



# ***Expensing Stock Options***

## *Executive Benefits A Good Alternative*

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August 2005

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# About This Report



**Financial Accounting Standard Board (FASB) Statement 123 (Revised 2004), Shared-Based Payment (Statement 123R) repeals the longstanding “intrinsic value” method of accounting for equity compensation prescribed by APB Opinion No. 25 (Opinion 25), and replaced original Statement 123 with a mandate that generally all equity awards granted to employees be accounted for at “fair value”.**

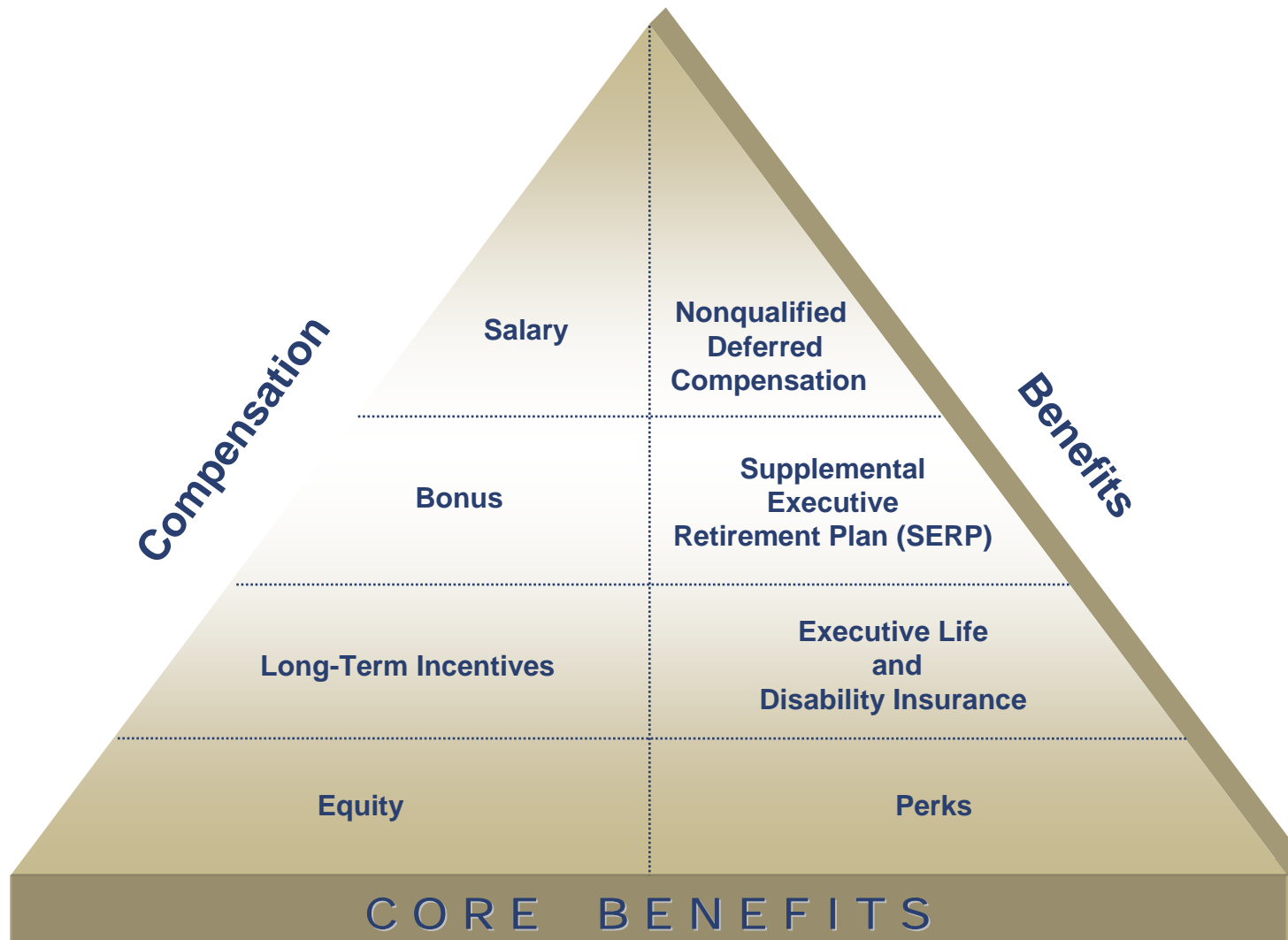
**The new rules states that calendar year public companies must comply with Statement 123R in the first quarter of 2006.**

**Now that stock options will have to be charged to earnings along with other forms of employee compensation, companies are re-evaluating an “all option” approach that makes business sense.**

**Companies need to look beyond equity programs and consider using forms of executive benefits.**

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# Executive Compensation and Benefits Strategy



# Balanced Approach



- ❑ While stock options are aligned with shareholder's interest (i.e. stock price appreciation) they have their limitation since stock options ***only reward absolute increases in stock price.***
- ❑ Thus, in a down or booming stock market ***stock options may under or over compensate employees.***
- ❑ Compensation Committees and management interested in rewarding other performance measures, including retention of top talent may be ***looking outside equity compensation to executive benefits.***

# Balanced Approach



- ❑ How well might executive benefits move companies toward their goal of recruiting and retaining the best employees and motivating them to do their best work?
  
- ❑ ***Performance – vested options or restricted stock/units*** would be the most direct route as long as the potential payout is viewed as sufficiently big and achievable to attract, retain, and motivate key employees.
  
- ❑ Are there different measurements that can drive behavior and meet company goals?

