



# obstacles & opportunities

THE NEW ERA OF EQUITY-BASED INCENTIVES

by Brandon Cherry

## OVERVIEW

The stock option expensing dust settled in December when the Financial Accounting Standards Board (FASB) issued its final, revised standard on accounting for equity-based grants (i.e. stock options, employee stock purchase plans, restricted stock, etc.) entitled FASB Statement Number 123r (FAS 123r). Under the revised standard, public companies will be required to expense the fair value of employee equity-based grants starting in the first quarterly reporting period beginning after June 15, 2005.

These are significant developments for companies offering employees equity incentives. The expense will be recognized as a non-cash charge to earnings, and therefore the new standard will not have an impact on a company's cash flow. However, there is concern that in an effort to minimize the accounting impact on Earnings Per Share (EPS), institutional investors will demand a lower annual run-rate (defined as the number of options granted in a fiscal year minus any cancellations or forfeitures divided by the total shares outstanding) and lower overhang (defined as the number of shares subject to outstanding stock options, plus shares available for future grant under the company's equity incentive plans, divided by the total company shares outstanding.)

In fact, the largest firm that currently advises institutional investors, Institutional Shareholder Services (ISS) has recently instituted a policy that could trigger a recommendation for a 'No' vote on company proposed equity incentive plans if the company's annual run-rate

exceeds a certain threshold. The concern for companies, especially small-cap companies where cash flow is critical and equity incentives are used to offset lower levels of cash compensation, is the erosion of their ability to attract, retain and reward employees.

Barring a last minute act of Congress, it is safe to say that expensing is a reality. In this edition of *Obstacles & Opportunities*, we look at key issues that you will face as your company transitions to the new FASB standard, including choosing a valuation methodology, choosing the right type of equity-based incentives and ways your company can balance the need to continue to offer equity incentives to drive employee performance against the concern of diluting shareholder value.

## OBSTACLES

### Exploring Valuation Methods

FAS 123r provides general guidance on valuation methodologies, permitting any valuation method that utilizes, at a minimum, the following six specific variables:

- Current price of the underlying company stock
- The expected volatility of the price of the underlying company stock
- The expected dividends to be paid on the underlying company stock
- The expected contractual term of the equity-based grant, adjusted for employee behavior
- The risk free rate of return one could expect over the term of the equity-based grant
- The exercise price of the equity-based grant

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The requirement to use these variables realistically leaves a company with two choices in valuation methodologies: closed-form models, such as the Black-Scholes Option Pricing Model or lattice models such as the Binomial Model. To further complicate matters and make the decision even more critical, once a method is chosen, the process of changing valuation methods requires a company to petition the Securities and Exchange Commission for a change in accounting practices. So the final decision on which model to use should not be taken lightly.

So where should you start and how can you turn this obstacle into an opportunity? Familiarizing yourself with your equity incentive programs will be the best first step and will serve you well throughout the entire process of determining the impact FAS 123r will have on your company. Historically, compensation and equity professionals have focused on determining competitive grant guidelines for the next fiscal year, ensuring an appropriate pool of stock options are available and maintaining relatively competitive overhang. With FAS 123r, a detailed diagnostic analysis should include critical equity plan statistics that may have been ignored in the past, including a three year historical and three year projection analysis of overhang, run-rate, employee grant guidelines, vested and unvested options, in-the-money and underwater options, and exercise history.

The flexibility that FASB has provided in choosing between these two valuation methods can result in potentially significant differences in the amount of expense a company must recognize. In addition, FASB has not provided explicit detail on how a company must come up with the six required variables, leaving companies with additional analysis in order to determine which valuation methodology is more appropriate. The education and familiarization process can help reduce the variability in your assumptions, regardless of the model your company ultimately chooses.

As for the models themselves, the Black-Scholes formula, although complex, is easy to calculate. The formula as well as variables such as volatility can be set up in a spreadsheet and your company's Black-Scholes

value can be determined. The complexity of this process will depend on the variables of the model, and the level of detail your company feels is necessary to satisfy the company's auditors. In addition, most companies have used this model in their footnote disclosures previously required under FAS 123, and that established knowledge by compensation and equity professionals makes it an attractive method.

Lattice models such as the Binomial model are very complex, and much of the information you collect and analyze throughout the familiarization and education process will be useful to your company. The Binomial model is a dynamic model that determines changes in the value of a stock option, in present value terms, over time based on the probability of stock price increases and decreases and the corresponding shift in exercise patterns of a company's employees. Your company will benefit the most if a valuation professional is used to conduct this analysis. Although this process is not cheap, most valuation professionals should provide a general cost/benefit analysis at your request.

