

Adapting to an Option Expensing Environment

Three Steps to Prepare Your Organization Immediately

By Brett Harsen

The call to treat employee stock options as an income statement expense is among the loudest and most contentious cry coming out of the public debate on corporate reform.

INTRODUCTION

Some companies (approximately 200 publicly traded companies as of this writing) acted early by publicly volunteering to adopt SFAS 123, the accounting treatment resulting in charges against earnings for the use of stock options. Many of these adoptions occurred over a three-month period in the summer of 2002 — the year accounting scandals brought down some of America's largest companies along with one of the Big Five accounting firms.

What about the other 95 percent (approximately) of publicly traded companies in the U.S. that have not yet embraced option expensing? They seem to be taking a "wait-and-see approach," choosing to continue granting "charge free" stock options to employees until forced to do otherwise. And some others — especially those in the high-technology sector — are actively fighting the mandatory imposition of option expensing. Meanwhile, some shareholders, international standard setters and the Financial Accounting Standards Board (FASB) are calling for mandatory stock option expensing.

In mid-March, FASB voted unanimously to revisit the issue of option expensing this summer and shortly thereafter reiterated its position that accruing an expense for stock options is the appropriate accounting treatment. FASB has announced that it will issue some form of exposure draft to solicit public comment on the issue in the first quarter of 2004. Given widespread speculation that option expensing will indeed be mandated by 2005 at the latest, it is clear that human resources and finance managers must understand the impact these accounting changes will have on employee equity programs, company financial statements and ultimately, shareholder value. Companies do not necessarily have to accept the merits of SFAS 123, but prudent managers should exercise due diligence and prepare for its imposition.

This article neither debates the validity of option expensing nor

endorses one accounting treatment over another. Rather, it addresses the three-step process that every U.S. company using equity compensation should follow over the next few months in order to prepare for this fundamental accounting change. This article provides a technical discussion of only one component of compensation — long-term equity. To the extent that an organization relies heavily upon this piece of total rewards (e.g., high-technology's dependence on broad-based stock option programs), it is important to take a step back and ask whether a large-scale shift in compensation philosophy and pay mix is required. That said, evidence from every sector of the marketplace suggests employee equity will remain a vital component of compensation in some fashion, regardless of accounting treatment. This evidence makes proper planning even more critical.

STEP ONE —EXAMINING THE MERITS OF EARLY VOLUNTARY ADOPTION

The rash of SFAS 123 adoptions in 2002 prompted FASB to fine-tune the transition from "charge-free" option accounting to option expensing. Originally, a company electing to account for stock options using SFAS 123 had only one choice: begin accruing expenses only for the options granted in the year of adoption and all years going forward. When it issued SFAS 123, FASB realized that this prospective method of accounting leads to a "ramp-up" effect. This effect understates option expenses in the first few years of adoption, steadily increasing until equilibrium is reached three to five years down the road, depending upon vesting practices.

In December 2002, FASB issued SFAS 148, an amendment to SFAS 123 that provides a choice among three transition methods for voluntary adoptions:

- a) **Prospective method.** Recognize an expense equal to the fair value for all employee stock options granted in and after the year of adoption (the original SFAS 123 method).

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- b) **Modified prospective method.** Recognize an expense beginning the year of adoption as if the fair value method was used to account for all employee stock option awards granted since 1995.
- c) **Retroactive restatement method.** Restate financials to reflect fair value accounting of stock options since 1995. The big catch, however, is that the use of the prospective-only method will not be available for fiscal years beginning after December 15, 2003. As a result, companies that use stock options as an integral component of compensation may experience the opposite of the ramp-up effect (a “ramp-down” effect, if you will) if forced to use a full adoption transition method (defined as either method b or c above). Stock option expenses will be abnormally high in the first few years of adoption, slowly receding to equilibrium in later years.

Buck’s Strategic Equity Compensation Planning Tool

Buck developed a proprietary compensation planning tool to measure the impact of SFAS 123. The measures provided include:

- Earnings-per-share impact of prospective versus full transition to SFAS 123
- Analysis of the impact of using alternative long-term equity vehicles on:
 - Value delivered to employees
 - Shareholder dilution
 - Accounting charges to the company
 - Impact on earnings-per-share calculations

Buck uses this tool to help clients with stock option programs decide if it makes sense to take advantage of the prospective-only transition method through early adoption.