## Example:

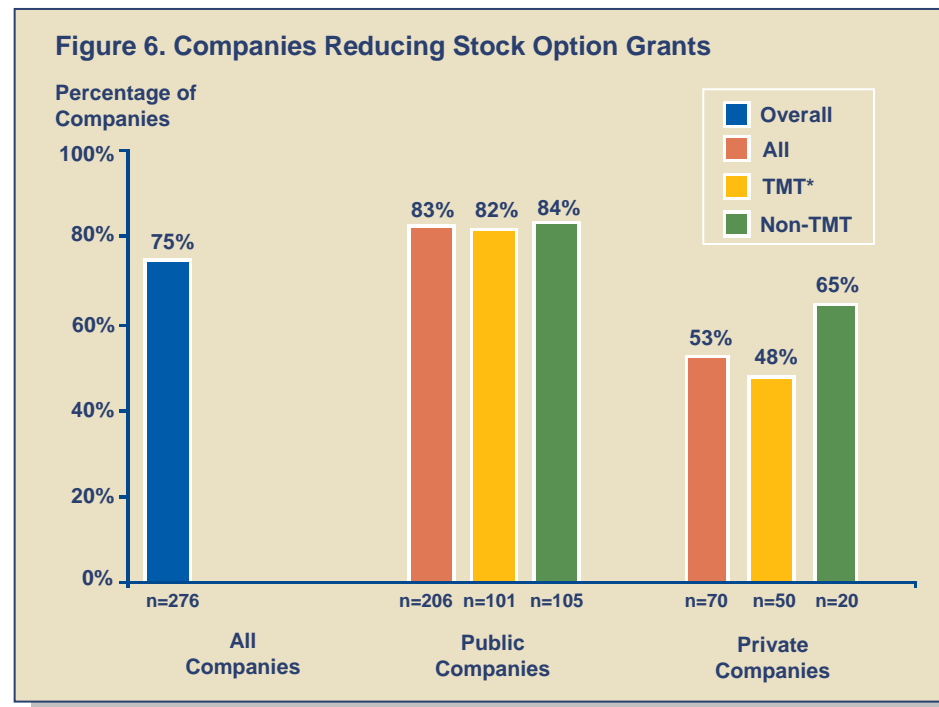
- Cost cutting;
- Working capital or market gain;
- Research breakthroughs;
- Margins.

# Balanced Approach



## Employers Cutting Back

- ❑ In a recent survey 75% of respondents said they were reducing the number of options granted.



Source: The 2005 Deloitte Stock Compensation Survey

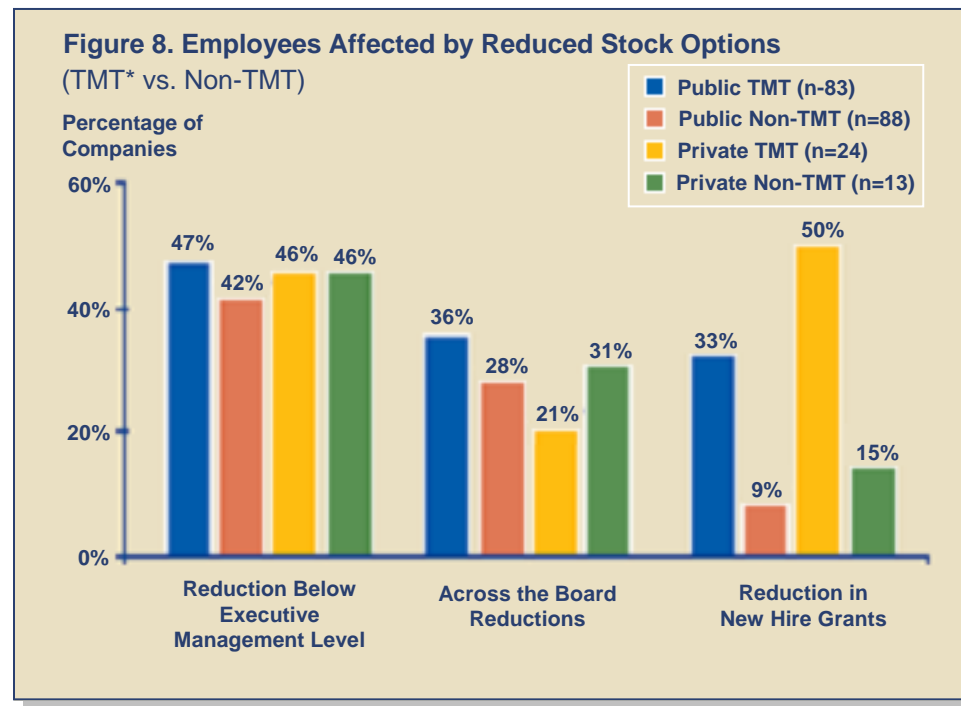
\* TMT - Technology, Media and Telecommunication industries as well as life sciences.



# Equity Based Compensation Alternatives



- ❑ In the survey 42% of all public companies and 31% of all private companies are reducing or eliminating employee participation in equity-based compensation programs, with no other benefit being offered in return.



