



IR Strategy Series

The Two Faces of Employee Stock Options

Powerful employee incentive or corporate looting technique?

In the wave of accounting scandals, investor disillusionment and proposed reforms following the collapse of Enron Corporation, few issues have generated as much attention and divisiveness as that of employee stock options. The debate over incentive stock compensation centers on two questions:

- What is the proper accounting treatment for employee stock options?
- Are stock options effective in aligning management incentives with the creation of shareholder value?

The outcome of this debate will have dramatic and continuing effects on the capital markets, due to the potential impact both on companies' financial statements and on the way in which employees and management participate in corporate value creation. More profoundly, this issue will have a direct impact upon sustaining investor confidence and interest in the equity markets.

The battle over options has been joined at a ferocious level by all relevant constituencies, including: the Congress, the Securities & Exchange Commission, the Federal Accounting Standards Board (FASB), the International Accounting Standard Board (IASB), industry groups such as the National Chamber of Commerce and the National Venture Capital Association, Standard & Poor's, and many powerful shareholder groups, controlling many billions of dollars in equity assets.

At one end of the debate is the premise that stock options are a vital non-cash element of compensation

required to attract and retain talented employees. Equity-based compensation, it is argued, contributes to decisions that maximize shareholder value by aligning

the interests of management with the owners of the company.

Reformers make the argument that the use of options in recent years has ballooned into a massive transfer of wealth from shareholders to senior management; that this has created perverse incentives for managers to manipulate results and maximize short-term performance; that options are not adequately accounted for as an expense, which is a deception to shareholders; and that the excessive use of options represents a ticking bomb with respect to future share dilution. A final tax policy argument is that current accounting rules do not require options to be subtracted from reported profits as an expense, but allows them to be subtracted from taxable profits in determining corporate taxes.

Therefore, crucial questions arise with regard to the fiduciary duty of directors and management to faithfully represent their financial results, maximize shareholder value and avoid corporate abuses. What are the emerging best practices in stock option policy and corporate disclosure? How can directors balance the objectives of retaining talented employees and providing management with proper incentives, while protecting shareholder interests? These questions should be at the top of the corporate agenda in today's environment and require that managers and directors reexamine their assumptions about equity incentive compensation.

“Though options, if properly structured, can be an appropriate, and even ideal, way to compensate and motivate top managers, they are more often wildly capricious in their distribution of rewards, inefficient as motivators, and inordinately expensive for shareholders.”

– Warren Buffet

The Evolution of Options – From Innovation to Excess in 20 Years

The seeds for the current perceived excess in the use of stock options were planted in the early 1980s when boards began to look for ways to give managers stronger incentives to increase shareholder value. At that time, it was believed that the poor performance of many public companies could be attributed to the fact that top managers in most instances did not have significant ownership stakes in the companies they managed. This led them to make sub-optimal decisions regarding capital allocation, expansion and overhead expense, which in turn led to the destruction of shareholder value. In economic parlance, such decisions are referred to as “agency costs,” which can encompass everything from investing in low-return industries, to maintaining a fleet of corporate jets, to avoiding risky, high-return growth opportunities.

By providing managers and employees with stock options that enable them to capture the benefit of future share price appreciation, the operators of the company will be encouraged to think like owners – focusing on shareholder returns rather than personal perks or empire building. Since the option gospel was first preached twenty years ago, there has been a dramatic increase in the portion of total compensation provided in the form of options. In the early 1980s, the average stock option grant was less than 5% of salary and bonus. According to the research by the Federal Reserve, in the early 1990s stock options were still typically smaller than an executive’s base salary. By 1998, the average senior executive was receiving stock options equivalent in value to more than twice his or her base salary and cash bonus combined.¹ And this trend continues to accelerate. A recent study by Bear Stearns accounting analysts estimates that stock option compensation for the S&P 500 grew at a compound rate of 56% per year for the period of 1998 to 2000, outpacing the growth in earnings by several factors.²

The impact of treating these munificent options grants as an expense would be dramatic. According to the same Bear Stearns study, the S&P 500’s aggregate earnings would have been reduced by 10% if options were expensed. For many heavy issuers of options, it would take them from net profit into a net loss. The reported earnings of communications equipment companies in the S&P would have declined by 170%, while computing and networking stocks would have

taken an 89% hit to earnings. Such a profound downward earnings revision would clearly have an even greater impact on emerging growth companies that are heavy issuers of options and generally carry high price-to-earnings multiples. Small-cap technology equities would be much more severely impacted than old-economy, mid- and large-cap companies.

