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[Options in for an overhaul](#)

- Kathleen Pender

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If you work at a company that offers stock options or an employee stock purchase plan, part of your pay package could be in for an overhaul.

This week, the Financial Accounting Standards Board will propose a new rule that could profoundly change the way companies compensate employees with stock.

After a comment period that could result in minor changes, the rule is expected to take effect for fiscal years starting after Dec. 15 for public companies.

The rule will require companies to record as an expense on their income statements the estimated value on the grant date of employee stock option and stock purchase plans.

This will reduce reported earnings (but not cash flow) for companies that offer stock option and/or purchase plans. To minimize this expense, many public companies say they will modify or even discontinue their plans.

The rule change will result in a much wider array of stock-compensation schemes, which could make it harder for employees to understand what they're getting and to compare one company's pay package against another's.

Today, companies have the option of recording the estimated value of employee stock option and stock purchase plans on their income statements as an expense or merely as a footnote. Until recently, almost all companies chose the footnote option, because it did not reduce reported earnings.

To qualify for the footnote, options had to meet strict requirements. If a company strayed from the script -- by tying options to performance, for example -- the options had to be "expensed."

Since almost nobody wanted to record an expense, most companies offered employees the standard footnote-eligible option.

In the future, all stock options must be expensed (although companies will still have a lot of leeway in valuing them). All other forms of cash and equity compensation, such as restricted stock and stock appreciation rights, already must be expensed.

The rule will free companies to craft new types of options, and to mix or replace them with other types of stock compensation.



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"There will be more variety on equity awards. Instead of one size is made to fit all, some companies will choose awards more appropriate to their situation," says Corey Rosen, executive director of the National Center for Employee Ownership.

Some companies are already doing this at the executive level.

Last year, only 83 percent of CEOs received option grants, down from 87.9 percent in 2002, and the median number of options awarded declined by 7.5 percent to 323,824, according to a study published last week by Equilar. The study covered 223 companies in the S&P 500 index that have filed proxies for 2003.

Meanwhile, the percentage of CEOs receiving restricted stock rose to 29.1 percent in 2003 from 26 percent in 2002, while the median value of those awards rose 39.2 percent to \$2.7 million.

The change has begun

Some companies are already making changes across the board.

Microsoft has replaced all employee stock options with restricted stock, which has less upside potential and less downside risk. Companies typically replace options with one-quarter to one-third as many restricted shares.

Coca-Cola has replaced employee stock options with stock appreciation rights. These rights give employees a bonus equal to the appreciation in the company's stock over a certain period. The bonus can be paid out in cash or shares. Coke is paying it in stock.

As companies seek to reduce their option expense, or tailor options to their needs, the "plain vanilla" option that employees have come to know and love will fade away, predicts George Paulin, president of compensation consulting firm Frederic W. Cook.

The standard option lets employees buy one share of stock at a set price, called the strike or exercise price, over 10 years. The strike price is equal to the stock price on the date of grant.

In the future, options may be issued with a strike price that is higher or lower than the stock price on the grant date. The option may only become vested, or available to exercise, if and when the company meets certain financial targets or if its stock price beats some index.

Some companies may reduce the term of the option to less than 10 years. In the mathematical formula that companies use to value options, reducing the term generally reduces the expense.

Employee stock purchase plans also may change, although not as drastically as options.

In a stock purchase plan, employees divert money from their paycheck to buy company stock at a discount. The stock is purchased once a period. The period could range from six months to two years, with one year being typical. The stock is purchased at a discount -- usually 10 or 15 percent -- off the market price on the beginning or ending date of the period. This "look-back" feature gives employees an additional profit, above the stated discount. Once they purchase stock, employees may hold it or sell it.

An employee stock purchase plan is similar to a stock option, with a shorter term. That is why the new rule will require companies to expense the estimated value to the employee of stock purchase as well as stock option plans.

"About 45 percent of companies say they will make changes in their employee stock purchase plans," says Rosen.

Some say they will eliminate the look-back period and/or the discount. This will reduce the expense the company must report, and discourage some employees from participating, which will reduce the expense even more.

Companies also could reduce the period, from say 12 months to six. This would have little impact on employees but would reduce the company's expense, the same way that shortening the term of an option would.

Some companies could impose a longer waiting period before new employees become eligible for the plan, or reduce the maximum purchase amount below the \$25,000 allowed by law.

Paulin has two large corporate clients that will require employees who acquire stock through a purchase plan to hold it for at least one year.

"They say, 'If I have to expense this, I want to have an ownership requirement,' " he says.

Other clients are afraid to impose an ownership requirement because if the stock price plummets, the company doesn't want to look as if it was "actively encouraging employees to hold shares," says Paulin.

Although some companies may eliminate their stock purchase plans, some may keep them going and kill options instead.

Stock market impact

How quickly and drastically companies change their compensation practices will depend, in part, on how shareholders react. Companies that are large option granters could post substantial earnings declines. If their stock prices fall in response, companies may take swift, dramatic action.

But because the buildup to option expensing has been so long and well publicized, and companies already disclose their option expenses in footnotes, shareholders may yawn. In that case, companies may react more leisurely.

About 40 to 45 percent of companies say they will eliminate options for non-management employees if they are forced to expense them, Rosen says, but he thinks the actual number will be closer to one-third.

Intel and Cisco Systems, two of the biggest opponents of mandatory option expensing, declined to say what they will do.

In addition to expensing, other factors could force companies to cut back on options for

rank-and-file employees.

Until June, option plans that were broad-based (meaning more than half the options went to non-officers and directors) needed only board, not shareholder approval. Starting last June, all option plans must be approved by shareholders.

Given the focus on option abuses at the executive level, and on the dilution caused by some broad-based plans, shareholder approval may be harder to get.

Also starting last year, brokers who hold stock for shareholders can no longer vote on option plans when the rightful shareholders don't. That could also make it harder to get approval for option plans, because brokers tended to vote with management.

Some people are hoping the new rule will rein in executive compensation. But that is not the rulemakers' intent and is not likely to happen. Although companies may replace options with other forms of stock or cash, executive compensation is not likely to come down.

"A lot of companies will cut out the lower people. The top executives won't be hurt," says Jesse Brill, chair of the National Association of Stock Plan Professionals.

Rosen agrees. "Executives won't suffer. One way or another, they will get their outrageous take," he says.

Net Worth runs Tuesdays, Thursdays and Sundays. E-mail Kathleen Pender at kpender@sfgate.com.

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