Source: The 2005 Deloitte Stock Compensation Survey

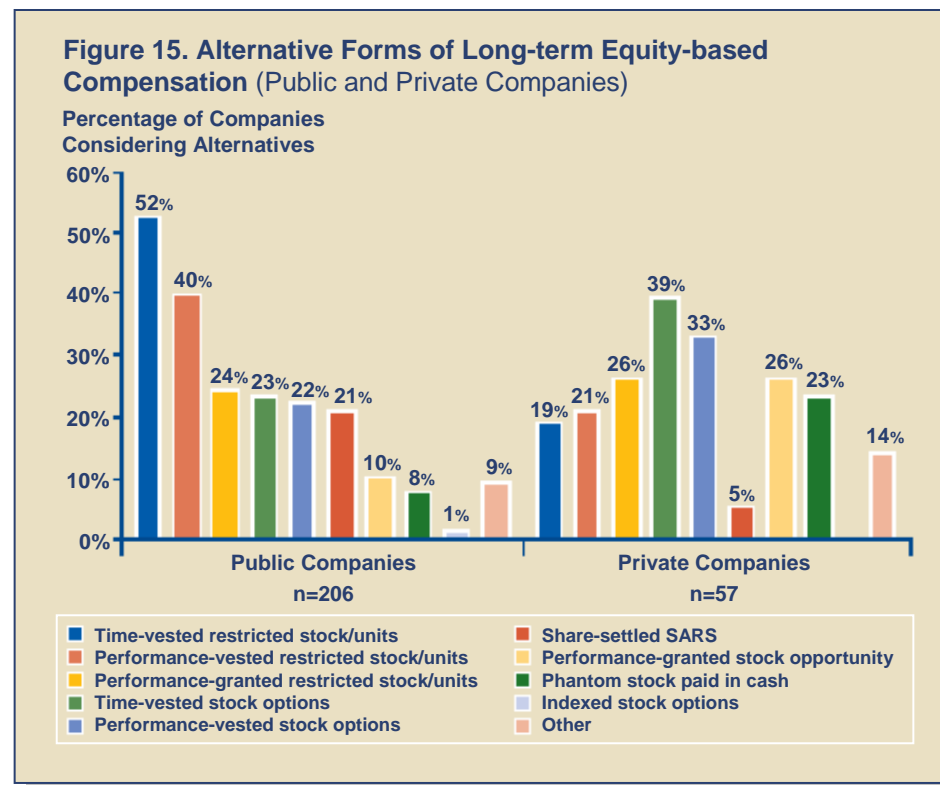
\* TMT – Technology, Media, and Telecommunications.



# Employers Cutting Back



- ❑ The majority of companies, both private (55%) and public (89%), are considering alternative forms of equity-based compensation.



Source: The 2005 Deloitte Stock Compensation Survey

# Long-Term Incentive Alternatives



Long-Term Incentive Vehicles	Share Usage (Dilution & Overhang Impact)	Linkage to Shareholder Return	Accounting Expense (Under FAS 123R or Other)	Retention Power	Participant Tax Timing
Stock Options	High	High	Expensed at "fair value" basis on grant date	Medium	At exercise
Service-Based Restricted Stock	Medium	Low to Medium	Expensed at "fair value" basis on grant date	High	When Earned* (Received)
Performance-Based Restricted Stock	Medium	Medium to High	Expensed at grant date and adjusted as expected award changes based on performance	Medium	When Earned* (Received)
Performance-Based Supplemental Executive Retirement Plan	None	Medium to High	Depends on how the Plan is structured – When vested or over the life of the plan	High	When Received (Deferred by Definition)
Performance Cash	None	Medium to High	Variable accounting (Market to Market)	Medium	When Earned* (Received)
Restricted Phantom Stock	None	Medium to High	Expensed at grant date	High	When Received (Deferred by Definition)

\*RCG/ECG 2005.

# Equity Based Compensation Alternatives



❑ **Restricted stock seems to be one of the alternatives to stock options as they have many **ADVANTAGES:****

- Unlike stock options they can't fall "underwater";
- They act as an incentive even when stock price falls;
- Less dilutive to shareholders.

❑ **However, restricted stock also has a number of **DISADVANTAGES:****

- Tax inefficiency from employee's point of view;
- Increased impact to the P&L as compared to stock options (if the company is not expensing its options).

# Equity Based Compensation Alternatives



- ❑ Instead of a Restricted Stock program, some companies have implemented “**Restricted Phantom Stock**” programs.
  
- ❑ Designed properly “Restricted Phantom Stock” plans:
  - Can offer same wealth accumulation to senior management as Restricted Stock;
  - Ability to defer gains and diversify the investment away from company stock risk without additional cost to company;
  - Vesting is not a taxable event to the executive as it is with Restricted Stock;
  - No dilution to shareholders;
  - Can be integrated with stock ownership guidelines;
  - Provides higher tax deductions to company and flexible tax planning opportunities to the executive;
  - Fixed accounting is allowed for Phantom Stock if the company settles the obligations in stock\*.

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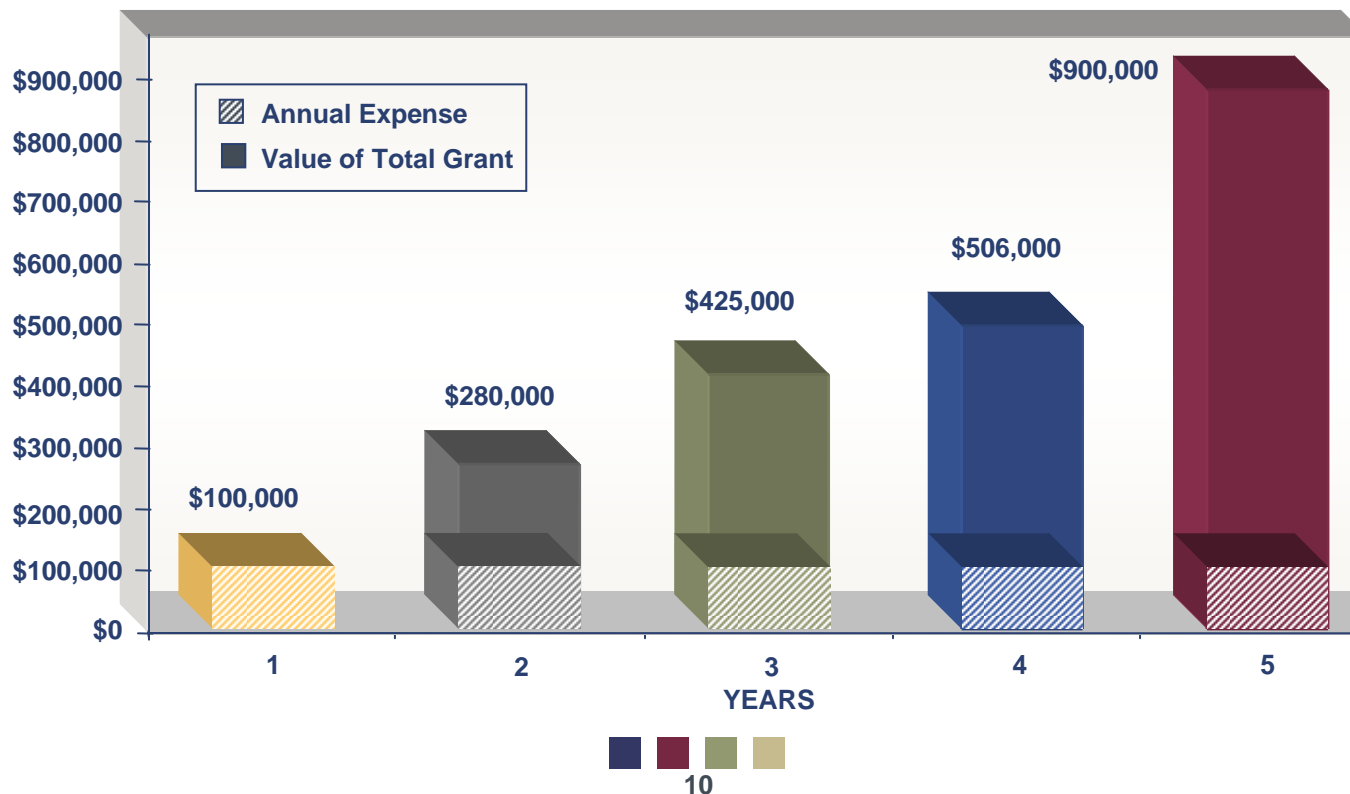
\* FASB Emerging Issues Tax Force (EITF) 97-14.