“I fear that failure to expense stock option grants has introduced a significant distortion in reported earnings – and one that has grown with the increasing prevalence of this form of compensation... Confusing markets is neither helpful nor permanent. If underlying corporate input costs are real, they cannot be obscured indefinitely.”

– Alan Greenspan

Finally, there is share dilution, the ticking bomb that impacts the float, shares outstanding and earnings per share. In 1982, options accounted for, on average, less than 3% of capitalization; in 1992 options increased to 7% of capitalization; in 2001 options were over 20% of capitalization. Cisco Systems, for example, discloses in a footnote to its financial statements that there are 354 million shares in exercisable options, a third of the 1.06 billion shares outstanding. As these options are exercised and the underlying shares are sold, the ownership interest of existing shareholders in future earnings is reduced proportionately. In order for shareholders to be made whole, either the company must buy back (higher priced) shares on the open market, or earnings growth must be so robust so as to compensate for exercised options share dilution – if not, the company will be unable to maintain a sustainable price earnings multiple.

In recent months there have been several important events that promise to dramatically alter the landscape of employee stock options:

- The International Accounting Standards Board (IASB) has issued an initial recommendation to require that all public companies record stock options as an expense in their income statements.
- A bill has been introduced in Congress that would deny significant tax benefits to companies that don’t expense options.
- Leading policy makers, including Federal Reserve Chairman Alan Greenspan, have expressed support for such reforms.

- Standard & Poor's has announced that going forward it will include options expense in its calculations of "core earnings" and has encouraged companies to provide the data required to calculate this impact on a quarterly basis.
- There has been a sharp increase in support by institutional investors for proposals to require shareholder approval for stock compensation plans.

Accounting Treatment of Stock Options

Determining the proper accounting treatment for the issuance of employee stock options is one of the most contentious and confusing issues in accounting policy. Part of this stems from the complexities involved in accurately estimating the value of derivative securities. While these techniques are commonly used by Wall Street traders and students of finance, they remain obscure to many managers, accountants, lawyers and even executive compensation experts. The confusion stems from the difference between the **intrinsic value** of an option (the spread between the exercise price and the current market price of the stock) and the **imputed** or **fair value** of that same option, which refers to the price that a rational investor would be willing to pay for the right to purchase shares at a fixed price for that period of time. This excess fair value over the intrinsic value is a function of the length of the option, the volatility of the underlying security, and a number of other inputs. For a free-trading option, this value can be reliably estimated using the Black-Scholes option pricing formula. However, these calculations are less precise for valuing employee stock options, given that the options vest over time and are not freely tradable.³

In 1994, FASB issued an exposure draft that suggested that options were indeed part of compensation expense and therefore should be charged against income at fair value, as determined by Black-Scholes. Financial executives, accounting firms and business groups entered into a pitched battle to derail this accounting reform. Technology companies in particular argued that expensing options would limit their ability to attract employees, inhibit capital formation and otherwise destroy the free market economy. Eventually bills were introduced in Congress that would have stripped FASB of its power to set accounting policy. The opposition to the new rule was so fierce that FASB eventually decided to allow companies the option of whether to deduct options as an expense in the face of their statements or provide this information as a pro forma footnote. Not surprisingly, only two companies in the S&P 500 have

chosen to burden their published EPS figures with this discretionary charge.

"The debate on accounting for stock-based compensation unfortunately became so divisive that it threatened the Board's future working relationship with some of its constituents. Eventually the nature of the debate threatened the future of accounting standards setting in the private sector."