The tool also rates the ability of alternative equity compensation vehicles to meet company and human resources objectives in a new accounting environment. Additional information on this innovative planning tool — Equity Compensation Planning Tool — is available in a PDF on Buck’s Web site

Companies experiencing this ramp-down effect are those that are:

1. Granting options at a lower value today than that of the options currently outstanding, due to sharp decreases in stock price, and/or
2. Beginning to limit their option use on a “go-forward” basis as a result of increased shareholder dilution caused by more aggressive grant practices in the past.

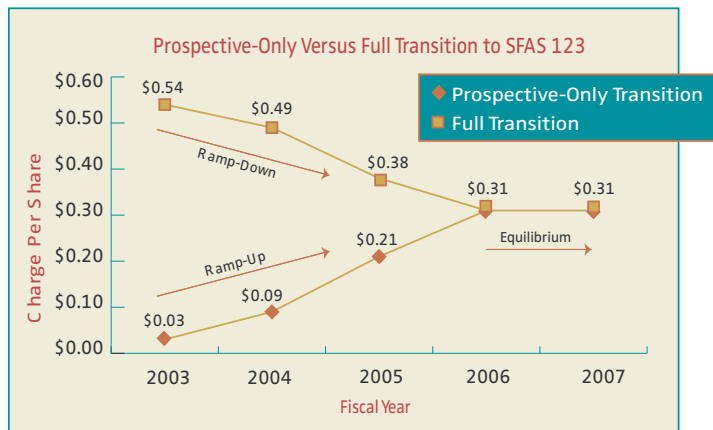
We know from the performance of the NASDAQ and NYSE markets over the past two years that many companies fall into the first category. Increased shareholder pushback over dilution caused by stock options places many companies in the second category as well.

Figure 1 illustrates the difference in the accounting charges accrued for prospective-only (i.e., ramp-up) versus full transition (i.e., ramp-down) for a hypothetical company that fits these parameters.

If a company is likely to find itself in a ramp-down situation, the critical question is whether or not to take a wait-and-see approach to SFAS 123 adoption given the potential loss of the financially preferable prospective-only adoption method. To explore this issue in more detail, every company should calculate the charges to earnings that would result over the next few years under each transition method. *This analysis must be done as soon as possible as the prospective-only method window is closing.*

Companies should understand exactly how the market will view these equity-related accounting charges. Will analysts view these charges as indicative of true company performance, or will they overlook them in favor of other financial measures? On this issue the jury is still out. However, polling company analysts may provide

Figure 1



valuable intelligence. The calculated data and feedback from analysts may be sufficiently compelling to prompt a company to adopt SFAS 123 early. However, if after considering the data and feedback a company decides to wait for FASB's mandatory imposition, it is making an informed decision based on its own due diligence.

STEP TWO — GOING BACK TO EQUITY COMPENSATION BASICS

It is now time to blow the dust off the old equity compensation manuals and examine the contents — as well as the organization's fundamental equity compensation philosophy. If the use of stock options requires a charge to earnings, companies must ask themselves whether certain employees will continue to receive as many options as they have in the past or, for that matter, will they receive them at all.

Additionally, the question must be asked whether stock options are still the right equity vehicle to use. As every human resources

manager learns in Equity Compensation 101, there is a lot more to stock than options alone. Other forms of equity range from the fairly well-known and understood like restricted stock to other, more exotic vehicles like performance shares, indexed options and stock appreciation rights settled in company shares (SARs). [See Figure 2.] (Please note that long-term formula cash plans and SARs settled with cash are excluded from the discussion as this article is intended to focus only on stock-based vehicles.)

Some of these other vehicles contain useful attributes such as performance hurdles and anti-dilution features. So why aren't they used more often? The simple answer is that, under current accounting rules (APB 25), these vehicles create accounting charges whereas traditional stock options are charge-free to the company.

The much-maligned variable accounting treatment makes some of these vehicles even more unpalatable. Variable accounting requires