# Phantom Stock



- ❑ **Fixed Accounting is a major Advantage with the Phantom Stock Alternative:**
  - EITF 97-14 states that if the company settles the obligation with shares instead of cash, the company can use Fixed Accounting;
  - This means no additional expense hit to earnings as the shares appreciate post-grant.

### Annual Expenses v. Value of Total Grant



# Phantom Stock

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- Phantom Stock eliminates any “overhang” issue for the company;
- Phantom Stock, with a deferred compensation feature, eliminates the need for the executive to take an 83b election;
- Phantom Stock plans do not require shareholder approval.



# Performance-Based SERP



- ❑ Performance-Based SERPs are another alternative.
  
- ❑ The Performance-Based SERP is designed as a defined contribution method similar to a 401(k) plan. Basically, the employer tracks each executive's SERP benefits as an account balance payable after the executive terminates employment.
  
- ❑ Until that time, the executive's deferred compensation grows in two ways:
  - Employer Contributions;
  - Earnings on Past Credits.

# Performance-Based SERP



## Employer Contributions

- The central component to a defined contribution SERP is a formula by which the employer commits to make regular credits to the executive's account:
  - Credits made as a percentage of the executive's pay, with the percentage fluctuating based on previously defined measures of corporate performance.



# Performance-Based SERP



## Employer Contributions (continued)

### *Example:*

- 2% of pay is targeted as annual credit for satisfactory performance, based on ROE, which is targeted to be 16%.
- The SERP formula could provide for annual credits equal to one-eighth (1/8) of ROE times the executive's base pay.
- A minimum percentage could be established, such as 1% of pay if the employer wants to ensure some minimal accrual toward supplemental retirement benefits.

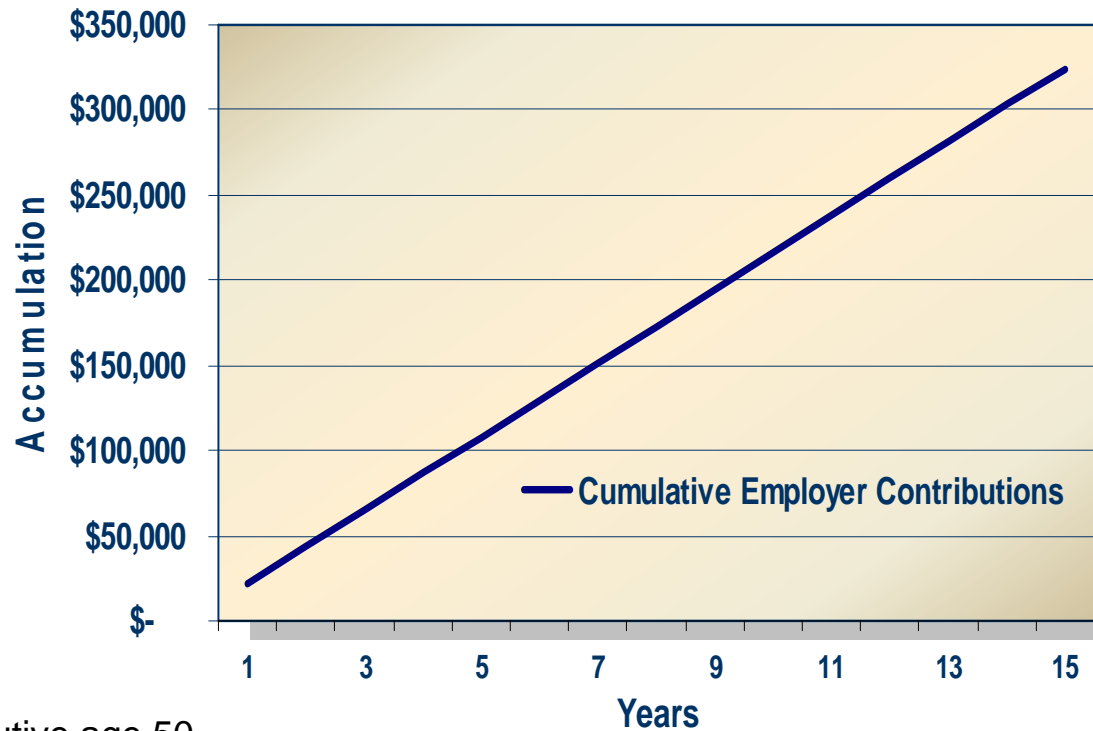
Note: Vesting – The employers' contributions would be subject to vesting.