– FASB Statement No. 123

Despite the FASB decision, dissatisfaction with option accounting has continued to simmer in the background. Warren Buffett famously summarized this line of dissent: "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses shouldn't go into the calculation of earnings, where in the world should they go?"⁴

Recently, the International Accounting Standards Board has picked up the battle where FASB left it, proposing that options be expensed at fair value, measured as of the vesting date (as opposed to date of issue, per FASB.) This proposal, which could impact U.S. standards by 2005 if adopted, has provoked a hue and cry from the same constituents who fought FASB's reforms. More immediately, Standard & Poor's issued a revised policy on measuring corporate earnings, under which this expense will be deducted from its calculations of "core earnings" from ongoing operations.⁵

The most significant current vehicle to reform stock options is the Levin-McCain-Fitzgerald Stock Options Bill S.1940, which amends the Internal Revenue Code of 1986 to provide that corporate tax benefits from stock option compensation expenses are allowed only to the extent that such expenses are included in a corporation's financial statements. Presently, a corporation may deduct for tax purposes the difference between the grant price and exercise price to the extent the options attribute that difference as income to the option holder.

The following table illustrates the current accounting versus tax treatment of stock options, and compares it to the proposed treatment under the bill. While companies could still footnote the estimated expense as before, this is unlikely due to the increased conservatism of major accounting firms, the desire of management and board members to preserve a valuable tax deduction that increases cash flow, as well

as a renewed interest in improving the transparency of financial statements.

COMPARISON OF ACCOUNTING AND TAX TREATMENT OF EMPLOYEE STOCK OPTIONS

CURRENT RULES		
	ACCOUNTING TREATMENT	TAX TREATMENT
Date of Grant	<p>Earnings Statement: Footnote disclosure of number of options granted during the period and display of impact on current earnings of estimated future value of options. Estimate is made using "Black-Scholes" formula that takes into account expected future volatility of stock. At time of grant, it is not known if stock price will rise, fall or stay the same. As an alternative, companies could reduce their earnings by the estimated future value of stock options.</p> <p>Balance Sheet: No impact</p>	No tax impact. An option granted at current market price has no "readily ascertainable market value." The tax code links corporate deductions for stock options to the time when the employee exercising an option includes the "spread" on exercise in income. The employee has no income and the employer gets no deduction at the time the option is granted.
Date of Exercise	<p>Earnings Statement: No earnings impact. Exercise of options by an employee is a transaction that is external to the operations of the company and has no place on the earnings statement.</p> <p>Balance Sheet: Company records receipt of payment for shares from employee as an increase in cash and an increase in paid-in capital in the amount of the exercise price.</p>	Employee includes in income the difference between the market price and the option price of the stock and pays income tax at individual rate. Employer records deduction for the same amount that employee includes in income. Amount of tax paid by employee usually more than amount of tax saved by employer due to higher individual tax rate.
LEVIN-MCCAIN-FITZGERALD BILL (AS DESCRIBED IN BILL SUMMARY)		
Date of Grant	<p>Earnings Statement: Same as current rules except that because of the tax cost associated with the footnote disclosure method, very few companies would provide the footnote and would, instead, reduce their earnings in the amount of the hypothetical value of the options granted.</p> <p>Balance Sheet: No impact.</p>	No tax impact. Same as current law
Date of Exercise	<p>Earnings Statement: Same as current rules.</p> <p>Balance Sheet: Same as current rules</p>	Amount of employer deduction limited to the amount of earnings reduction taken in year options granted Employee would include in income full amount of difference between market price of stock and option price. Mismatch occurs between amount employee includes in income and deduction allowed to employer.

Do employee stock options contribute to increasing shareholder value?

If adopted, these new accounting rules promise to place companies' equity compensation policies under an even greater level of shareholder scrutiny. While some members of the public may object to executive compensation that they deem to be unseemly, most sophisticated investors will agree that managers who engender truly superior performance are usually underpaid. Their concern is that many managers are being compensated for poor performance or for simply "swimming with the tide" due to the way in which most options plans are currently constructed. The concerns can be summarized as follows:

- Since most options are 10-year options issued at the market price, executives capture the gains attributable to a rising market, rather than to superior performance.
- Because executives are not required to hold the actual stock, they do not share the downside risk to which other investors are exposed.
- The desire to put their options "in the money" will sometimes induce senior managers to make positive projections that are unsupported by the facts. Executives then cash out, and other

shareholders are left holding the bag (Enron being a notable example).