Figure 2

Equity Vehicle	Description	APB 25 Treatment	SFAS 123 Treatment
Stock Options	<i>The right to purchase company stock in the future at a predetermined price</i>	<i>No charge to earnings if granted at fair-market-value Fixed charge to earnings equal to any discount below fair-market-value ("discounted options")</i>	<i>Fixed charge equal to the fair value at the time of grant based on an option valuation model such as Black-Scholes</i>
Stock Appreciation Rights (SARs) Settled in Stock	<i>Right to receive company stock in the future equal in value to the spread between the then fair-market-value and an "exercise price" established today</i>	<i>Variable charge to earnings recorded each reporting period equal to the spread between the stock's fair-market-value and the exercise price</i>	
Indexed Stock Options	<i>The right to purchase company stock in the future at an exercise price that fluctuates with the up or down movement of a particular stock index</i>	<i>Variable charge to earnings recorded each reporting period equal to the spread between the stock's fair-market-value and the index driven exercise price</i>	
Restricted Stock	<i>Right to receive a full-value share of company stock at a pre-determined point in the future</i>	<i>Fixed charge to earnings equal to the full fair-market-value of the underlying stock on the date of grant</i>	<i>Fixed charge to earnings equal to the full fair-market value of the underlying stock on the date of grant</i>
Performance Shares	<i>Right to receive a full-value share of company stock if and only if certain predetermine performance goals are met</i>	<i>Variable charge to earnings measured and recorded each reporting period equal to full fair-market-value of the underlying stock</i>	

Note: While there are multiple variations on these five primary equity vehicles, this article focuses on these alone in the interest of facilitating a high-level overview.

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Figure 3

Objective	Likelihood of Achieving Objective				
	Low				High
Emphasize reward for performance	Restricted Stock	Stock Options	SARs	Indexed Options	Performance Shares
Maximize employee retention	Performance Shared	Indexed Options	Stock Options	SARs	Restricted Stock
Reduce shareholder dilution¹	Stock Options	Indexed Options	SARs	Restricted Stock	Performance Shares
Minimize accounting charges¹	Stock Options	SARs	Indexed Options	Restricted Stock	Performance Shares
Allow for ease of communication/administration	Indexed Options	Performance Shares	Restricted Stock	SARs	Stock Options

¹ Assuming equal value being delivered to employees under each alternative vehicle.

the difference between the value of the company stock underlying the grant and the amount, if any, the employee has to pay to acquire it be measured at each reporting period and deducted from the company's earnings. Not only is this charge subject to fluctuation from period to period, but is uncapped as well — the higher the stock price goes, the higher the expense. The fact that unknown, uncapped earnings charges are the kinds of things that keep CFOs up at night clearly explains why most companies won't even consider some of these vehicles. SFAS 123 effectively levels the accounting playing field. As Figure 2 illustrates, SFAS 123 removes the accounting bias against particular equity vehicles. Every form of equity compensation now involves some level of expense, but that expense is always fixed and it is always known at the time of grant. Freed from the quagmire of variable accounting, companies operating under SFAS 123 can now choose the vehicles that best meet their specific business and human resources objectives. Figure 3 illustrates each equity vehicle's effectiveness in meeting five common objectives.

There is no "one-size-fits-all" solution. Each company must define its own particular objectives and chose the vehicle(s) that will best achieve them. In many cases, the solution may involve taking a menu approach. Choosing the best mix of vehicles by organizational unit and/or by employee level. Hypothetical case studies of two organizations considering changes to their equity programs in preparation for option expensing are presented on pages 4 and 5. The companies find themselves in very different situations and therefore require different solutions.

COMPANY A

Industry: Plastics Manufacturing

Historic Practices: Use of equity compensation concentrated only at the top of the house. Equal mix of traditional stock options and restricted stock granted on an annual basis.

Challenges: The cyclical nature of the business results in fairly predictable ups and downs in the company's stock price. While the stock price is not extremely volatile, this cyclicity resulted in a substantial number of stock options being underwater for extended periods of time. Shareholders are questioning the heavy use of restricted stock, indicating that it amounts to a give-away of company value without emphasizing sustained performance. They point out that the company's typically very low turnover and strong loyalty in the senior management ranks negates the need for restricted stock to act as a golden handcuff.

Solution: Company A decides to replace 50 percent of the target long-term equity award value with indexed options linked to a set of peer companies in the same the performance of Company A relative to its peers and will automatically adjust for the external market factors that create the industry's cyclical stock movement. Executives will be rewarded when Company A outperforms the peers, regardless of the absolute movement in stock price.

To counter shareholder concerns regarding the possible over-compensation indexed options may provide during market downturns, the company provides the remaining 50 percent of the

target long-term equity award value in the form of performance shares. The performance shares are tied to pre-defined financial goals and will provide an incentive for executives to drive absolute results in addition to those relative to a peer group.

With this solution, Company A avoids underwater options as long as it is outperforming peers, and the give-aways associated with the restricted stock are replaced by shares that are only delivered if shareholder-acceptable performance objectives are met.

COMPANY B

Industry: Software and Software Services

Historic Practices: Traditional stock options granted to all employees. No other equity vehicles used.