# Performance-Based SERP



## Employer Contributions (continued)



- Executive age 50.
- Formula 2% of base pay earning 7% annual.
- Salary \$150,000.

This hypothetical illustration shows how the performance of underlying accounts could potentially affect an account balances. It may not be used to predict or project investment results.

# Performance-Based SERP



## Earnings on Past Credits

- The employer may secure significant accounting benefits by tracking each executive's benefits in the form of deferred shares of employer stock. If this is done, no expense arises from appreciation in their value.
- An employer may instead opt to pay SERP benefits in cash, or to measure the earnings on SERP accounts by a measure other than stock price.



# Performance-Based SERP



## Earnings on Past Credits (continued)

There are many choices for crediting interest or earnings to the executive's account. Some of the most common are:

- A fixed or market interest rate, such as prime;
- A corporate performance measure such as a percentage of ROE; or
- Mutual fund investment selected by the employer (often to mirror 401(k) plan choices).\*

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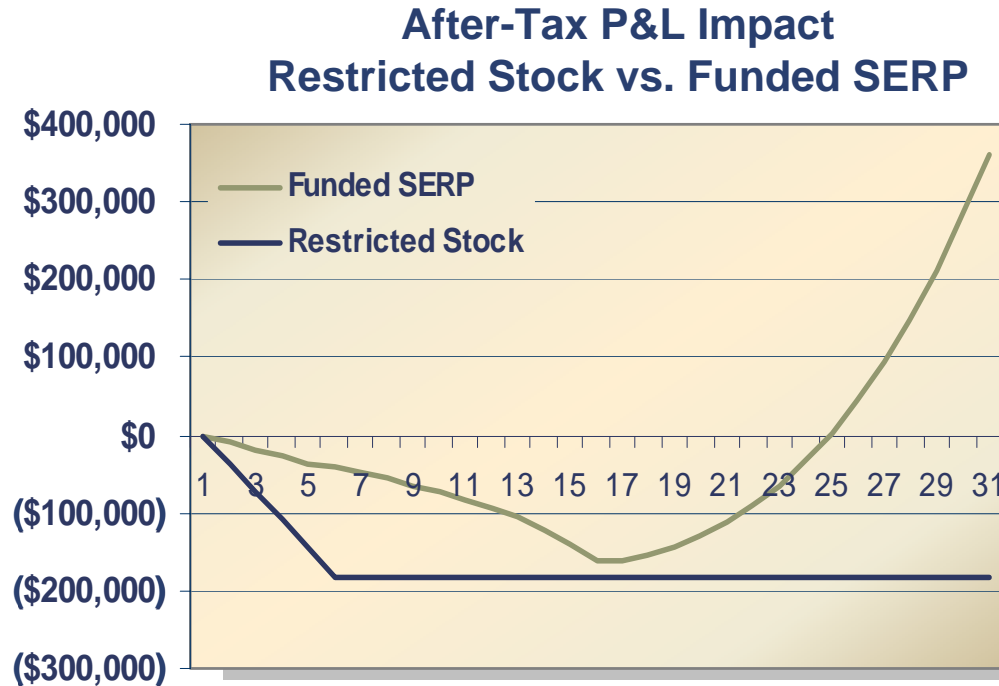
\* Could allow executives to self-direct.

# Performance-Based SERP



## Restricted Stock vs. Funded SERP

Many organizations are using Performance-Based SERPs as an alternative to issuing restricted stock. The following chart compares the P&L Impact.

