Making executive pay work

Stock-option expensing will probably satisfy governance and shareholder activists, but it may also prove to be a blessing in disguise, forcing, or enabling, companies to design a new plan that enables them to reward executives with stock and that satisfies shareholders. Moreover, such a plan, essentially a portfolio of stock incentives, can decrease accounting costs and increase the perceived value that is delivered to employees. These executive compensation consultants describe - what else! - the options companies now have for rewarding executives.

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Imagine how much more productive our country would be if executive pay was working like it should in every organization. Unfortunately, many commentators believe that executive pay is not working at all, and in assigning blame, they point their fingers at boards of directors for not pulling in the reins on executive compensation. The times are changing, however. We believe that boards have a golden opportunity to make executive pay work because they now have more tools to help link executive rewards more directly to agreed-upon performance goals. This article discusses the sea change that is occurring in executive compensation.

Whither the stock option?

Until recently, traditional wisdom in executive compensation circles held that giving executives stock options would tie those executives' personal interests to the long-term investment objectives of the shareholders. Our federal government, meanwhile, reinforced Canadian executives' preference for options by reducing the taxation of options by 50% compared to 100% of cash compensation and other stock-based vehicles. And by imposing a $1.0 million limit on deductible fixed compensation (e.g. salaries) for executive officers, the United States government inadvertently made the granting of stock options the preferred method of increasing executive pay.

During the late 1990s, companies issued millions (and in the U.S., billions) of dollars worth of stock options, hoping to motivate their employees. Those days are likely over, for a variety of reasons, including shareholder concerns about the ever increasing dilution due to the issuance of options and new accounting rules requiring companies to expense options. Moreover, there is the perennial concern over the public's perceptions of excessive executive pay and apparent disconnects between pay and company performance. In addition, studies have shown that the accounting cost of stock options exceeds employees' perceived value of those options. Finally, there has been a crisis in governance that has caused a reexamination of corporate accounting standards. No wonder some feel that stock options are dead in the water.

The use of stock options has been declining in Canada, much more so than in the United States.

This trend started well before stock option expensing became inevitable, due in part to the lobbying efforts of major Canadian institutional investors. For example, in Watson Wyatt's annual study of executive compensation practices in Canada, we found that:

- the annual option grant rate in 2002 had declined at the median to 0.9% of the total number of outstanding shares from 1.4% in 2001
- the total number of outstanding options ("dilution") had declined at the median from 6.2% to 4.6%, and
- the total potential option dilution ("overhang") had declined at the median from 9.2% to 8.1%.

Meanwhile, stock option overhang in the U.S. is starting to come down from a historical high of 16.1% in 2002, mainly because companies are granting fewer new options, and as the U.S. economy begins to improve, employees are starting to exercise many options that were previously out of the money.

Accounting-for-share plans

The subject of accounting-for-share plans has received considerable press during the past two years. Canada's Accounting Standards Board decided to lead the accounting world by mandating stock option expensing for all publicly-traded companies for fiscal years beginning on or after January 1, 2004.

Despite fierce resistance from some quarters, it now appears likely that the major international accounting standards bodies will require companies to account fully for the cost of all their employee share plans from 2005 onwards. While this will have a significant impact on a company's financial procedures, it is also important for compensation committees and human resources personnel, as there is likely to be a significant affect on the design of these plans.

Key features of the forthcoming international accounting standard for share plans:

- All types of plans are affected, including all-employee plans as well as executive plans
- Fair-value expense determined at the date of grant of the share incentive
- Result is charged against earnings over the vesting period
- Valuation to involve assumptions about forfeiture before vesting, effect of performance conditions, timing of option exercise, share price volatility and other factors - the choice of these assumptions can have a significant effect on the resulting P&L charge
- Cash-settled plans, such as share appreciation rights and most deferred stock unit grants, will be treated as cash liabilities with the charge being adjusted each year on a mark to market basis to reflect share price movements
- Equity-settled plans will be trued up for experience always in respect of forfeitures and sometimes in respect of performance conditions; however, there will be no revision or 'truing up' of the charge in respect of share price movements subsequent to the grant date
- The treatment of performance tests depends on whether they are the 'market-price based' or not.

