

COMPLIANCE WEEK

Expensing Rule Drives Stock Awards

By Melissa Klein Aguilar — March 27, 2007

Exclusive research provided to Compliance Week shows that the equity-compensation landscape has changed dramatically over the past two years, since new accounting rules required public companies to expense the value of stock options granted to employees.

While stock options remain the most popular form of equity compensation, companies are doling out far fewer options than they did during the dot-com heyday. In addition, experts say more and more companies are shifting some portion of their equity awards to restricted stock or restricted stock units, known as “RSUs.”

“There’s a clear movement away from options to full value shares, either restricted stock or restricted stock units,” says Alexander Cwirko-Godycki, senior analyst at Equilar.



Now that options get the same accounting treatment as other forms of equity compensation, companies appear to be moving to a “best fit” model, says Bruce Greenblatt, a principal at Mercer Human Resource Consulting.

Greenblatt “Companies are taking [a] step back now that the playing field is level among the equity vehicles that they can use and they’re deciding which mix of vehicles is best for them,” he says.

An analysis of aggregate equity awards at Fortune 1000 companies provided to Compliance Week by research firm Equilar, Inc., shows that the median number of stock options granted per company plummeted 40 percent from fiscal 2003 to 2005, which was the year that Financial Accounting Standard 123(R) took effect. FAS 123(R) was the standard promulgated by the Financial Accounting Standards Board that mandates companies expense the value of stock options. At the same time, the median number of restricted shares granted per company increased by roughly 41 percent. Still, experts say that while options are down, they’re far from out.




“It’s not so much that companies have abandoned options, but they’ve introduced RSUs or restricted stock grants as part of their stock granting compensation practices,” says Stephen Fackler, a partner in the law firm Gibson Dunn & Crutcher. “Stock options are still the single most popular vehicle being used.”

Fackler Companies are awarding less equity overall today than they did just a few years ago, observers say.

“Aggregate equity use came down for large companies with revenue over \$1 billion from

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THE DATA

about 1.8 percent in the year prior to the adoption of FAS 123(R) to about 1 percent in 2006," says Greenblatt, who notes that his firm's own findings show trends similar to the Equilar data.

A snapshot survey of 142 U.S. companies conducted by Mercer in 2006 showed stock option value across all employee groups shifted from 70 percent or more of the long-term incentive mix in 2004 to about 50 percent in 2006. Meanwhile, the use of restricted stock accounted for about 40 percent of the LTI mix in 2006, up from 15 to 20 percent in 2004.

The Most Bang For The Least Expense

Still, while companies have reduced the number of options they award and in some cases have also narrowed the pool of employees eligible to get them, they haven't abandoned options by any means. In 2005, 95.2 percent of the Fortune 1000 reported stock option grants, down slightly from the 96.7 percent of companies that reported option grants in 2003, according to the Equilar data.

Experts note that the adoption of FAS123(R) did significantly boost the use of restricted stock grants, which weren't as widely used prior to the new accounting rules, since they already had to be expensed. In 2003, only 47.8 percent of the Fortune 100 reported restricted stock grants. By 2005, that percentage had risen to 57.1 percent, according to data from Equilar.



Carter
at the University of Pennsylvania's Wharton School.

In 2005, 58.5 percent S&P 1500 companies granted some form of restricted stock to their CEOs, compared with around 20 percent in 2001, notes Mary Ellen Carter,

an assistant accounting professor

at the University of Pennsylvania's Wharton

School.

"The accounting changes have been the impetus for causing companies to reassess," says Gibson Dunn's Fackler. "They want to make certain they're getting the most

Below is the analysis of Fortune 1000 equity-compensation trends for fiscal years '03, '04, and '05, provided by Equilar, Inc., to Compliance Week. All data presented below reflects aggregate awards to all employees, including rank and file:

Median Number Of Stock Options Granted Per Company

The overall trend in this category: A 40.1 percent decline of stock options granted per company from 2003 to 2005:

Year	Median Number	Increase/Decrease
2003	1,905,000	
2004	1,513,000	-20.6%
2005	1,141,000	-24.6%
Compound Change (2003-2005)		-40.1%

