STOCK OPTIONS: *Still Alive?*

DON'T COUNT THEM OUT YET. MANY TYPES ARE STILL VIABLE.

BY SAM SHAH

In 2002, we witnessed the fall of corporate giants. WorldCom. Global Crossing. Even noted linguist William Safire couldn't resist the urge to coin a new word on the street: "Enronnish." The atmosphere reached a low point, forcing the federal government to respond by pledging to restore investor confidence and promising to hold corporations and their officers accountable.

In 2003, we have seen Sarbanes-Oxley in motion. The phrase "corporate governance" is peppered across every type of business and financial media outlet. The government attempted to set a path in 2003 to avoid the ills of 2002.

In 2004, we can't safely foresee an increase in movement on corporate governance (if the government's lack of movement in 2003 is any barometer). But we can expect to see a shift in the manner in which companies choose to compensate their employees. Companies that have historically attracted, retained, and motivated employees with stock options will now have to adhere to major changes in accounting standards with respect to stock options.

ARE STOCK OPTIONS THE ENEMY?

The debate surrounding stock option expensing initially polarized the financial world, casting options as a major factor in the country's economic recession. Major investors like Warren Buffett of Berkshire Hathaway said companies should expense their option costs. Coca-Cola heeded the words of its largest shareholder (Berkshire) and announced in mid-summer 2002 that it would voluntarily expense options.

Technocrats such as Intel's Craig Barrett adamantly opposed expensing options. In the technology sector, Barrett argued, firms relied on options as a vital tool to stimulate business, reward performance, and retain key employees. Expensing, he said, would dissuade companies from offering them.

SURVEYS AND EMPIRICAL RESEARCH

The stock options debate, as this magazine aptly noted, turned out to be "much ado about nothing." A Towers Perrin survey of 100 companies with stock option plans found that during a 90-day period before and after these companies announced they would expense options, their stock prices did *not* change significantly (other than what would normally be expected for this time period, given normal market fluctuation).

The National Center for Employee Ownership (NCEO), curious to learn what academics thought, conducted its own survey of 37 business school finance professors. Only 16% of the respondents believed option expensing would have a "significant" impact on stock prices of companies with option plans. The remaining 84% said expensing would have "little" or "no" impact on companies' stock prices. As Corey Rosen, executive director of the NCEO, said, "The options expensing debate turned out to be the 'Y2K' of stock options—much feared, but of little consequence." He argued, "These results, along with recent empirical studies, suggest that companies should stop designing equity compensation plans to fit an accounting standard. Instead, these plans should be designed to optimize the value for their cost."

FASB'S DECLARATION

This debate raged throughout 2002. The Financial Accounting Standards Board (FASB) eventually weighed in during 2003, and its recommendations will most certainly alter the landscape for options accounting in 2004. In short, companies issuing options will have to record the expense on their income statements.

Retrospectively, however, the results from the surveys, the research, and FASB should have been intuitive: Markets already considered the options expense. The crux of the debate centered on where, exactly, this cost would be reflected. Before 2003, companies traditionally disclosed option costs in footnotes, where any capable equity researcher could find them and incorporate them into their valuations.

FASB put an end to this, recently announcing that, sometime in 2004, it would recommend that options must be expensed on the income statement (FASB's decision is also believed to be synchronous with guidelines drafted by the International Accounting Standards Board (IASB)). Kay Thomas, author of *Consider Your Options*, a leading text on options, sums up the controversy well: "It's easy to learn the amount of the stock option expense for any publicly traded company. They're required to reveal this information in their financial statements, so anyone who's interested can look it up. Changing the way they reveal this information won't be a big deal."

OUTLOOK FOR 2004

Microsoft sounded the bell early by announcing in the summer of 2003 that it would move to phase out stock options in favor of restricted stock. Analysts have suggested various theories to explain the software giant's move, saying that it was influenced by FASB's recent decision, that Microsoft was acknowledging the motivating aspects of restricted stock, or that it had realized the company is maturing.

Regardless of Microsoft's rationale, one thing is certain: It won't be the last company to consider the equity compensation alternatives to stock options. Already, executives, lawyers, accountants, and other financial professionals are studying the alternatives available. Here's a snapshot of things that might come.