The most important change from the original international proposals concerns the treatment of performance conditions. There is a significant difference between what are termed "market price-based" tests, such as those based on total shareholder return (TSR), and "non-market-price-based" tests, such as Return on Capital Employed (ROCE). For market price-based tests, an

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allowance will be made for the probability of achieving the performance condition at the date of grant; no subsequent revision can be made. However, for non-market price-based tests, the initial valuation must assume a best estimate of the outcome, namely either that the test is passed, or that it is not, or in the case of a test with multiple possible outcomes, whichever one of those outcomes is regarded by management as the most likely. If the actual outcome of the test is different from the initial assumption, the expense will need to be trued up.

Unlike most of the rest of the world, the U.S. has had a share-plan accounting standard for many years. However, providing that the plans satisfied certain conditions, it was possible to disclose the costs only as a note to the financial statements, rather than as a charge to the P&L. Nearly all U.S. companies took this approach until recently, and designed their share plans accordingly. In practice, this has led to less desirable plan designs with companies favouring option plans over share-grant plans, and the exclusion of any performance conditions, as these would generally trigger an accounting charge under the old standard.

Noting that over 500 U.S. companies have already adopted stock-option expensing, the Financial Accounting Standards Board issued an exposure draft of a new standard in March 2004. A final standard will follow later in the year, which will probably apply to fiscal years commencing on or after December 15, 2004. It is expected that this standard will be similar to the international standard, although there may well be some initial differences that will be later harmonized. We expect that the differences between the Canadian and the international standards will likely also be resolved.

The valuation approach

In order to calculate the appropriate accounting charge, it is first necessary to place a fair value on the shares or options issued at the date of grant. The valuation of share-option plans in particular is problematic. The traditional way to do this is to use the Black-Scholes formula, which was developed in the 1970s. However, Black-Scholes was designed for valuing traded options and does not take into account the specific features of employee or executive option schemes, such as forfeiture, vesting periods and performance conditions. Furthermore, two of the key parameters - share price volatility and dividend yield - have to be assumed to be constant over the term of the option. While this would not usually be a problem when valuing short-term traded options, it can be unrealistic in the case of employee options, where the potential term until vesting and subsequent exercise can be as long as 10 years. Accordingly, the international standard suggests that a Black-Scholes approach will not generally be acceptable for accounting purposes.

In the light of this, Watson Wyatt has modified the Black-Scholes methodology, and called it Present Economic Value, or PEV for short, which allows for all these features. As well as stock options, it can also be used to place a value on almost any type of share plan, including restricted stock units or performance shares.

For the first time, employee share plans will have an impact on the P&L statement. This is focusing

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corporate minds on whether these plans provide value for money. It is quite possible that there could be a trend away from employee option plans, as the steep stock market falls of recent years have shaken employees' faith in the value of these plans. Companies may, therefore, feel that share awards will be a better approach going forward, although option plans may remain more popular at the executive level. A move away from option plans will also help companies who may be coming up against their share dilution limits. Current indications are that US companies will both restrict eligibility and reduce grant levels in response to the accounting changes. Some companies may choose to eliminate all-employee plans completely, in order to focus on key executives.

The fuss about option expensing

Several Watson Wyatt studies have shown that investors consider stock option expenses as real expenses, even if reported only in the footnotes. As a result, the stock prices of companies that have chosen to expense options have not plummeted. So, one might wonder, why all the fuss? The new standard will, however, level the playing field between different types of share plans. As a result, option expensing could have very significant positive implications for plan design and thus help make executive pay work better than in the past.

There are two key aspects to this:

- First, given that option plans will no longer have an advantage from an accounting point of view, their use will decline somewhat in favour of more straightforward share grants, such as restricted share units, particularly for all-employee arrangements. The most high profile example of this trend is the case of Microsoft, but there are others.
- Secondly, it is no longer disadvantageous to put performance conditions into share plans. Taken together with shareholder and media concern about the weakness of the link between executive pay and shareholder return, this could well herald the inclusion of more performance conditions, at least in executive share plans.

