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SPECIAL FEATURE

Stock Compensation: A Look at Past and Future Options

by Brad Hill

"Did You Know?" See inside back cover for updates that concern you!

OnLine

This Month

✷ COMMUNICATIONS

Can Your Plan's Participants Take a Market Swing in Stride?

It wasn't "black Monday," but the recent volatility in the stock and bond markets has created quite a reaction among investors.

In that environment, you don't want your employees making inappropriate investment choices and locking in losses. That unfortunate outcome can result when participants don't have the tools to make investment decisions that are right for them.

The good news is that employees with a longer view of their investment strategy (and perhaps more importantly, those that *have a strategy*) are taking the market changes in stride.

Those who did weather the recent upheavals successfully have something in common. They are knowledgeable about basic investment concepts. In many cases, their employer created an environment that supported smart decision making.

How You Can Help

A variety of investment options and the flexibility to move between them are very desirable plan features. But the more choices you offer, the harder it is for many participants.

In fact, the greater the array of possibilities, the more likely someone is to opt for a "safe" choice now and worry about a strategy later. If they do include stocks or bonds in their portfolio,

SPECIAL FEATURE

COMPENSATION PROGRAMS

Stock Compensation: A Look at Past and Future Options

Compensating employees through stock options has dominated the news recently. Most of the attention has been given to the FASB proposal to require recognition of a compensation expense for granted options. As we go to press, the outcome of the FASB proposal is uncertain. However, the focus on stock compensation is sure to continue.

At the same time that many corporate boards are examining the FASB implications and whether stock options have any redeeming values, some companies are expanding plan participation to include all employees. Following is a critical look at offering stock options to all employees, and a review of some clever alternative stock programs.

A stock option is an option to purchase shares of company stock at a stated price over a given period of time, frequently 10 years. Stock option plans are typically adopted because they are believed to facilitate employee ownership in company stock and tie the employees' gains to the shareholders' gains. Roughly 80 percent of all major companies in America offer stock options to executives.

Options will be much more valuable at the "most improved" company...

Recent moves by Pepsico, DuPont, Waste Management, Merck and Pfizer, to name a few, indicate a growing trend to push stock options deeper into the organization, offering options to employees at all levels. In tandem with this move, is consideration of using stock options to replace a portion of employees' annual salary increases. These trends demonstrate an increasing focus on stock options as a compensation vehicle. Should the total earnings of all employees be tied, in any way, to stock price? Let's examine how prudent it is to use stock options as a form of compensation for the rank and file, and what other forms of stock compensation could more meaningfully reward employees.

What Determines Stock Option Value?

In order to assess whether stock options are a fair way to incent and reward employees — that is, whether they encourage employees to work longer, harder or smarter — let's examine the primary factors influencing the value of stock options.

- **Company performance.** The extent to which a company performs above expectations is a major influence on stock price. For a company that consistently attains a return on equity of 25%, it may take a heroic return on equity of 30% to exceed expectations and therefore to budge the stock price. But for a company that regularly realizes a 5% return on equity, a 10% return may send the stock price soaring. It is not necessarily the performance level that determines the market value, but rather the performance versus expectations. Options will be much more valuable at the "most improved" company than at the company that has consistently performed at an outstanding level.
- **External business factors.** The impact of a competitor's pricing or the cost of raw materials are just a couple of the items that can affect a company's stock price.
- **Market psychology.** The ebb and flow of the general market may lift a stock price higher in times of optimism and high consumer confidence, and it may bring a stock lower in anxious, uncertain times.
- **Option grant date.** The value of a stock option may be profoundly impacted by the date on which it is granted. If stock options are granted at a low point, the future is bright. If options are granted at a high point, it may be some time before they realize any sizeable appreciation.

STOCK PROGRAM EFFECTIVENESS

Ability to Meet Program Objectives

Stock Program	Long-Term Ownership	Reward Past Individual Performance	Reward Future Company Performance	Provide Compensation	Link Executive Gains to Shareholders	Increase Shareholder Value
Stock Options	Low	Medium	Medium	Medium	Medium	Medium
Restricted Stock	High	Medium	Medium	High	Low	Low
Salary Replacement Options	Medium	Low	Medium	High	High	High
Purchased Options	Low	Low	Medium	Low	Medium	Medium
Premium Options	Medium	Low	High	Low	High	High
Performance Options	Low	High	Medium	High	Medium	Medium
Index Options	Medium	Low	High	Low	High	High
Vesting Schedules	High	Low	Medium	Low	Medium	Medium
Restricted Match	High	Low	Medium	Low	Medium	Medium
Deposit Shares	High	Low	Medium	Low	Medium	Medium
Career Shares	High	Low	High	Medium	High	High
Contingent Grants	Low	Medium	Medium	Medium	Medium	Medium

- **Option exercise date.** Finally, an element that most employees will have some control over. . . the date that they exercise the option.

The Problem with Options

Most investors would agree that in the long term, company performance will be the most significant predictor of stock price. Further, in today's employee involvement environment it is admirable to communicate to employees that everyone can make a difference, and to reinforce this message by offering everyone stock options. But, with the only item under the employees' control being the option exercise date, it is likely that the only activity the employees will work harder or longer at is examining the day to day movement in company stock price. Stock options for the general employee population will not meet their intended motivational, ownership, or shareholder value objectives for the following reasons.

- **No line of sight.** The most powerful incentives are those that link a payout to results that are directly under the control of the employee. Few employees can see the impact that their contributions have on stock price. The inability to directly link employee efforts with stock price destroys the motivational value of options.