- Because the imputed value of an option increases as stock volatility increases, managers may have an incentive to pursue high-risk projects.
- Companies that either overtly (through an option exchange program) or tacitly (through increased options grants) reprice options when the share price falls are rewarding managers for poor performance.

The issues and empirical evidence regarding the optimum construction of an equity compensation policy are complex and still evolving.⁶ However, the underlying principle is simple: It is in the interest of shareholders to provide managers and employees with equity compensation to the extent that the marginal increase in shareholder value that results is in excess of the Company's cost to provide that compensation. Because the Company always has the option to sell free trading options and then pay this cash to the employee, the Black-Scholes pricing model provides a reasonable estimate of the opportunity cost of issuing these securities to employees. Companies typically cite three primary reasons for providing stock options as part of employee compensation:

- 1) Options enable companies to attract and retain talented people who are critical to the company's success. (This is particularly true in sectors where the market opportunities are very large and technology changes very rapidly.)
- 2) Options enable young companies to reduce their cash usage and thus avoid issuing stock at unfavorable current valuations.
- 3) Options create a powerful incentive structure that aligns employee efforts and management decision-making with creating shareholder value.

There exists significant academic evidence that granting options does make a contribution to improving corporate performance for reasons 1 and 2.⁷ However, the record on the benefit of using options to align management incentives is far less clear. For this reason, in setting their equity incentive compensation policies, managers and boards of directors should focus on two primary questions:

- What is the appropriate level of employee stock options in which the marginal gains in firm performance will outweigh the fair value of the options that are issued?
- How can an options plan be designed so as to maximize the incentive alignment for senior management?

In every case, these decisions will be driven by company-specific factors, including: the degree of dependence on key personnel; level of competition in the labor market; the perceived size of the market opportunity and achievable earnings growth rate; the mix of salary, bonus and stock compensation; the risk and diversification preferences of individual managers. Nonetheless, there are some broad ideas that companies should consider so as to prepare for this potential change in accounting policy and better position themselves with the investment community.

Five ways to improve your stock option plan

1. Establish a corporate policy regarding maximum stock option dilution.

As recently as 20 years ago, stock options comprised 5% or less of the company's capitalization. Today, stock option packages have ballooned to 25% to 35% of total capitalization. Boards of directors are increasingly developing corporate policies to establish limitations with respect to the percentage of

stock options relative to capitalization, to not exceed approximately 5% to 20% of total capitalization, depending on the growth stage of the company. Such programs can further ensure that the number of stock options will not exceed a fair balance to shares outstanding. Implicit in setting stock option policy is the anticipated future growth rate of earnings per share. In that regard, option packages directly linked to corporate performance can ensure that the number of options issued is proportional the rate of increase in earnings per share, so that options and EPS growth stay in balance. Fewer options would be issued, if any, during those periods in which earnings growth is below normal.

2. Establish mandatory stock holding for senior executives.

So as to better align the interests of management and shareholders, many companies have recently begun to require that top management maintain a target level of stock holdings, typically set at two to five times their annual salary. The ownership of a significant number of underlying shares is likely to instill a more long-term perspective in management and counteract the incentive to increase earnings volatility and/or reduce dividend payouts. A recent study by the Wharton School established that such programs result in improved financial performance and stock returns within the two year period after such programs are put in place.⁸

3. Match share re-purchase programs to stock option packages.

Generally, corporations design stock re-purchase programs to counter share price declines beyond what management thinks is the fair market value. Assuming that past stock option packages may have extended beyond the ranges described in recommendation #1, boards should consider the use of share re-purchase programs to rebalance stock option packages so as to not exceed the norms incorporated in the first recommendation. Microsoft is a consistently generous issuer of employee stock options that also deploys a significant portion of its free cash flow to repurchase shares from the market. In this way shareholders and the investment community can feel more comfortable that share dilution will not exceed earnings per share growth, thereby adversely impacting price/earnings multiples.

