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FOCUS ON:

ALIGNING COMPENSATION WITH BUSINESS STRATEGY: "GETTING OUT OF THE STOCK OPTION MORASS"



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A morass, according to the dictionary, is "something that is intricately and often bewilderingly complex." That's an all-too-accurate description of the debate over stock options and executive compensation. Part of the confusion stems from the heated emotions surrounding the subject: Options have become a hot-button issue in the public arena, associated with the collapse of stock prices and the recent spate of corporate governance and accounting scandals. In the aftermath of the late-'90s stock market bubble, it appeared to many observers that executives were profiting from options while other shareholders were taking big losses. In conjunction with the accounting scandals at Enron, Global Crossing, and other companies, the perception spread that options-based compensation was unfair. Largely because of this perceived unfairness, the debate over executive stock options now comes wrapped in clouds of anger and resentment.

THE TECHNICAL BACKDROP

Regulators and corporations themselves are trying to clear away the confusion, but their progress is slow and uneven. The Financial Accounting Standards Board (FASB), the industry body responsible for establishing U.S. accounting rules, has been examining several alternative proposals for accounting for stock options. In April 2003, the FASB agreed that stock-based compensation should be recorded as an expense, and the Board plans to issue an "exposure draft" later this year that could become effective in 2004. While the FASB deliberates, corporations in the meantime must choose between two very different methods of accounting for options-based compensation. They can either follow the long-established method prescribed by a rule known to accountants as APB 25, or they can adopt a method prescribed by a rule identified as SFAS 123.

Under the intrinsic-value-based method prescribed by APB 25, options generally do not result in a charge to earnings. Companies electing this method are however required by SFAS 123 to report in the notes to their financial statements pro forma net earnings and earnings per share calculations assuming the options had been expensed. Companies electing to adopt

SFAS 123, by contrast, are required to use a fair-value-based method of accounting for stock-based employee compensation plans, estimate the fair value of options at the time they are granted and record that value as an expense. It is almost inevitable that the options will have a different value when exercised than their initial estimated value, but SFAS 123 prohibits corporations from reflecting that difference in their financial statements. To date, only about 200 mostly large corporations - many under considerable pressure from their industry peers - have adopted SFAS 123. The momentum for more widespread adoption has stalled, however, in part because of doubt that SFAS 123 accurately captures the value or the final cost of options.

The debate over the appropriate accounting treatment for employee stock options further complicates the difficult executive-compensation decisions facing corporations today. On one side is the public outcry over stock options and executive pay in general, questioning whether the compensation is fair and reasonable. On the other side is corporations' need to retain valuable executives and reward genuine performance excellence. Without speculating on the outcome of these debates, we believe it is possible to discern some trends in executive compensation. Our thinking on this subject has been greatly enriched by [Stewart Reifler](#), a compensation expert in the New York City office of law firm [Vedder Price Kaufman & Kammholz](#). Like [Reifler](#), we believe that the coming changes in executive compensation will be evolutionary, not revolutionary. "How are we going to compensate executives in the future?" he asks. "We're still going to use the same tools, but we're going to use variations of them." [Reifler](#) also expects options distribution will be far less widespread in the future. "We're still going to see corporations awarding options," he says. "But most likely only to their senior-level executives."

COMPENSATION STRATEGY

What has not changed, however, are the principles of compensation strategy, which are to motivate and reward executives for improving corporate performance and genuinely adding to shareholder value. If stock price alone were an accurate way

to measure those things, options would make perfect sense: They reward senior managers if and only if their efforts produce gains in their company's stock price, and the rewards increase in proportion to the stock's appreciation.

The theory underlying options-based compensation probably holds true in what could be called a moderate stock market, where prices are closely correlated to corporate performance. But over the past 30 years, stock prices, up or down, have shown only a weak correlation to performance. In the feverish market of the late '90s, how much of any one stock's rise had to do with the company's performance and how much of it had to do with a general rise in stock prices?

The same is true on the down side, particularly for mid-cap or small-cap companies whose stocks often don't make it onto the radar screens of the big institutional investors and brokerage houses. A mid-cap company can turn in excellent performance - across-the-board growth in revenue, earnings, ROI, cash flow - and yet the stock won't budge due to lack of coverage. And even the stock of a company that is widely followed and performs well can get caught in the downdraft when the overall market collapses. In such cases, stock options will fail to reward executives for what may be comparatively strong performance

ALTERNATIVE APPROACHES

In an effort to forge a tighter link between executive pay and performance, compensation experts have devised several alternative approaches. One of the most compelling alternatives is the restricted stock unit, or RSU.

RSU grants, properly structured, can establish a clear connection between compensation and performance. In such plans, the size of the RSU award is conditioned on comparative performance in the marketplace. And to keep the focus on the long term, RSUs usually have a vesting schedule over an extended period of time. Stock options, on the other hand, establish no real link between corporate performance, except as performance imperfectly reflected in the stock price. The options are awarded, they vest at the end of some period of time, and then there is an additional period during which the options can be exercised. With RSUs, the company can build a much more conspicuous incentive program

that aligns performance with reward. "That's especially important in today's climate," notes Reifler. "Corporations want to be seen rewarding superior performance, not just giving out stock."

A growing number of leading-edge companies are using RSUs as a primary component of long-term incentive plans, or LTIPs, to compensate their senior executives. But such plans are appropriate for a much wider range of organizations - including the early-stage, venture-backed companies that heretofore have been the biggest proponents of stock options awards. A word of caution, however: The tax and accounting treatments of RSU awards are complex, and LTIPs must be carefully designed to avoid either adverse accounting consequences or adverse tax consequences (for the executive and/or the corporation).

Having offered that caveat, let's take a look at how a progressive LTIP might work: First, pick a time frame. For this example, we'll set three-year horizon. Then decide what should be measured. Instead of using stock price alone as the sole measure, for good or ill, we can measure, for example, revenue growth, profit growth, and growth in return on shareholder equity. An executive will earn a certain number of RSUs at one or more future dates, based on the attainment of those performance indices.

Each of those indices are measured at the end of each year of the three-year plan. The growth in those metrics is compared against the records of the company's major competitors. Let's say that in year one, the company's revenues grew by 15 percent. How did the company's key competitors do? The company gives itself a score based on its ranking relative to

the competition's. The score is weighted to give extra credit for being number one in the peer group, and then the weighting diminishes until the point where the value of the LTIP goes to zero. You do this because if you're dead last in your peer group, it should matter much less that you grew revenues by 15 percent.

Another advantage of RSUs is that they eliminate what has become a sore point for many companies: the practice of repricing options in a down market. Repricing stirs resentment among shareholders and the general public because it permits executives to make their shares worth more than they are in the real market - an advantage other shareholders can't enjoy. Options almost invite this kind of problem, because they force boards and executives to focus on their company's stock price as of the date the options are granted and the price as of the date the options are exercised. RSUs eliminate that repricing worry.

There's one more argument in favor of RSUs, and it might be the most compelling one. In many options programs, the senior executives never really become shareholders. Rather than exercise and purchase \$5 per share options when the market share price is \$10, they simply collect a check for the difference between those two share prices. They never end up as a shareholder. That doesn't happen with RSUs. The reward comes in the form of real stock. It makes executives shareholders, and ideally, they continue to be for some time. That assures other shareholders that the executive team is not just a bunch of hired guns - they are shareholders, too. And isn't that the whole idea?

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