- **Uncontrollable risk.** The rank and file should not be placed in a position where some of their total compensation is based on stock performance. While the highly compensated may be in a position to "gamble" a portion of their earnings on market performance, the lower paid are not in a position to risk their earnings on a vehicle blown around by the influences discussed above.

- **Cash flow problems.** If employees want to exercise their options and hold the stock, they must pay for the stock and pay any capital gains tax (on the difference between the grant and exercise price) at the time of exercise. Coming up with the money to exercise stock options and to pay taxes on the option gain will place a strain on many lower paids.

- **Limited stock ownership.** Stock options granted to executives are typically exercised within 5 years of the grant date, and many of

Option ownership and stock ownership are not the same thing.

those exercised are then sold. For lower level employees, the exercise and sale is likely to be even sooner. Option ownership and stock ownership are not the same thing. Stock options are not providing for a long-term investment in the company, and it is unlikely that any organization is benefiting from the higher levels of loyalty and commitment usually attributable to long-term ownership.

- **Increased dilution.** It's bad enough that shareholders must endure the effects of dilution from the executives' stock options. Undoubtedly, the stock options offered to the rank and file will not be at the expense of the executive group, they will be in addition to the executives' options. While we can appreciate the equity achieved by letting all employees in on a little compensation secret that has been making millionaires out of executives for years, the shareholders will end up paying the high price of dilution.

Alternative Stock Programs

Concerns with these problems, increasing shareholder interest in stock compensation, and further proxy disclosure required by the SEC, have led to some imaginative alternatives to the stock option, including the following.

With indexed options, executives recognize gains only if the company stock out-performs some index of investment alternatives...

- **Salary Replacement Options.** Recognizing the value of stock options, companies such as General Mills and International Multifoods have asked executives to forego compensation in exchange for their stock options.
- **Purchased Options.** Some compensation experts have recently suggested that executives purchase their options for a price determined by the Black-Schoales valuation model.
- **Premium Options.** AT&T, Colgate and United Airlines have all issued premium or "out-of-the-money" options. These options have fixed incremental strike price increases that are set on the grant date. These incremental strike prices can communicate to the executives where the company would like to drive future stock prices. Executives would be rewarded only to the extent that the stock price exceeded these levels.
- **Performance Options.** Companies such as ITT have tied the exercisability of options to stock price thresholds (e.g., the stock price must increase by 40% before options are exercisable). Rather than stock price performance, companies could tie exercisability to other measures such as ROIC, EVA or earnings growth.
- **Contingent Grants.** Instead of tying option exercisability to performance, some organizations, such as Banc One and Whirlpool, have tied the grant of options to company performance.
- **Indexed Options.** Companies attempting to avoid windfall options gains due to a general upswing in the market may wish to consider indexed options. With indexed options, executives recognize gains only if the company stock outperforms some index of investment alternatives, such as peer companies, the S&P 500 or T-Bond rates.
- **Deposit Shares.** In order to receive stock options at companies such as RJR Nabisco and Corning, executives must own and deposit with the company a specified number of shares for the duration of the option. . . mandatory ownership.
- **Career Shares.** Alcoa suggests that options gain shares, the shares representing the spread at exercise minus the shares necessary to pay taxes, be held until retirement.
- **Vesting Schedules.** Companies struggling to increase long-term share ownership are imposing three to five year mandatory holding periods after the exercise of options, especially effective if the option cannot be exercised until the end of the option term.
- **Restricted Stock Match.** Howard Johnson & Company recently designed a restricted stock match program for Pegasus Gold

Corporation, under which eligible employees could elect to use up to 20% of their annual bonus awards to purchase company stock. Under the program, for every three shares of stock the employee purchases, the company grants two shares of restricted stock. One share vests three years from the date of grant, and the other share vests five years from the date of grant. With this program, Pegasus is attempting to:

1) leverage current bonus payments
2) encourage employee stock ownership
3) retain high performing employees
4) tie employee interests to shareholder interests.

Evaluating Stock Compensation Programs

Like Pegasus, when companies introduce a new compensation program, they should attempt to identify what the company is trying to achieve with the new program and how it differs from the objectives of their other compensation programs.

Table I illustrates a framework for examining stock compensation program objectives. While you may have a different opinion as to each program's effectiveness, the grid's factors should help you to assess 1) whether you have multiple stock programs geared to the same objectives, 2) whether your stock programs complement one another, and 3) if introducing one of these stock programs will complement your existing compensation scheme.

Stock options have become a way of life in many companies, but shareholders, the SEC and FASB are uncovering the hidden costs of options to the company. These challenges have forced companies to develop some novel alternatives which promise to yield greater returns to the company by recognizing the value of company stock, the value of ownership and the benefits of a true long-term incentive.

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Did You Know...

Model Form for Joint & Survivor Benefits

The IRS has asked for comments from the public on the notice requirements surrounding Joint and Survivor annuity options in qualified retirement plans. The request for comments indicates that the IRS is considering issuing a model form for plan payout options. Comments can be made through June 25, 1994.

IRS to Appeal Deductions for Interest on Deferred Compensation

Our last issue described a Ninth Circuit Decision in which a taxpayer was allowed to deduct interest accrued on deferred compensation. The IRS has argued it could cost the government billions of dollars and appealed.

IRS Will Find Lost Participants

The IRS has issued Rev Proc. 94-22 explaining the guidelines and procedures involved in asking the IRS to find lost retirement plan participants.

Regulations Issued on Compensation Cap

The IRS has proposed regulations designed to implement the limitation on the employer deduction for compensation in excess of $1 million. The regulations provide employers with guidance on satisfying the cap and explain the exception for performance based compensation. The new limit is effective for taxable years beginning in 1994.