It is our experience that much of the software and online tools that are available do not provide the user with the same level of detail and the knowledge and experience that a valuation professional can provide. The software and tools often use a static binomial model, or a model that does not allow the user to adjust for employee trends based on the changes in stock price over time. If you are considering this type of binomial valuation methodology, we would recommend using the Black-Scholes model and saving yourself the effort and cost of Binomial pricing software or tools. Regardless of the model your company chooses, we still recommend compensation and equity professionals conduct the detailed analysis of your company's equity-based incentive programs.

Although it is impossible to determine which companies will benefit from the various valuation methodologies, we can provide some insight to help compensation and equity professionals get started down the path to choosing the best model for their company.

### **Choosing the Right Model**

Companies that do not regularly rely on stock options as part of broad-based employee compensation or companies who have a nominal annual run-rate and limited unvested stock options outstanding may find that using the Black-Scholes model, although in most cases less precise, may be more efficient and ultimately less costly than going through the more rigorous and expensive Binomial model analysis.

Companies with a high annual run-rate and a large number of unvested equity incentives outstanding should consider using the Binomial model as a method to determine the expense that will be carried on the financial statements. With a large number of equity incentives to be expensed, even the smallest changes to assumptions could have significant impact on the expense, and using the Binomial model provides more flexibility.

These considerations are not the only issue that should be addressed when trying to determine the final impact FAS 123r will have on your company. The other obstacle will be to determine whether your historical equity plan design will still provide the best return on investment, align employee and shareholder interests, and deliver ownership and value to employees.

## **OPPORTUNITIES**

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### **Strategies for Managing Your Expense**

Regardless of the valuation methodology a company chooses, the data mining and education that you undertake will provide valuable information on your employees' behavior and treatment of their equity incentives. From this analysis, you may find the company would benefit from an overhauled equity incentive structure. If it is determined that the valuation method that is best for the company will create an issue with your current equity grant practices, there are a number of alternatives that your company can use to reduce the expense hit while continuing to provide your employees with the opportunity to participate in ownership of the company.

Companies that are searching for alternatives to traditional stock option plans are generally those that have granted stock options to a broad base of employees and have recently been tasked by shareholders or senior management to reduce run-rates. Compensation and equity professionals are being put in the precarious position of maintaining effective levels of pay based on historical grant practices while reducing the net number of equity incentives granted on an annual basis.

### Pay-For-Performance

Companies that wish to continue to use stock options are also considering other strategies to minimize or reduce the impact of FAS 123r. One strategy is to align the company's annual performance review with eligibility to participate in the company's stock option plan. By requiring a minimum rating during the annual performance review, companies are reducing the number of employees eligible to participate in the plan and providing an attractive incentive to obtain a performance rating sufficient to participate. However, companies that are using this strategy must have a well defined and well communicated annual performance review process.

### Tighter Eligibility

Other companies are simply setting the eligibility to participate based on the employee's level within the company, usually with manager or director level being set as the threshold. Where shareholders are requiring a fixed annual run-rate, companies are finding it is more effective to make meaningful equity grants to a limited number of employees rather than try and spread the equity grants around to everyone. Providing an employee an opportunity to buy 100 shares via an option grant vesting over four or five years can backfire and may be a disincentive.

### Accelerated Vesting

Still other companies are taking steps now to reduce the impact of historical option grants and limit annual-run rate in the future. This is especially true with companies that will have a large number of underwater and unexercised stock options on the FAS 123r effective date. These companies are finding it practical to accelerate the vesting on those options to remove them from the expense calculation in June, as only outstanding and unvested options will be included in the expense.

### Restricted Share Conversion

For companies looking for an alternative to stock options, the most popular alternative is to replace all or a portion of the competitive stock option grants with performance vesting restricted shares. This is due, in part, to the fact that restricted shares generally require fewer shares than stock options to deliver the same net benefit and are expensed over the life of the vesting requirements at the value of the shares on the date of grant. Restricted shares have an absolute value on the date of grant, whereas options are also expensed over the vesting period based on the estimated value of the stock options. This makes restricted shares more attractive from an accounting perspective as well as from a shareholder dilution perspective.

Restricted shares are usually structured as a grant of stock that is restricted from sale until certain vesting restrictions are met. If vesting requirements are not met, the stock is forfeited. Companies may find that using restricted stock to replace the entire competitive value of an equity package may be possible without substantial impact on dilution and run-rate.

The following examples provide a simplified approach to a complex process that should include an analysis of the impact to both company and employee.