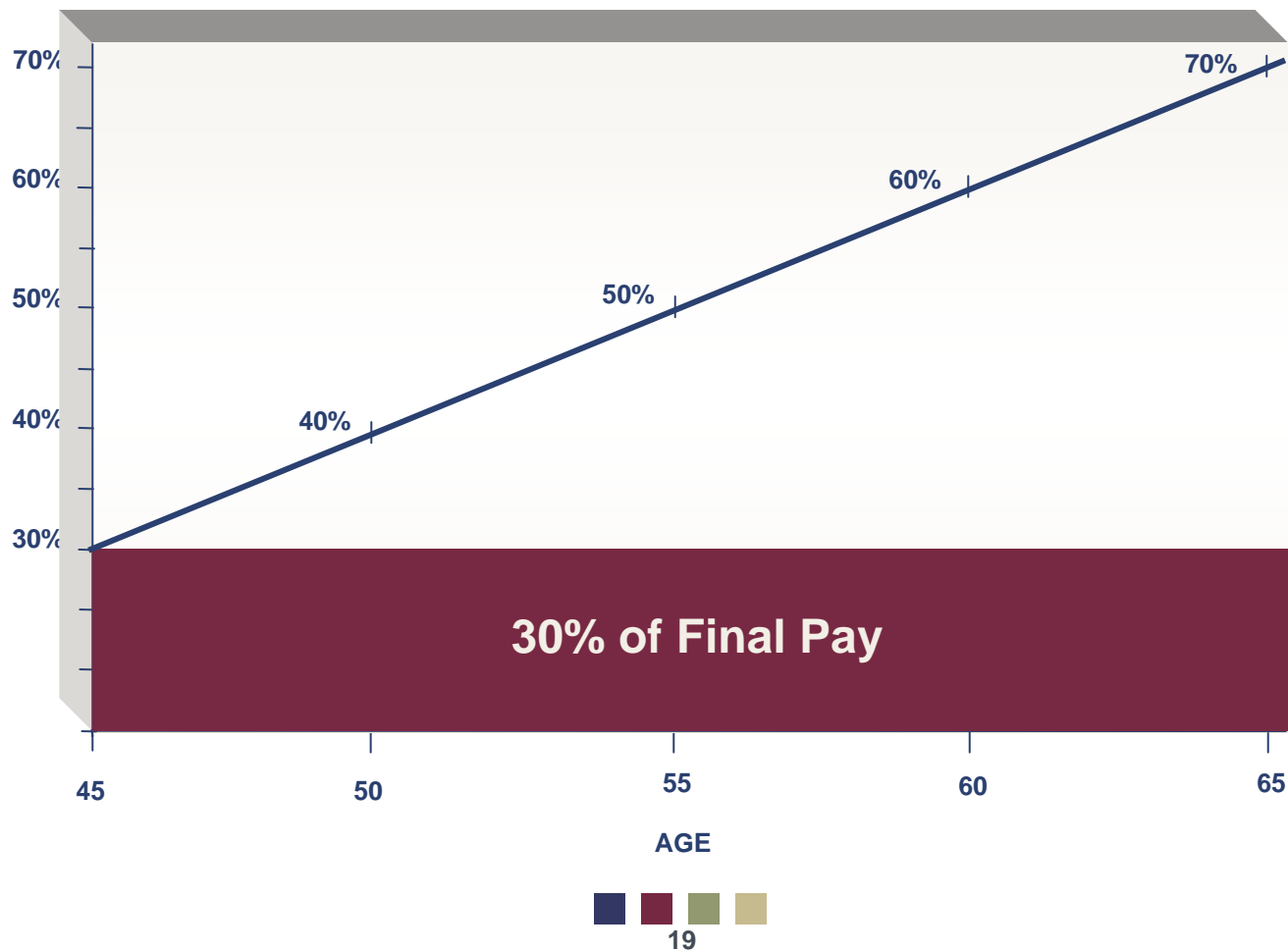


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# Performance-Based SERP



- ❑ Plan could provide base for retention, i.e. 30% of final pay at retirement with “performance kicker”, i.e. 2% per year.



# Case Study

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- ❑ To illustrate the financial impact of the alternatives, we have prepared a “case study”.
  
- ❑ Case study alternatives:
  - Restricted Stock;
  - Phantom Restricted Stock;
  - Performance-Based SERP.

# Case Study



## FAS 123R: A Level Playing Field - Example

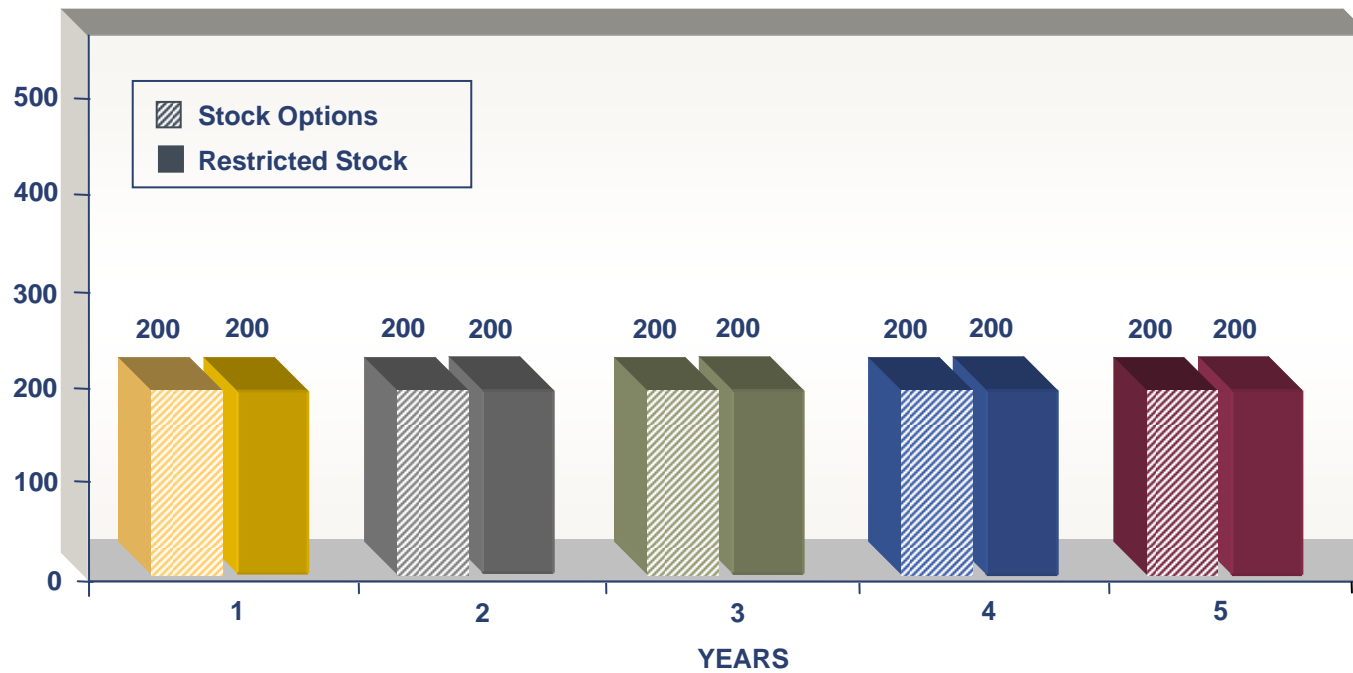


# Case Study



- ❑ Dollar results for stock options vs. restricted stock grants under 123R:

