

What If Stock Options Are Expensed?

Scenario Planning For Future Long-Term Compensation

- ◆ *Momentum is building to require expensing of stock options.*
- ◆ *Companies cannot afford to merely participate in the debate.*
- ◆ *Companies should begin thinking now about how they might change their reward strategies if options become an income statement expense.*



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CURRENT OPTION EXPENSE PROPOSALS

The movement toward requiring an income statement expense for stock options has accelerated remarkably in the months since Enron declared bankruptcy.

Those in favor of expensing options have significantly more support than when the issue was debated by FASB and Congress in the 1990s. We believe there is now a reasonable chance of an expense charge requirement in some form, perhaps as high as 50/50, despite President Bush's recent declaration of support for the *status quo*.

THE "CAMPS" ¹	
Pro Option Expense:	No Option Expense (Status Quo):
<ul style="list-style-type: none"> • Federal Reserve Chairman Alan Greenspan • Financial Accounting Standards Board (FASB) • International Accounting Standards Board (IASB) • Some Institutional Shareholders/Shareholder Organizations • Warren Buffet • Senators Levin & McCain • Treasury Secretary Paul O'Neill 	<ul style="list-style-type: none"> • President Bush • US Chamber of Commerce • Corporate Lobbies • Senator Lieberman* • SEC Chairman Pitt

* A recent proposal by Senator Lieberman would provide tax incentives (0% capital gains rate) for "long-term" holdings (shares held at least 3 years) if companies adopt stock option plans where at least half the options are granted to non-highly compensated employees.

There are two potential methods for calculating option expense charges being seriously discussed.

1) Expense options at the time of grant based on an estimate of options' "fair value" (such as Black-Scholes value)

This is the most commonly considered approach. Stock option "fair value" is estimated using an option pricing model (the most common is Black-Scholes). It is important to note, however, that "fair value" is only theoretical and not based on any actual cost. This gives its critics substantial reason to object.

2) Expense options based on actual value realized by employees at exercise

This approach is less commonly proposed, but it does reflect the real values realized by option holders. Under this approach, stock option expense equals the total value in the option when it is exercised by the employee. The costs of this approach clearly are onerous to companies when option gains are material.

Our discussion will focus primarily on how executive compensation might change if the much more likely "fair value" approach is enacted.

¹ The debate about whether or not options should have an accounting expense has been well documented in recent press, including the following articles; "Stock Options Come Under Fire in Wake of Enron's Collapse", *The Wall Street Journal*, March 27, 2002, and "Options: It's Time for Companies to Come Clean", *Business Week*, April 1, 2002.

HOW THE EFFECTS OF THE OPTION ACCOUNTING CHARGE MIGHT PLAY OUT

INITIAL IMPACT

In the discussions to date on this topic, legitimate questions have been raised on the impact of options' expense on company valuations and access to capital and talent.

In terms of any one-time expense of already outstanding stock options upon a change in accounting rules, we would not expect a dramatic impact on valuations. We tend to side with perspectives recently expressed by Alan Greenspan that markets are sophisticated with respect to the impact of stock options on earnings and recent research to this effect. We believe that any required one-time charges likely will be treated as were the one-time expenses from implementing FAS 106 in the early 1990s when companies were required to account for projected retiree medical costs. Companies booked large accounting charges, but did not experience significant changes in valuation—that is, the market was sophisticated enough not to overreact.

As regards access to capital and talent, some companies, like technology start-ups, will be genuinely damaged if charges are required. It may also make it more difficult to recruit talent to troubled companies, who can least afford any additional expense. Established companies will need to adjust to retain talent. It will probably be painful, but those who adjust fastest and best may actually gain a competitive advantage.

ONGOING IMPACT

As a change in the accounting rules becomes more likely, smart companies will re-examine the rationale and efficacy of their current long-term pay programs in the “new world”. They also will examine the flexibility they have under their current shareholder-approved plans to change the forms of long-term pay going forward. Influencing companies' review of their current long-term pay practices should be a clear view of how and why current stock option practices came to be.

THE OLD WORLD CASE FOR STOCK OPTIONS REVISITED

Most company's stated goals for stock option plans include:

- Competitive practice (other companies offer this opportunity)
- Attract and retain talent (people want and expect options)
- Align management and shareholder interests (options gain value only when stock price rises)
- Motivate sustained long-term performance (options last 5-10 years)

These philosophical reasons will lead some companies to react to an option expense charge by resisting any change. We believe that companies could be well served by examining their “reasons” to understand all the factors which led to the quantum leap in stock usage over the last five to ten years.