Median Number Of Restricted Shares Granted Per Company

The overall trend: The median number of restricted shares granted per company increased by 40.6 percent from 2003 to 2005:

Year	Median Number	Increase/Decrease
2003	193,397	
2004	223,116	+15.4%
2005	272,000	+21.9%
Compound Change (2003-2005)		+40.7%

Number, Prevalence Of Cos. Reporting Stock Option Grants

The overall trend: The prevalence of companies reporting stock option grants fell from 96.7 percent in 2003 to 95.2 percent in 2005:

Year	Number Of Companies	Percent Of Companies
2003	883	96.7%
2004	873	95.6%
2005	869	95.2%
Compound Change (2003-2005)		-1.6%

Number, Prevalence Of Cos.

compensation bang for their compensation expense dollar.”

However, he says the shift toward restricted stock and away from options would have occurred, perhaps to a lesser extent, even without FAS123(R).

“The accounting rules have influenced how stock compensation gets delivered in significant way, but they were also largely coincidental with what companies were already doing in response to the substantial decline in equity values in 2001 after the tech bubble burst,” he says. When equity values plummeted, “Companies still needed a way to deliver value through stock compensation vehicles to attract, motivate, and retain personnel at all levels.”

Dilution, Taxes And Performance

From a compensation philosophy point of view, he says boards and management like awarding a mix of options and restricted stock or RSUs because it provides “a more predictable flow of compensation and improves the retention value of the stock award package.”

While FAS123(R) is the main driver for the shift toward restricted stock, Equilar’s Cwirko-Godycki says shareholder concerns about dilution have also been a factor.

Since RSUs and restricted stock are less dilutive than options, “Companies can deliver the same value by giving less shares,” says Cwirko-Godycki. To deliver the same value as granting one share of restricted stock, he says, a company would typically have to grant three stock options.

In response to pressure from investors, many companies have lowered their run rates, which measure the potential dilutive effect of new option grants by calculating the sum of options granted and options assumed divided by the total shares outstanding.

The median run rate among the Fortune 1000 fell from 1.5 percent in 2003 to 1 percent in 2005, according to Equilar. Greenblatt at Mercer says he expects the downward pressure on run rates to continue. “Companies are more intent making sure the amount of equity issued in compensation plans is responsible,” he says.

Another benefit of restricted stock is “a nice tax feature that options don’t have,” notes Carter at Wharton. For restricted stock, executives can opt to make a Section 83(b) election, which allows them to pay taxes on the grant date instead of when the date restrictions lift. Then, taxes are based on the fair market value on the grant date, and any subsequent appreciation is taxed at the lower capital gains rate.


Carter says restricted stock has another benefit over options. “Even if the stock price drops, with restricted stock, the holder still has something of value,” she says. “The incentive is still there even if the stock is underwater. In a volatile market, that means something.”

Reporting Restricted Stock Grants

The overall trend: The prevalence of companies reporting restricted stock grants rose from 47.8 percent in 2003 to 57.1 percent in 2005:

Year	Number Of Companies	Percent Of Companies
2003	436	47.8%
2004	474	51.9%
2005	521	57.1%
Compound Change (2003-2005)		+19.5%

Source

 Analysis Of Fortune 1000 Equity Compensation Trends For Fiscal Years '03, '04, and '05 (Equilar)

Greenblatt says more companies are using performance-vested restricted stock or performance shares at the senior executive level.

“In the current environment, there’s more information than ever before about executive pay out there,” says Greenblatt. “With that additional information comes added scrutiny, so there’s more pressure to ensure compensation programs are aligned with company performance.”

At the senior-executive level, performance plans accounted for about 28 percent of the pay mix in 2006, says Greenblatt. “We expect to see that number continue to become a larger portion of the total.”

Theo Sharp, managing director at compensation-consulting firm Pearl Meyer & Partners says he’s also seeing more companies move towards performance-based restricted stock grants at the senior executive level.

“A lot of investors are pushing companies to use performance measures on equity,” he says.

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