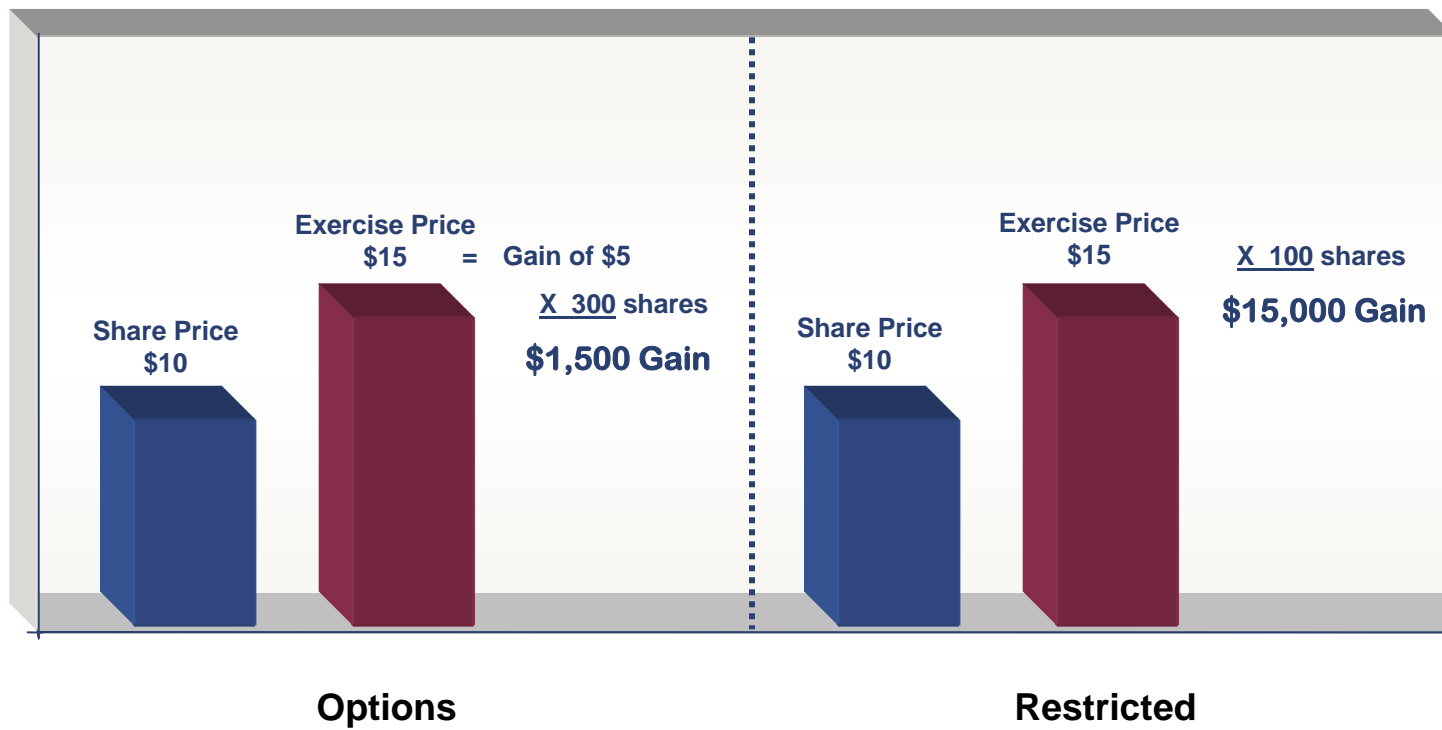
### Stock Options (300 shares) v. Restricted Stock (100 shares)