Challenges: Because of Company B's heavy reliance on stock options to attract and retain talent at every level in the organization, its issued stock option overhang (number of options outstanding as a percent of total common shares outstanding) is above its industry's average. Retention is a significant issue at the company due to its Silicon Valley location and the close proximity of many direct labor competitors. Shareholders, while generally supportive of broad-based option usage, are concerned over the high levels of potential dilution. Additionally, some investors are advocating a greater pay-for-performance focus at the senior management levels.

Solution: Company B recognizes shareholder concerns over potential dilution, but must reconcile this concern with the broad ownership culture inherent in the high-technology marketplace where it competes for labor. In order to remain competitive and to preserve its employee ownership culture, the company decided to switch from granting traditional stock options to SARs settled in stock for all employees below senior management. These SARs have the look and feel of traditional options from the employee perspective and, therefore, maintain the equity culture and provide for a transition that is easy to communicate to employees. However, based on the company's projections, these SARs will require about 70 percent fewer shares to settle than would traditional options, resulting in far lower shareholder dilution.

For the senior management, 50 percent of target equity award value is delivered using SARs with the remaining 50 percent in the form of performance shares tied to specific financial objectives. The SARs provide a less dilutive alternative while helping to address the

company's concerns over retention in the very competitive industry in which they operate. The performance shares address the shareholders' desire for greater pay-for-performance linkage for the top of the house.

STEP THREE — SELL THE NEW PROGRAMS TO SHAREHOLDERS AND EMPLOYEES

Even the most elegant solutions to equity compensation challenges can fail if they are not properly executed. One of the most important aspects of proper execution is communication — to both shareholders and employees.

Communicating with shareholders occurs when companies are getting their authorization to make equity program changes. Both the NYSE and the NASDAQ approved new corporate governance rules that require shareholder approval for any new equity plans or any material modifications to existing plans.

The majority of plans currently in existence are referred to as "plain vanilla" plans that allow only for the granting of traditional stock options or, in some cases, restricted stock. Since many companies' current plans do not allow for the use of alternative equity vehicles, shareholder approval is necessary to modify the plans. Getting the approval requires informative and diplomatic communication. The proxy statement must be transformed from an obligatory disclosure filing to a carefully written campaign statement explaining exactly how these requested equity program changes are good for the company, for employees and, ultimately, for shareholders.

In preparing this statement, it is imperative that the company researches the interests and preferences of its investors. Many institutional investors, for example, want to be consulted on the issue of equity compensation early in the process. While investors may recognize the benefits of certain equity vehicles, they may also want to limit the amount and/or timing of such grants in any given period. Spending a little face time with these important shareholders up-front may yield a wealth of information that can be incorporated into the proposed equity plan to facilitate its approval.

Once a company obtains shareholder approval, it must turn its attention to employees. Any changes to the status quo will be met with some resistance; the better the explanation for the change, the easier the transition. Unfortunately, inadequate employee communication is all too often the reason for failed programs.

Buck Proxy Solicitation Services

Given that shareholders now debate equity compensation practices through proxy actions, many organizations are turning to external proxy solicitation experts to facilitate open communication with those shareholders. Solicitation services also educate proxy voters on a company's compensation practices, since obtaining shareholder approval for those practices is in the best interest of all involved. Buck provides clients with strategic proxy solicitation services. It assists clients by engaging their shareholders in productive discussions that lead to shareholder approval of corporate proposals.

The most useful advice is to be open and honest — something easier said than done. As always, employees must understand why any particular path was chosen, and specifically, how these changes relate to the company's compensation philosophy and the organization's overall rewards system.

The highly publicized accounting scandals of 2002 and the ongoing option accounting debate can also be used to the company's advantage in this situation. The much publicized push for increasing corporate governance reforms may make it easier to explain to employees why programs need to adapt to the new business environment. Placing the changes to the company's equity programs in a real-world context enables employees to be more informed and less anxious.

IN CLOSING

Just as there is no "one-size-fits-all" equity compensation program, there is no single path to follow when making the transition from APB 25 to SFAS 123. But the three steps outlined here provide the foundation for a systematic, logical approach to successfully making the change.

The final chapter in the debate over option accounting is by no means over. Prudent human resources and financial managers, however, must proactively make the best of this limited window of opportunity to understand what the implications could be for their companies should FASB choose to mandate the expensing treatment. By doing so before FASB makes its next move, organizations will be poised to react decisively when the time comes.

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