4. Consider out-of-the-money or indexed options

Equity investors expect to be compensated for the risk of holding common stocks by achieving a certain rate of return. Otherwise, why would they buy equities versus bonds? However, most long-term investors would be happy to compensate top management for returns that consistently beat those of their industry or a market index. If the company decides to put in place a generous options package for senior management, then it is reasonable to expect that it will contain an expected minimum rate of return that management must exceed. This can take two forms. **Out-of-the-money options** are set so that the exercise price incorporates the minimum expected return investors would demand over a ten-year period. In this way, options would only benefit an executive whose share price beats the average return that is expected by equity investors. **Indexed options** are constructed so that the exercise price is keyed to the trend of a basket of industry peers or to a benchmark such as the S&P 500 or Russell 2000 indexes. That way, managers are not punished for downturns in the broader market or rewarded for bull-market exuberance. Because each out-of-the-money or indexed option has a much lower imputed value, managers can be issued many more options to compensate them for the increased risk they bear. Such options also have a higher **delta**, meaning that the holder stands to gain more from a given increase in share price.⁹ Only a CEO who strongly believes in both the company's prospects and his or her own abilities is likely to embrace such a leveraged compensation scheme. Such a shareholder-friendly philosophy is likely to attract growth-oriented investors who prefer for management to bear a greater degree of economic risk.

5. Carefully communicate the company's incentive compensation philosophy and design

With a well constructed employee stock option plan in place, the final step is to construct a thoughtful and consistent communications plan to explain the objectives and plan mechanics to investors, employees and other interested parties. Long-term institutional investors understand that the ability to attract and retain superior management teams and talented employees is a key determinant of success; they are also aware that even in the recent downturn, competition for proven talent remains intense. As long as the company is able to demonstrate that its policies are truly oriented towards achieving superior returns, and not the

enrichment of management, they will support and understand the use of options as a key element of a performance-weighted approach to compensation.

Summary

The debate about stock option policy is currently accelerating, not diminishing. Examples, such as Steve Case of AOL receiving nearly \$100 million in long-term stock options during a period in which the company has lost \$50 billion in market capitalization, are attracting reformers from all camps. Knowledgeable directors and managers concerned about their fiduciary duty to shareholders will be wise to anticipate this issue and begin the reform process today. A rational, thoughtful policy, pegged to increasing shareholder value and lowering the cost of capital, will likely be rewarded by loyal shareholder support.



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¹ "The Impact of Employee Stock Options on the Evolution of Compensation in the 1990s," Hamid Mehran and Joseph Tracy, Federal Reserve Bank of New York, March 2001, page 5.
² "Employee Stock Option Expense: Pro Forma Impact on EPS and Operating Margins - The S&P 500," Bear Stearns, Pat McConnell, September 2001, page 7.
³ Most senior executives believe that the Black-Scholes model significantly overstates the value of option-based compensation, as it does not take into account that management members are restricted from trading their company's stock for much of the time and are forced to maintain an undiversified net worth. Interestingly, studies have shown that middle managers often vastly *overestimate* the fair value of their stock options. In addition, because most employees will tend to exercise their options once they are "in the money," they forfeit an average of 50% of the theoretical value of their options through early exercise. (Mehran and Tracy, page 4.)
⁴ Essays of Warren Buffet: Lessons for Corporate America, Warren E. Buffet, 2001, page 215.
⁵ "Measures of Corporate Earnings," Standard & Poor's, May 14, 2002.
⁶ "Executive Equity Compensation and Incentives: A Survey," John E. Gore, Wayne Guay & David F. Larcker, The Wharton School, January 2002.
⁷ "Performance Impact of Employee Stock Options," Simi Kedia and Abon Mozumdar, Harvard University, January 2002.
⁸ "Performance Consequences of Mandatory Increases in Executive Stock Ownership," John E. Gore & David F. Larcker, The Wharton School.
⁹ "Pay to Performance Incentives of Executive Stock Options," Brian Hall, Harvard University, July 1998.