# Case Study



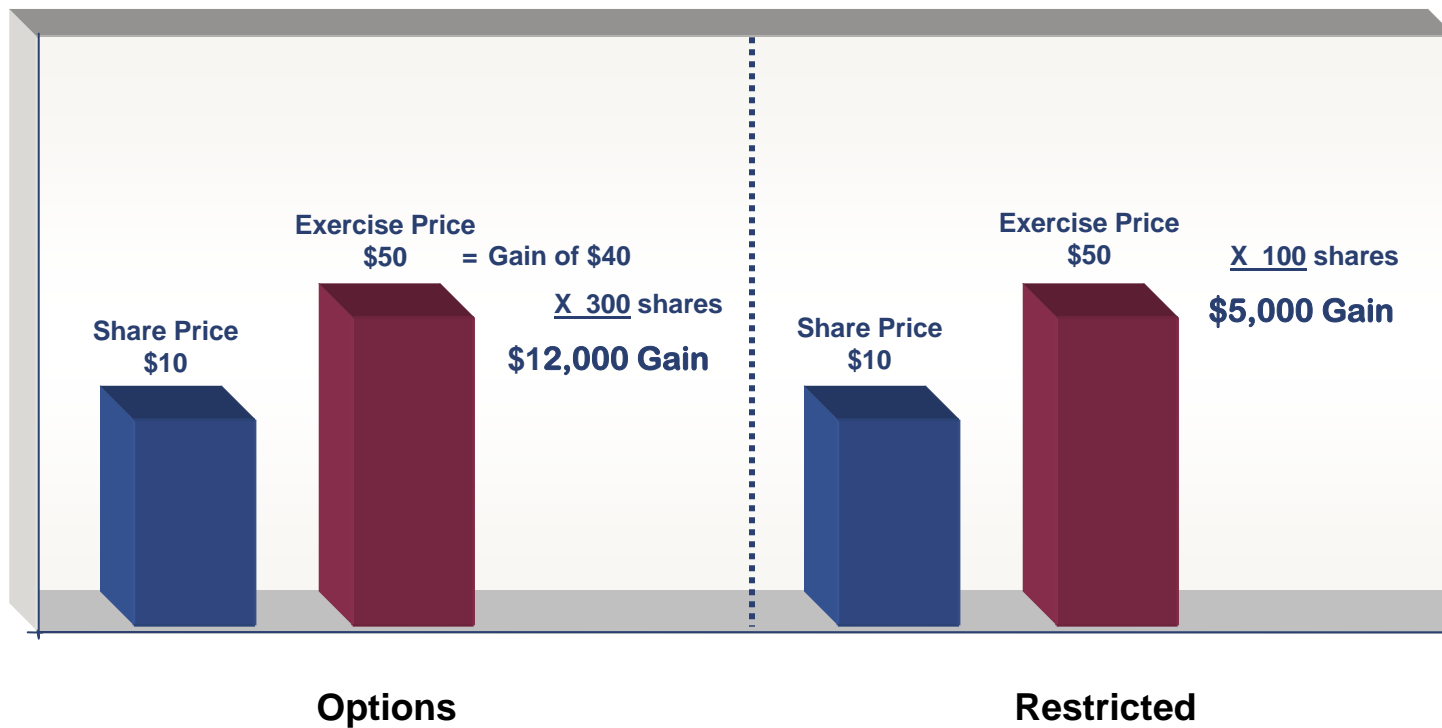
## Economics to Executive



# Case Study



## Economics to Executive



# Case Study



## Restricted Stock (100,000 shares) v. Phantom Restricted In Performance-Based SERP (100,000 shares)

Restricted Stock		Phantom Restricted	
100,000	Shares	100,000	
\$10.00	Grant Price	\$10.00	
\$15.00	Vesting Price	\$15.00	
\$1,500,000 x 40% \$600,000	Taxation A+ Vesting	Ø *	

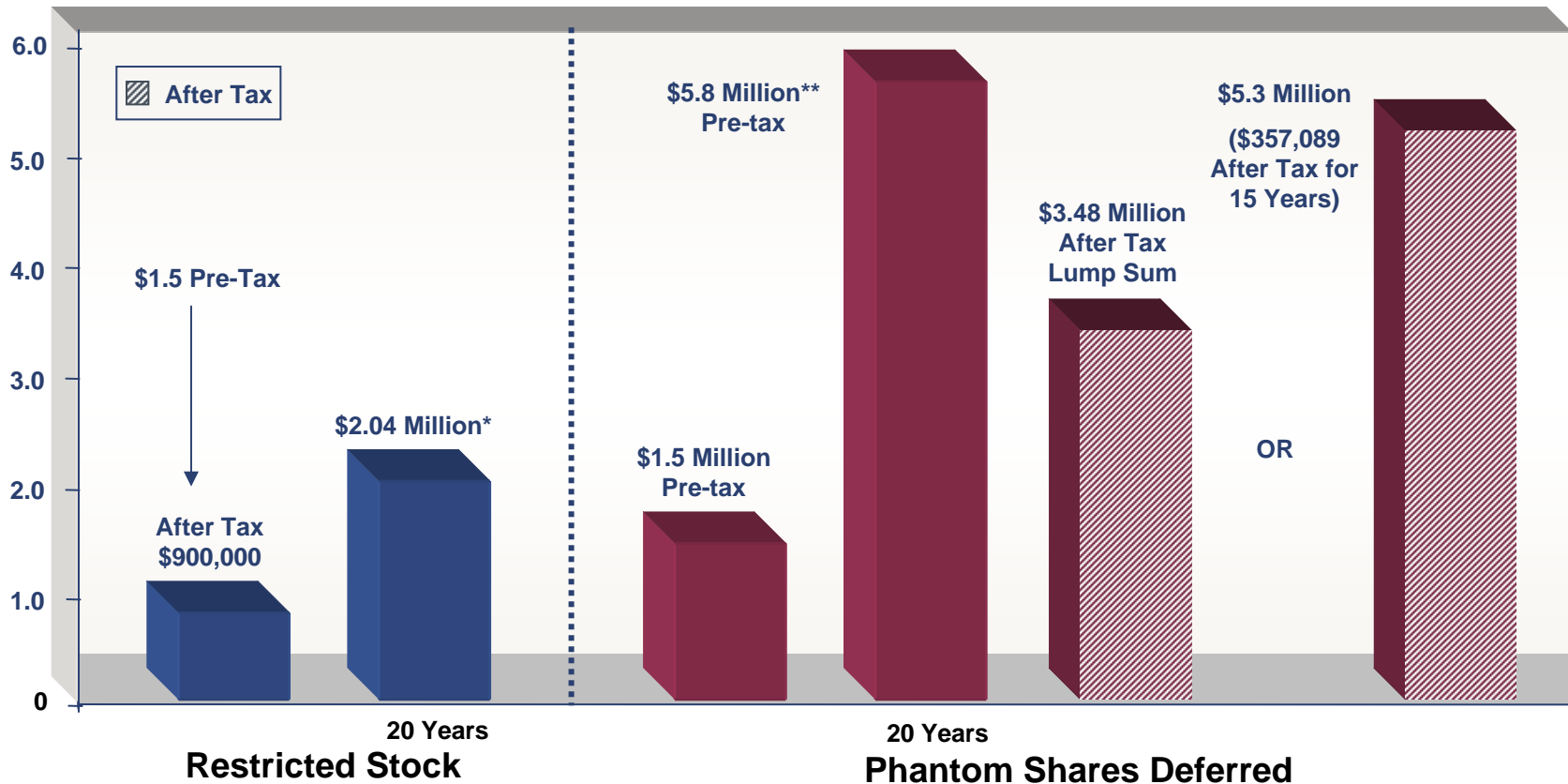
\* There is no tax at vesting, only at distribution.

# Case Study



## Advantages of Phantom Shares/Performance-Based SERP In Deferred Compensation Plan

(Assumes 7% Pre-Tax Return)



This hypothetical illustration shows how the performance of underlying accounts could potentially affect an account balances. It may not be used to predict or project investment results.

\*Assumes \$1.5 Earns 7% pre on 4.2% after tax.

\*\*Assumes \$1.5 Earns 7% pretax in deferred compensation plan for 20 years.

# Case Study

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## □ Performance-Based SERP

- As an alternative, the company could make an annual contribution to SERP based on predetermined goals.
- The company could informally fund plan and recovery company cost.
- Assuming the same annual contribution (expense level) of restricted stock, executive could diversify investment.

# Conclusions

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- Look “out of the box” for alternatives to expensing stock options.
  
- Consider different measurements for driving behavior that will impact shareholder performance.
  
- Look at executive benefits as an alternative.



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