specific goals and objectives are and reward them accordingly. If you don't have best practices in place, develop them - then implement them.

4. Do my people have tools and resources to strategically do their job? You have the right people for the job and they want to advocate for your product or services. They are performance-driven and hungry for education with skill and talent to achieve the best to offer as a business model. But if you don't provide the education and necessary tools to your associates then their efforts may not justify the rewards you put forth.





5. Do I have adequate evaluation models? How well do your people understand their role in your business? What is their job knowledge? How do they rank in problem-solving, troubleshooting, professionalism, motivation, and interaction with others? Evaluations are two-way communication tools: you get insight on their performance and style; they get an opportunity to refocus and develop new goals.

6. Are my metrics based on real numbers or where I want them to be? Dream about the possibilities of your business and what the next level is, but make sure your metrics are based in the here-and-now. Real numbers are needed to measure your true sustainability. Customer service must be great; performance goals met.

7. Are my best people allocated properly? We are born with intrinsic skill sets like being a people person, critical thinking, creativity, etc. Your employees are valuable assets and it's important to make sure they are utilized to the greatest potential.

8. Am I encouraging group or corporate division? Us vs. Them mentality will tear your business apart from the inside out. Compensation packages are made to promote motivation and forward movement but when not implemented correctly may instigate your people instead.

9. What is the purpose of compensation and incentives? Many businesses with equity compensation and incentive programs in place for a long time often lose sight of its purpose: To promote behavior that boosts your business and take it to the next level. Hoarding your resources is short-sighted and ultimately harmful to your company.

10. What is range of expectation? In a perfect world, all of your employees function at the top level; they are motivated, self-propelled, and go above and beyond for your business. If you reward your top achievers the same as those who simply show up to collect a paycheck then you strip away any motivation to level up. In the real world we have a range of expectation: Low - Medium - High. Your incentive programs should therefore have levels for achievement as well.

Overview of the Fundamentals

Be the main attraction. To attract and retain the best available personnel you must be clear, consistent and concise. Be succinct about company goals and make sure your bonus structure is based on milestones, but be fluid enough to make changes so you don't set yourself up for failure.

Watch your bottom line. Do not drain your cash or adversely affect the bottom line. Company objectives need to be met before bonuses are paid. Invest in the personnel who are instrumental to your success. These are the people who are the company makers or breakers. When they believe in you as an effective leader and they know you will take care of them, they will develop an emotional and financial ownership to your success. They have a vested interest so your success helps them achieve the next level in their success too.

Have a clear mission. It's one thing to have a mission statement and vision for your business, but if your key employees aren't vested you potentially face a revolving door, which may cost you in the long-run. It takes time and resources to train new employees. It also hurts the overall morale when good people leave because they don't feel like they are appreciated.

Match skill sets to the job. Hire appropriate people and be mindful of the skill sets required for the job at hand. Here's an example: Direct sales vs. Dealers. Direct sales people are closers. They seek out prospects, find valuable assets, close the deal and keep looking for more. They're scrappy individuals. Dealers handle wholesale numbers; they motivate others in a team-oriented atmosphere. These people generally seem more laid-back and develop relationships. Put a dealer in a direct sales position and they may not close a deal in a long time because they're trying to build a relationship. Throw a scrappy closer in a dealer's position and they may come off as abrasive. This is why evaluations and peer reviews are critical to business health.

Low - Medium - High. You will have employees that work at different levels based on what motivates them. Make sure your equity compensation and incentives program acknowledges that one size does not fit all. Low level employees do the bare minimum in acceptable performance. They show up and do what is asked of them - nothing less and nothing more. Medium level employees show up and do a good job but they have the potential to do better, if only they were more consistent. High level employees are self-propelled. They consistently go above and beyond the call of duty.

Your compensation packages should reflect and reward based on those varying levels of execution. If low level employees are compensated equally then nothing exists to motivate your high level personnel. It becomes demoralizing and counterintuitive.

K.I.S,S. Keep It Simple, Sweetheart. Keep your compensation plan simple so everyone understands them and drives employee and customer results. Be wary that it doesn't entice people to do the wrong thing for a promised payout. Numbers don't lie. Accurate inventory counts and audits don't lie. Make certain you reward good behavior and good results because rewarding bad behavior behind a smoke screen of good results is detrimental to business and your reputation.

Machete and jungle analogy. Things are great and everyone's excited about sharpening all the machetes. They're cutting down the trees, clearing the brush, and making a wide path. But no one's looked around and asked if we're even in the right jungle.

Make sure performance measures and evaluations are linked to the organizational goals. A great compensation plan is very valuable when you have the right people with the right behavior doing the right thing, but it doesn't do you any good if you're performing in the wrong direction.

Seek professional help. Before you implement a compensation plan, speak with auditors, tax professionals, and strategic consultants who specialize in these things. You want to invest in someone who is effective and efficient especially if your business is on the line.

One size does not fit all. Start-ups and fledgling enterprises will be looking for cost savings anywhere they can. It will be tempting to borrow someone else's model and compare/compete but you might end up sabotaging your company. What works for one company may or may not work with another. Be aware of what your limitations while setting your sights to where you want to be. Find proper counsel to make sure this is done right and done well the first time around. It will save you in the long run.

CONCLUSIONS

Don't lose sight of the fundamental value / purpose of equity compensation / incentive plans = right behavior

Long-term viability = get it right with outside help

Be nimble enough to make course correction as necessary

ABOUT THE AUTHOR

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David Nour is an enterprise growth strategist and the thought leader on Relationship Economics® —the quantifiable value of business relationships. In a global economy that is becoming increasingly disconnected, The Nour Group, Inc. has attracted consulting engagements from over 100 marquee organizations in driving unprecedented growth through unique return on their strategic relationships. Nour has pioneered the phenomenon that relationships are the greatest off balance sheet asset any organizations possesses, large and small, public and private. He is the author of several books including the best selling *Relationship Economics* – Revised (Wiley), *ConnectAbility* (McGraw-Hill), *The Entrepreneur's Guide to Raising Capital* (Praeger) and *Return on Impact – Leadership Strategies for the age of Connected Relationships* (ASAE).

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