THE ALTERNATIVES

Options Modification. Companies with options can modify their existing plans to satisfy upcoming changes in accounting standards. Despite the negative press, options could remain the best tool for certain companies in 2004 and beyond. Here, companies should keep compensation amounts in line with the cost, scaled against future labor market indicators. Companies might also elect to reexamine the size of their award pool to limit participation. (These types of restrictions will undercut any "broad-based" ownership, assuming such a culture exists, which could negatively affect corporate performance.) Companies can further adapt their plans by tinkering with vesting schedules and valuation methodologies.

Restricted Stock. Companies that choose to follow Microsoft could issue this equity instrument under specified guidelines, such as time served and other criteria. Restricted stock, much like stock options, helps companies attract, retain, and motivate workers, enabling companies to align awards with corporate goals. Companies also benefit from tax deductions when these shares vest. Yet drawbacks exist. Companies can claim only the fair market value as a compensation expense. If share prices drop, companies can get a smaller than expected tax break.

Stock Appreciation Rights (SARs) and Other Forms of Phantom Equity. SARs entitle participants to the increase in a stock's value without giving them actual shares. This increase is realized either with cash or more stock. SARs enable employees to reap the financial benefits of stock ownership without truly giving them any property, for these instruments don't require cash from participants. Companies also find SARs attractive because they don't involve actual shares (and thus don't dilute ownership), thereby requiring no securities registration. On the other hand, if stock value increases, the company must expense the entire award. (Theoretically, SARs aren't conducive to broad-based ownership environments. Participants don't possess "real" equity; instead, they profit from stock price increases.) Regardless of their drawbacks, SARs could become popular in light of FASB's recommendation.

Employee Stock Purchase Plans (ESPPs). Participants may directly purchase stock with their own money, usually at a discount, in an employee stock purchase plan. Consequently, purchasers assume a financial risk. With ESPPs, companies create savings mechanisms for participants to accumulate funds (via payroll deductions, at times matched by the company), which in turn are used to purchase stock. Because these plans are qualified plans, companies avoid the compensation expense while generating cash through the transaction. ESPPs must be offered to all eligible employees, which makes them valuable instruments for broad-based ownership. (Traditionally, they don't make a strong cornerstone for an ownership culture, however, given the financial risk participants assume.)

Performance Shares. Companies also have the opportunity to align individual performance with their own organizational goals by using performance shares, which are grants of stock or stock units allocated to employees over time. Because employees pay for them, performance shares retain value from the beginning. This helps ensure share longevity and can reduce underwater risk. Furthermore, performance shares can reduce a company's compensation charge, overhang, and the cost of stock compensation under FASB's current standards. These shares, however, could become a company expense because of their link to external stock prices, which are subject to fluctuation, manipulation, and fraud.

EDUCATIONAL OPTIONS

Those familiar with equity compensation understand that options aren't dead. Today, more than 10 million employees in the U.S. have received options. As more wealth is tied to options and other equity instruments listed above, and as equity compensation becomes a bigger chunk of workers' total compensation, accountants will have to familiarize themselves with new recording standards in a rapidly changing financial climate.

Accountants are trying to stay one step ahead of these changes, educating themselves about the mechanics behind equity compensation and the rules governing these distributions. This atmosphere has attracted many accountants to Santa Clara University's Certified Equity Professional Institute (CEPI). The CEPI's mission is to test for competence in three levels of equity compensation. To become certified, an individual must pass two or three comprehensive examinations designed to test knowledge of accounting, taxes, regulations, and laws. This type of information is highly attractive to companies seeking administrators, lawyers, and accountants in this evolving professional field. According to CEPI Program Director Mark Clem, CEPI's "accredited certification program is designed to address the growing need for professionalism in all aspects of stock plan administration, analysis, and auditing."

The CEPI, founded in 1989 through the University's Leavey School of Business and Administration, awards an industry certification, a Certified Equity Professional (CEP) designation, to those students who have successfully completed either two or three levels of examination. Students participate in distance-learning programs that culminate with exams offered across the nation in more than 30 cities, usually administered biannually. Continuing education credits are also required in order for CEPs to maintain their designation.

THE HORIZON

FASB's recommendation in this atmosphere of corporate governance will force financial professionals, particularly accountants, to be knowledgeable not only about accounting standards that affect stock options but also to understand the alternative instruments for equity compensation. They will also have to understand how the new laws and regulations function to ensure their companies or clients satisfactorily comply with new standards. As management accountants, you would be wise, then, to familiarize yourselves with these new standards before the regulators force you to. ■

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