## EXAMPLE

For this analysis Presidio Pay determined the equivalent of one stock option in terms of restricted shares. To determine the equivalent value, Presidio Pay made the following assumptions:

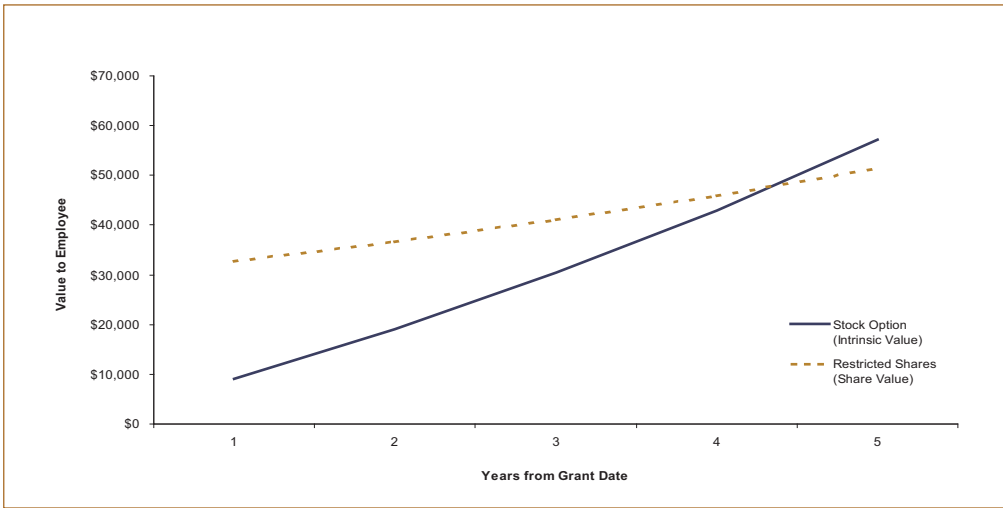
- The present value of a stock option is worth less than its grant value (exercise price multiplied by the number of options granted) on the date of grant.
  - It is generally accepted that stock options are worth less at the time of grant than their face value due various risk factors, such as stock price volatility and a fixed exercise price.
  - Presidio Pay used a Black-Scholes value of **65%**, which means that a rational employee would trade an option granted at \$10.00 share for \$6.50 in cash on the date of grant.
- Restricted share grants will have time based vesting requirements only
  - Time-based vesting reduces the risk of not receiving the underlying stock to essentially nothing, making a restricted share more valuable to the employee than a stock option.
- The grant value of restricted shares is worth more than the present value of a stock option.
  - Regardless of how a company's share price fluctuates over the lifetime of a share of restricted stock, the employee will receive a benefit at the time of vesting equal to the value of the stock price on the date of vesting. Therefore, it is assumed that, all else being equal, an employee would choose the restricted share over the stock options, unless a further discount is applied to the value of the restricted share to compensate for having no downside to holding restricted shares. For this analysis, Presidio Pay applied an arbitrary **40%** discount to determine the exchange value of restricted shares to stock options. Although this discount is arbitrary in this example, the discount chosen by a company should be carefully thought through based on past company performance as well as employee behavior.
- A stock price appreciation of **12%**, compounded annual, was chosen for this example.

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We assist with the competitive assessment, design, implementation and communication of:

- Total Compensation Strategy
- Annual Cash Incentives
- Long-Term Equity and Cash Incentives
- Benefits and Perquisites
- Employee Agreements
- Severance and Change-In-Control Arrangements

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The following chart illustrates how 1,950 shares of restricted stock, given the above assumptions, will deliver more value in actual dollars to the employee than 5,000 stock options. Only after the fifth year, and at a 12% compounded annual stock price appreciation, will stock options deliver more value than restricted shares. And this also assumes that employees will hold the entire original stock option grant through the fifth year before they choose to sell. In reality, many employees choose to exercise and sell a considerable portion of their stock options at the time the options vest, making the restricted share grant even more valuable in terms of real dollars delivered.

In addition to the benefit to the employee, it is important to note that it takes considerable more stock options to deliver this growth than restricted shares, which is the primary benefit to the company for exchanging restricted shares for stock options. What this means is, a company can provide the same real value in

dollars to employees, and maintain a lower annual equity grant run-rate. Other benefits of using fewer shares include a lower denominator when calculating earnings per share as well as a compensation deduction on the full value of the restricted as opposed to the intrinsic value (the difference between the stock option exercise price and the fair market value on the date of exercise) from the stock option grant.

CONCLUSIONS

It is important to realize that there is no silver bullet, and a company's ultimate solution will depend not only on historical practices but projected use of equity-based incentives over the next two to three years. Companies that rely solely on either their future needs or historical practices to determine what is best will be doing themselves a disservice. Ultimately, educating yourself and your peers will prove to be the most effective method of minimizing obstacles that will arise from FAS 123r. Detailed knowledge of your plan, the historical behaviors of your employees, expectations of company growth, future projections of equity incentive use, and expected company performance will put you in a position to make clear and thoughtful decisions.

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