First, as important as the stated philosophical goals, the truth is that the 90's bull market made everyone aware of a vast potential wealth in stock options, making them very attractive to employees. Second, the market moved with extreme focus on earnings expectations, making extra compensation expense anathema (or at least problematic) and these expenseless options even more attractive. And, finally, as long as stock prices kept rising, there was a happy coincidence of employees being rewarded and shareholders being content. If bull markets lasted forever, there probably would be no real force behind today's debate on option expensing.

THE NEW WORLD CASE FOR LESS PLAIN VANILLA PROGRAMS

However, bull markets don't last forever and the regulators typically fight the last war, not the next. So, just when options will be less valuable (in a bear market) and their use would probably naturally taper off anyway, we see a regulatory drive to limit them.

During the last decade when so many factors lined up to favor stock options, it is no surprise that most companies abandoned other vehicles, such as cash long-term incentives that focused on value-enhancing financial performance. They also by and large rejected such notions as performance-oriented or indexed stock options, because these carried an accounting expense and required much higher dilution to deliver value equivalent to their garden-variety brethren, the plain stock option. At the same time, institutional investor organizations criticized restricted stock as a "gift".

However, in our "new" less bullish markets, some flaws in the universal use of stock options are beginning to emerge. Chief among these, in our view, is that in many circumstances, options are now valued *less* by employees than their theoretical "fair value".

Particularly for mature companies, both our experience and some recent academic research² tell us that employees will put a relatively low value on new options because of uncertainty that they will have real value in a reasonable timeframe in a problematic stock market.

To the extent this is true, then the addition of an accounting charge for options may well make them an *inefficient* compensation vehicle—many will have less perceived value to talent than their "cost" to the company. The longer an essentially down or even flat market continues, the truer this will be. (Those of us practicing since the 70's remember when executives much preferred restricted stock or cash incentives because they perceived that even with good company performance, the equity markets did not return the favor with an increased stock price.)

Of course, there will remain some situations where employees will value stock options at or above their "fair value" (where stock price prospects are rosy). Also, the shareholder-friendly nature of stock options, where the employee gains only when the shareholder does, cannot be ignored.

Stock options will continue to be heavily used, despite their expense, in turnaround and start-up companies where the prospects for future stock price growth are high if the company is successful. However, options alone may not do the job, given their expense.

² "Stock Options for Undiversified Executives", *Brian Hall and Kevin J. Murphy*, February, 2001.

WHAT WE EXPECT TO SEE IF OPTIONS ARE EXPENSED

If stock options must be expensed, we believe many companies will review, and then change, their current long-term incentive programs. We can make some additional hypotheses about what changes we would expect to see in long-term incentive practices.

- The first trend we expect to see is a continuation of companies' recent exploration of long-term incentives besides stock options. Some companies have begun looking at other long-term program alternatives in response to the stock market slowdown and resulting underwater stock options. We have outlined a number of alternative long-term incentive designs in the tables following this discussion and describe the programs and their accounting treatment under current and proposed accounting rules.
- As companies examine other long-term incentive designs and deal with the "cost inefficiency" of stock options (for lower to moderate growth companies), we expect to see them moving to hybrid (or multi-vehicle) long-term incentive designs where different kinds of programs are combined based on the company's pay strategies. For example, a company's long-term incentive strategy might include some stock options, some cash performance plans and some restricted stock. We might expect to see companies focus their use of options on more senior corporate positions where they are likely to be valued more, and perhaps be more appropriate from a shareholder perspective, and less on junior employees or business unit management. Cash incentives or stock with stronger line-of-sight to direct and measurable contributions might take the place of broad employee stock option programs.
- One likely outcome is that restricted stock will be an apparent long-term incentive of choice for many companies. Its cost to the company will be less (or, at most, the same) as its perceived value by employees. Depending on shareholder reaction, the use of restricted stock could still be met with resistance by organizations like Institutional Shareholder Services (ISS).
- Cash long-term incentive plans and performance share plans would likely become much more prominent. Companies may take the opportunity to design business unit incentives (including value creation sharing plans or simulated equity) to drive specific performance in key parts of their organizations. As companies use cash long-term incentives more frequently, shareholders will likely require more disclosure in order to approve the plans. We would expect increased scrutiny of long-term incentive plan performance measures and even specific payout formula disclosure to be considered.
- If the company's shareholder-approved plan allows only stock options, the company will have limited flexibility in dealing with option expense. We expect to see companies assuring themselves of future flexibility by returning more to the "omnibus" plans of the 80's and 90's—plans which allow a "smorgasbord" of choices, including restricted stock plans in various forms, performance cash or performance share plans as well as stock options.

