

COMPENSATION: STOCK OPTIONS

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The Way Things Were

Someone working during the bubble years of the 1990s would have been very aware of a compensation tool that was earning accolades: stock options. Whether awarded options themselves or aware of someone who had been, they would have known that some of the most dynamic companies were offering compensation packages that included sizeable option grants. Chances are good, too, that such a person would have known, known of, or read about someone (or perhaps several people) who grew rich thanks to options.

The boom years are now a memory, but so is the recession that followed them, and so employees surveying the job market, remembering the gains that can be had from options, are interested in receiving options as a part of their compensation packages. These same employees will quickly note that options grants today are decidedly smaller, and offered less often, than they were only a few years ago. Why?

Companies are less generous with options now because in 2004 the Financial Accounting Standards Board (FASB) issued a rule change mandating that options be expensed. Prior to the rule change (FAS 123R), the pertinent FASB guidelines for proper accounting treatment of options were covered in FAS 123: "Accounting for Stock-based Compensation". FAS 123, adopted in 1995, suggested that options be expensed in the manner they are now. However, since this was only a suggestion few companies acted on it and the financial statements of most public companies seemed to indicate that their options programs had no cost.

Arguments against Expensing

The National Venture Capital Association (NVCA), probably the biggest opponent of FAS 123R, has been vocal in criticizing several aspects of it. Objecting to the cost of the measure, the NVCA maintains that FAS 123R will impose \$80,000 - \$130,000 (or more) in additional annual costs for private companies that issue options. Noting that the value of an option grant is unknown at the grant date (and could potentially be worthless), the NVCA has attacked the value of existing options pricing models and maintains that the best course would be a return (at the very least for private and newly public companies) to the reporting requirements in existence prior to FAS 123R. Arguing that the granting of options is a cash-free transaction, the NVCA maintains that options do not represent an expense. And, oddly, the NVCA has employed the argument that stock options should not be considered compensation. The NVCA, led by president Mark Heesen, has done a remarkable job arguing against FAS 123R, but to date those arguments have not convinced FASB to alter its position.

Counter-Arguments to the NVCA's Objections

- 1 Cost of compliance: FAS 123R addresses a broad swath of companies, and the companies which have stock option plans will tend to be able to absorb the additional costs of complying with the new accounting regulations.
- 2 Difficulty in valuing options: FAS 123R specifies two options pricing models (both of which tend to return similar values) that the financial community has largely accepted as providing reasonable estimates of the value of options.
- 3 Options as an expense & Options as compensation: Warren Buffet, perhaps the world's most successful investor, has this to say on the subject: "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?"

New Compensation Plans

Without a doubt, compensation packages in the era of options expensing will be different (though notably, most firms that will be affected by FAS 123R have not yet implemented or even announced changes in compensation structure), but they will not necessarily be worse. Cash compensation will most likely rise. Options grants will continue to be offered, but more judiciously. Restricted stock grants will probably be employed more widely. Compensation plans as a whole will tend to be geared more towards performance, and broad-based, generalized plans will disappear. Employees need not reduce their expectations, but only adjust them.

The size of option grants and the number of employees receiving them are likely to decline. But this decline will not affect all employees equally. Many HR experts believe that broad-based options plans will be eliminated, while executive options grants will be merely trimmed.

By assigning a cost to options, FASB may have done a great favor for traditionalists who prefer cash. When Dell announced in 2003 that it would reduce the number of options it granted the company opted to offer senior executives larger cash bonuses instead. Likewise, Yahoo has de-emphasized options and emphasized cash bonuses. It is hardly a nightmare scenario to imagine employees ending up with fewer options and more cash.

Options are not the only form of equity compensation, and with the loss of their preferential accounting treatment, companies will feel free to utilize other forms of equity compensation, most notably restricted stock. Unlike options, restricted stock has value on the day it is issued, and many human resources professionals believe it may be a more effective retention tool than options. There is considerable evidence that companies intend to make use of this tool. Microsoft, on the day it announced that it would cease offering stock options, informed the investment community that it would instead offer grants of restricted stock. If other firms follow Microsoft's lead, employees could end up with compensation packages whose value is considerably less volatile.

The 1990s are over, but talented employees will continue to be well rewarded by the companies that seek to hire and retain them. Although the full extent of changes in compensation is not yet known, the design of compensation packages will almost certainly change. However, the premium that talent demands will continue to be paid; employees need only reorient themselves to a new mix of compensation.

What to Look for in a Compensation Package

Employees and job seekers would be well advised to rid themselves of any sense of entitlement they may have. Employers are willing to offer lucrative compensation but will do so only if they are receiving value for their dollar. Performance-based compensation is the overall trend in the job market, and those willing to perform at a high level will find themselves compensated at a high level. A recent survey of 74 (public and private) Silicon Valley technology companies by Top 5 Consulting Group highlights this trend:

<u>Types of Vehicles:</u>	<u>% of Cos Considering:</u>
Restricted stock or restricted stock units	55%
Performance share or cash plans	36%
Performance accelerated restricted stock	29%
Performance contingent stock option plans	12%
Cash based profit sharing plans	10%
Stock appreciation rights (SARs)	10%

Premium or indexed stock options

2%

Employees and job-seekers should keep the following in mind:

- 1 Those holding or seeking non-executive positions will tend to see the cash component of their compensation plans increase and a reduction in the equity-based compensation.
- 2 Equity will remain a key component of executive compensation plans, but will increasingly feature restrictions intended to better align the interests of employees and shareholders.

Additional Issues

For most employees, the capital gains tax paid on stock sales is considerably less than their income tax rate. As a result, a heightened emphasis on cash compensation will for some have negative tax consequences. There is currently no indication that employers view this as a serious issue, and for the time being this will have to be considered a regrettable side-effect of a necessary change.

While the NVCA loudly proclaimed that venture-backed firms would not raise their levels of cash compensation if the options expensing rule were adopted, there is no indication that venture-backed firms have lost their appetite for high-quality employees, and they will likely follow the overall compensation trends outlined in this article.

In addition to editing the weekly newsletter for HireSites, Scott Brown also was responsible for the development of its flagship services, ResumeDirector and ResumeArrow. HireSites specializes in resume distribution and posting services to help job seekers streamline the search process. For more information, Scott can be reached via email at sbrown@resumedirector.com or by phone at (212) 545-5318.