Meanwhile, a recent Watson Wyatt survey of nearly 650 high-income employees in the U.S. who received stock option grants confirmed the findings of several theoretical academic studies (e.g. Hall&Murphy), namely that employees discount the value of stock option grants by 30 to 50 percent relative to the options' actual economic value (i.e. 30 to 50% of the "fair value" expense to the company). According to Watson Wyatt survey responses, the discount that employees place on stock option grants varies with company size and performance, as well as the employee's investment style. For example, employees in smaller organizations who more accurately know their company's stock price tend to place larger discounts on stock option grants. Conversely, employees at better-performing companies (as measured by total returns to shareholders) and higher-income employees tend to place smaller discounts on stock option grants. The study also noted that employees will tend to discount the value of stock option grants because they are risk-averse and less than fully diversified investors.

While employees may undervalue stock option grants by as much as 50 percent, they place a much higher value on shares of restricted stock. The Watson Wyatt survey found that the average discount placed on restricted stock is only 18 percent. These values imply that there are opportunities for employers to reduce their stock-based compensation costs by 20 to 30 percent by converting their stock option plans to restricted stock unit grants. It will become increasingly hard for companies to justify offering a benefit that costs one dollar while employees value it at only 50 to 70 cents.

What to do?

Employers will need to find more cost-effective ways to compensate and motivate their employees because investors are willing to pay a premium for companies where the interests of senior management and shareholders are aligned.

While stock options may be losing their appeal, there are ways companies can increase the perceived value of stock-based plans while simultaneously reducing their accounting costs. Companies can accomplish this by using a portfolio of stock incentives, including restricted stock units, performance share units and stock purchase plans, in addition to stock options. Such a move can decrease accounting costs, increase the perceived value delivered to employees and be more shareholder-friendly.

A portfolio of stock incentives can be used as a substitute for, or reduce, traditional stock option grants and allow compensation committees to set more specific objectives for each component of the portfolio, rather than the traditional plain vanilla time-vested stock option approach. Companies also need to:

- Evaluate grant sizes very carefully. Especially for top management, grants are probably already large enough to be a motivating factor.
- Create more direct stock ownership by senior executives. Real stock ownership has certain advantages over options, including influencing retention and changing executive behavior. Watson Wyatt studies consistently conclude that high executive stock ownership, unlike high option overhang, yields superior returns to shareholders.
- Require executives and directors to announce their intention to sell stock before the sale and to disclose the sale afterward.
- Encourage the compensation committee to seek direct access to independent advisors on long-term incentive and executive compensation issues.

A good example of how to increase executive stock ownership in a shareholder-friendly way is to create a management stock purchase plan (MSPP). An MSPP is an effective way to encourage stock ownership by allowing executives to acquire notional stock units on a pretax basis from current income that would otherwise be paid in cash, e.g. annual bonuses. The advantages of an MSPP to the employer are predictable and controllable accounting costs. Companies typically offer a 25 to 50 percent match, the cost of which is spread over the vesting period. In addition, there may be tax advantages to the employer if the match is settled in cash on vesting and/or is funded by purchasing shares on the open market.

MSPP purchases can be mandatory, voluntary or a combination of the two, depending on factors such as executive stock ownership levels and firm culture. Typical plan features include:

Eligibility - limited to designated members of senior management.
Match - a 25 percent match on the fair market value on the date of purchase.

Mandatory purchase - participants could be required to use 25 percent of their bonus to acquire notional stock units.

Voluntary purchase - participants are usually allowed to make voluntary purchases beyond mandatory levels (typically without the company match).

Restriction on sale - unit are usually restricted from sale for a period of three years, and in some cases until after the executive terminates or retires.

Certainly, an MSPP is not appropriate for every company. Each needs to seek its own balance based on strategy, culture and history. What is universal is the need for companies to determine equal or better ways of motivating executives - given the diminished importance of options - or else face the consequences of poorer performance and angry shareholders. Making executive pay work is now more possible than ever, thanks in part to the advent of stock option expensing.