Whether or not the accounting rules change, now is also a good time for companies to take the time to review their long-term incentive plans, returning to fundamental guiding principles, and to make sure they are wisely using equity-based and/or cash long-term incentive plans to drive business performance and create shareholder value.

STOCK OPTIONS

Type of Stock Option	Description/Accounting	Comments
FMV Stock Option	<p>Description</p> <ul style="list-style-type: none"> A stock option with an exercise price equal to the fair market value (FMV) of the company's stock at time of grant. An employee only realizes value if the stock price rises above its at-grant level. <p>Current/Future Potential Accounting</p> <ul style="list-style-type: none"> No expense currently. In future, may have expense based on "fair value" under various proposals being discussed. More remotely, could bear an expense on actual value received by the option holder when they exercise. 	<ul style="list-style-type: none"> Current accounting treatment (no expense), tax benefit (employer gets tax deduction when employee exercises) and the 1990's bull market have made FMV stock options the long-term incentive of choice for most companies. Options will likely continue to be an important long-term incentive which shares a portion of <i>incremental</i> stock price gains with employees who help create those gains. Companies would be likely to moderate use of options overall and develop other long-term incentive vehicles in tandem with and/or in place of options. Stock options will continue to have high employee perceived value in situations with strong stock price growth/recovery prospects (high growth companies, start-ups and turnarounds).
Discount Stock Option	<p>Description</p> <ul style="list-style-type: none"> A stock option with an exercise price <i>below the FMV</i> of the company's stock at time of grant. The option has some value even if stock price doesn't increase after grant (as long as the price does not decrease below the exercise price). <p>Current/Future Potential Accounting</p> <ul style="list-style-type: none"> Currently expense equal to the aggregate discount amount is recognized over the vesting period. If fair value option expense is enacted, expense will be higher than current expense. 	<ul style="list-style-type: none"> Discount options have more value per option to employees than FMV options requiring fewer options granted to deliver the same long-term incentive (LTI) value. Shareholder opposition to discount options and their extra earnings charge has and will create limits on their use.
Premium Priced Stock Option	<p>Description</p> <ul style="list-style-type: none"> A stock option with an exercise price <i>above the FMV</i> of the company's stock at time of grant. The option only has value if the stock price increases above the at-grant FMV and further still above the exercise price after grant. <p>Current/Future Potential Accounting</p> <ul style="list-style-type: none"> No expense currently. If fair value option expense is enacted, will have <i>less</i> expense per option than FMV options. 	<ul style="list-style-type: none"> Used in some situations with senior executives as an added achievement hurdle; but a much larger number of premium options are required to deliver a given value. Typically are not effective for lower level employees who may not perceive much value in a premium option. Favored by shareholders, they have less expense per option than regular options under a "fair value" expense and could see more use in start-ups, turnarounds and where Board/ leadership expects high stock price appreciation.
Indexed Stock Option	<p>Description</p> <ul style="list-style-type: none"> An individual's stock option gain is based on stock performance relative to an index – only outperforming the index is rewarded <p>Current/Future Potential Accounting</p> <ul style="list-style-type: none"> Expense equal to the aggregate in-the-money (intrinsic) value at exercise is estimated ("marked to market") over the life of the option. 	<ul style="list-style-type: none"> Although highly performance oriented and "shareholder-friendly", onerous variable accounting charges make issuing indexed options disadvantageous relative to stock options. Also requires more indexed options to deliver a given LTI value.

