PRESERVING PERFORMANCE PAY

MAINTAINING THE POWER OF STOCK-BASED COMPENSATION WHILE MINIMIZING THE ABUSE OF IT.

By Katrina Mantzke, CPA, and B. Douglas Clinton, CPA

The abuse of stock options played a part in many of the recent accounting scandals. Only now, with these scandals behind us (let's hope), can we clearly see how and why stock options were abused. From these difficult lessons, we have learned what's needed to preserve the effectiveness of stock-based compensation. At the same time, we expect corporations to replace stock options with other forms of stock-based compensation since the Financial Accounting Standards Board (FASB) will likely require corporations to expense the options they grant.

STRUCTURING STOCK PAY

Stock-based compensation is a powerful tool for attracting and retaining valued employees and motivating them to act in the best interests of shareholders. Yet we've learned that we need to structure stock-based compensation so management's behavior and shareholders' expectations are—in fact—aligned. Two things can help with this: (1) Make vesting periods long-term, and (2) tie stock-based compensation to individual performance.

Short vesting periods can lead to abuse. The majority of stock options granted in the past had relatively short vesting periods, some as short as one year, many two years. Some managers manipulated financial results and/or used other tactics to drive up their corporations' stock prices and cashed in—at the expense of other shareholders. But this kind of abuse is difficult to sustain over an extended period of time because the company's operations won't support fictitious financial results. Long-term vesting periods would help to mitigate this kind of abuse.

Next, stock-based compensation should also be tied to individual performance. By its very design, stock-based compensation ties a manager's personal wealth to the overall wealth of the corporation. This helps managers think more like shareholders. But without linking stock pay to individual performance, managers can be rewarded for merely "biding their time." Many stock-price increases in the 1990s had more to do with overall stock market gains than with true increases in a company's intrinsic value. Tying stock-based compensation to individual performance measures would prevent employees from becoming wealthy through no effort of their own.

Individual performance measures that have been used in the past include earnings per share and various rates of return. These measures can motivate managers to contribute to the long-term corporate wealth better than stock-price appreciation because managers have more control over these measures than they do stock prices.

DIFFERENT INSTRUMENTS

Even if stock options are restructured to appropriately motivate managers yet prevent them from gaming the system, the new, anticipated financial accounting rules for options may make other forms of stock-based compensation more attractive.

Financial accounting rules have always required corporations to expense their grants of stock-based compensation other than stock options. But under the FASB's proposed Statement of Financial Accounting Standards, "Share-Based Payment," corporations will now be required to expense their grants of stock options as well. This expense must be calculated using an option-pricing model, which is far more complex than the calculation of expense related to other forms of stock-based compensation. In light of this, we expect that restricted stock and stock appreciation rights (SARs) will become more popular than stock options.

Many companies, including Microsoft, Time Warner, and Sprint, have stepped up their use of restricted stock in compensating their employees. Restricted stock is stock granted to an employee as compensation, but ownership of it is restricted until a vesting period lapses. SARs, a lesser-used form of stock-based compensation, provide employees with cash compensation measured by the appreciation in the corporation's stock price over time. Employees don't have to pay the corporation to obtain either restricted stock or SARs—as they must do to exercise options. But what the corporation forfeits in cash inflows from options may be offset by the easier financial accounting for restricted stock and SARs. Still, all other things being equal, SARs drain a corporation's cash, which may explain why they haven't been as popular as options or restricted stock.

Restricted stock and SARs also have characteristics that employees prefer. To employees, stock options are the least desirable form of stock-based compensation because the employee must lay out cash to buy the underlying shares. In addition, the employee must pay federal and state income taxes and FICA taxes on the profits from exercising the options.

Employees also prefer restricted stock over stock options because there's no cash outlay; the employer gives the stock to the employee. Still, the employee is responsible for paying the related taxes on the compensation resulting from the restricted stock.

Finally, employees prefer SARs over both options and restricted stock because SARs are typically paid in cash, giving the employee the wherewithal to pay the related taxes. Existing shareholders also prefer SARs because shares are not issued and, therefore, their ownership interests are not diluted.

Whichever form of stock-based compensation a corporation uses will reflect the balance it must strike between achieving corporate goals and satisfying employees.

THE FUTURE FOR STOCK-BASED PAY

As we venture forth into the future, corporations will continue to use stock-based compensation because it remains a powerful tool for motivating management to act in the best interests of shareholders. But we'll likely see stock options replaced by other forms of stock-based compensation. Regardless of which specific type of stock-based compensation is used, we need to learn from history so we don't repeat it—that is, stock-based compensation must be structured to maintain its unique benefits yet minimize its potential for abuse by making vesting periods long-term and tying the compensation to individual performance. ■

Katrina Mantzke, CPA, Ph.D., is assistant professor of accountancy at Northern Illinois University. You can reach Kate at (815) 753-6209 or kmantzke@niu.edu.

B. Douglas Clinton, CPA, Ph.D., is associate professor of accountancy at Northern Illinois University. You can reach Doug at (815) 753-6804 or clinton@niu.edu.