RESTRICTED STOCK

Type of Restricted Stock	Description/Accounting	Comments
<p>Time Vesting (“Normal”) Restricted Stock</p>	<p>Description</p> <ul style="list-style-type: none"> A share of stock that becomes owned by employee at the end of a vesting time period. <p>Current/Future Potential Accounting</p> <ul style="list-style-type: none"> Fixed expense equal to the aggregate grant amount (number of shares X price per share at grant) is amortized over the vesting period. 	<ul style="list-style-type: none"> Currently restricted stock is used sparingly except in special situations including; as a component of long-term incentives for senior executives, as special awards upon hire/promotion to increase share ownership, as a deferral in annual incentive plans to promote share ownership. As a long-term incentive, shareholders prefer stock options over a restricted stock “gift” since they require an increase in stock price for the award to have any value. In the future, if stock options carry an income statement expense, restricted stock might become a preferred long-term incentive despite shareholder distaste.
<p>Performance-Accelerated Vesting Restricted Stock</p>	<p>Description</p> <ul style="list-style-type: none"> A share of restricted stock that will become owned by the employee at the end of a vesting time period. The stock can vest sooner than the time vesting period if specified performance objectives (e.g., hitting and maintaining a stock price target) are met. <p>Current/Future Potential Accounting</p> <ul style="list-style-type: none"> Same expense as time vesting restricted stock, i.e., a fixed charge based on aggregate grant value (number of shares X price per share at grant). If the accelerated vesting occurs, the expense accelerates as well. 	<ul style="list-style-type: none"> A slightly more shareholder-friendly form of restricted stock, but still less favorably viewed than options since employees will ultimately receive the stock even if the performance objectives are not achieved. Expense is fixed at stock price at grant, so not subject to variable accounting.
<p>Performance Vesting Restricted Stock</p>	<p>Description</p> <ul style="list-style-type: none"> A share of restricted stock which vests <i>only</i> if performance objectives are met. <p>Current/Future Potential Accounting</p> <ul style="list-style-type: none"> Expense equal to the aggregate award value at time of vesting is accrued for over the vesting period (i.e., the total expense charge is variable based on the number of shares that ultimately vest and their price at the time of vesting). 	<ul style="list-style-type: none"> Although this is the most shareholder-friendly form of restricted stock, the accounting treatment discourages its use since the earnings charge is uncapped instead of fixed at the grant value as it is for other forms of restricted stock.

CASH LTIP

Type of Long-Term Incentive	Description/Accounting	Comments
Cash Long-Term Incentive Plan	<p>Description</p> <ul style="list-style-type: none"> An incentive plan that can be designed with customized performance measures and payout formulas – based on performance over period of years – with payouts made in cash. <p>Current/Future Potential Accounting</p> <ul style="list-style-type: none"> Currently expense equal to the full value of the expected payouts accrued over the plan term. 	<ul style="list-style-type: none"> If options are expensed, cash plans would make a comeback as companies recognize their potential efficiency (but goal setting always has the potential to be problematic).

PERFORMANCE SHARES

Type of Long-Term Incentive	Description/Accounting	Comments
Performance Shares	<p>Description</p> <ul style="list-style-type: none"> An incentive award earned for achieving specified performance objectives over a period of time plus/minus change in stock price. Incentive payouts typically made in shares of stock. <p>Current/Future Potential Accounting</p> <ul style="list-style-type: none"> Expense equal to the full value of the payouts, including stock price change, is accrued over the plan term. 	<ul style="list-style-type: none"> More typically seen in larger, more established companies that can “afford” long-term incentives charges for a limited executive population. Has same accounting and payout characteristics as Performance Restricted Stock, but with less perceived “Restricted Stock” taint. However goal setting is often an issue. In the future, performance share plans could see an increase in popularity as they can be structured to focus on both financial and stock price performance (for example, value creation in a business unit).

LEVERAGED STOCK PURCHASE

Type of Long-Term Incentive	Description/Accounting	Comments
Leveraged Stock Purchase	<p>Description</p> <ul style="list-style-type: none"> A purchase of company equity by an employee. The employee’s capital contribution is leveraged by a company contribution or loan. <p>Current/Future Potential Accounting</p> <ul style="list-style-type: none"> Currently treated as a purchase (no compensation expense) if employee contributes all capital or loan has sufficient recourse. Compensation expense based on ultimate value of shares purchased if employer contributes part of purchase price without sufficient recourse. 	<ul style="list-style-type: none"> Currently used occasionally in start-up/early stage organizations or special circumstances. Major problems have occurred at companies when the stock price falls and executives cannot pay off their loans. For example, the outsized loans to certain executives such as Hilbert at Conesco and Ebberts at WorldCom have added a considerable taint to loans to executives. Some Boards will hear “loan” and want nothing to do with it. In a stock option expense environment, start-up companies may increasingly investigate these more complex and riskier types of plans.