

American Compensation Association

14040 N. Northsight Blvd. • Scottsdale, AZ 85260

Telephone 480/951-9191 • Fax 480/483-8352

http://www.acaonline.org • E-mail acanews@acaonline.org

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Mith Mohanna or Becky J. Tignor, Mohanna & Associates Inc.,

3400 Silverstone, Suite 108, Plano, TX 75023 800/800-0341;

972/596-8777; fax 972/985-8069; E-mail becky@mohanna.com

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American Compensation Association

About ACA – The American Compensation Association (ACA) is a not-for-profit organization of more than 25,000 members who are engaged in the design, implementation and management of employee compensation and benefits programs in their respective organizations. Founded in 1955, ACA is governed by a Board of Directors elected from the membership, and it is the premier organization dedicated to excellence in total compensation. Affiliated with the Canadian Compensation Association (CCA) and the Global Remuneration Organization (GRO), ACA serves the worldwide needs of the compensation and benefits management profession by conducting education and certification programs, promoting and sponsoring research activities, producing a variety of educational and informational publications, and providing networking opportunities.

VIEWPOINT



Indexed Stock Options: A Solution to the Excessive Pay Issue

By Fred Whittlesey, Compensation and Performance Management Inc.

This year's executive compensation disclosure season brought the expected flurry of observations, accusations and recommendations from journalists, critics and experts. From *The Wall Street Journal's* "CEOs are assured of getting rich – however, the company does" to *Business Week's* "Is Greed Good? ...CEO pay is excessive ...," the theme is unreasonable compensation unrelated to performance. Many culprits are cited: seven-figure base salaries, egregious bonus and severance arrangements, outlandish golden parachutes and lucrative supplemental retirement plans – but none is greater or more visible than stock option gains.

Most U.S. executives receive options with an exercise price set at fair market value on the grant date. Any upward movement in stock price, no matter how slight, produces compensation, even if such price appreciation is minimal and below expected performance levels. However, if overall stock prices increase 10 percent every year and investors receive 5 percent or 6 percent with no risk from government bonds, why reward an executive when the company's stock price increases only 5 or 10 percent per year – particularly if the overall market or the value of the company's peers has increased 20 percent or more? The increasing use of tactics such as equity swaps and zero-cost collars that allow executives to lock in option gains underscores the need to restore the pay-for-performance relationship in stock options.

The idea that executives should not benefit from normal – or below normal – market returns is not new. Many remedies have been proposed. The benefits of an obvious solution – indexed options – were trumpeted in Alfred Rappaport's recent article in the *Harvard Business Review*. The concept is simple. If the option exercise price is indexed to an expected level of performance – for example, the Standard & Poor's (S&P) 500 index – the option will provide compensation only when the company's stock price outperforms that index.

Conversely, if the index declines due to a broad downturn in market or industry conditions, the company whose stock price decreases less will provide optionees with compensation for that performance. Thus, indexed options may eliminate the need for another offensive practice: option repricing.

Companies increasingly are considering indexed options and, though still rare, the reactions are highly positive among pay critics. The *Crystal Report* cited Level3 Communications' grant of indexed options to the CEO, applauding their "willingness to do the right thing, even though the right thing is more risky and even though the right thing will have the effect of reducing accounting net income."

This comment alludes to the knee-jerk response to indexed options, unfavorable accounting treatment – a convenient argument against a compensation approach that requires true performance to deliver rewards. Rappaport highlights the absurdity that an indexed option "costs" more, in terms of compensation expense on the income statement, allowing companies to justify the use of fixed-price options granted at fair market value.

New evidence indicates the earnings-charge argument is on its last legs. While academic economists have long argued that noncash accounting expenses have no real effect and



LETTER TO THE EDITOR



VIEWPOINT

I was happy to see an article on gainsharing in the July/August issue of *ACA News*. However, after reading the piece, I feel the authors were irresponsible in their many unsubstantiated generalizations about "Generation X," and I question the appropriateness of *ACA* printing such an article.

According to the authors, Generation Xers "have a low tolerance for stress," "will admit defeat before attempting a project they feel is doomed from the start," and "dislike situations that develop into a competitive atmosphere." If these things are true, then the authors have an obligation to cite the research that proves this. If these are the opinions of the authors and not based on research, then they should make this clear in the article.

Imagine publishing unsubstantiated generalizations about a group of people based on their race or gender. For example, would you print an article that boldly states that women (or men) "have a low tolerance for stress," without first asking the authors to substantiate the claim? In effect, your magazine has done just that, but here the generalizations are based on age. The article is by no means anti-Generation X; many of the traits attributed to Generation Xers are positive, but the authors have an obligation to substantiate these as well as the negative generalizations.

I appreciate the many fine articles you publish, but would prefer that articles littered with unsubstantiated generalizations about any large, heterogeneous group of workers be omitted from future *ACA* publications.

Bob Demmel, CCP

(Pre-Generation X!)

financial experts and investors downplay earnings per share (EPS) as a valid indicator of corporate performance, the media's continued use of EPS as shorthand for economic performance has perpetuated the concern over stock option expenses. On the other hand, a recent study cited in *The Wall Street Journal* indicates 72 percent of brokerage firm reports provide a cash-flow multiple in addition to an earnings multiple, and dozens of companies now report a cash earnings number. Other pending changes in accounting rules will likely be the death knell for EPS.

Excluding certain types of expenses quickly is becoming the norm for financial reporting, manifested in headlines reading "earnings, excluding charges... were in line with analysts' expectations." In other words, "we are profitable if you exclude expenses we don't think are real expenses." EBIT (Earnings Before Interest and Taxes) and EBITDA (excluding also Depreciation and Amortization expense) increasingly are accepted as valid measures of operating performance. Will EBITDASO (excluding also Stock Option expense) be next?

The earnings-charge argument against indexed options should never again pollute the dialog of stock option design, as the data points to the following conclusions:

- Noncash expenses are moot, and cash flow is a more meaningful performance measure. (Sorry, Wall Street and would-be financial experts in the media.)
- A compensation device that delivers less compensation (an indexed option) cannot cost more than one delivering more compensation (a fixed price option). (Sorry, FASB.)
- Stock options – while creating ownership dilution – conserve cash, are a financially and strategically effective compensation tool and should be a cornerstone of total compensation strategy. (No apology needed.)
- Stock option plan design should not consider earnings impact – dilution, yes;

EPS, no. (Sorry, conventional executive compensation designers.)

- Indexed options ensure executives earn compensation only when corporate performance exceeds certain threshold levels of return, creating a true pay-for-performance system. (Sorry, executives – the free ride is over.)

Yes, there are design challenges in using indexed options, such as selecting the appropriate index and determining option grant size under the riskier structure. Newly public companies and those in volatile industry sectors will face a particularly difficult task. Yet, this is no excuse for continuing option grants at fair market value for senior executives of established public companies. Pay-for-performance arrangements require selecting performance measures and targets, which is never a perfect process. Designing performance-based compensation programs is part science, part judgment and forever imperfect. Remember when incentive compensation for nonmanagement employees met resistance based on these difficulties?

While this position is highly controversial, Rappaport and I are not alone. Alan Greenspan has endorsed indexed options and Warren Buffett believes they're a potential solution to options that are "wildly capricious in their distribution of rewards, inefficient as motivators, and inordinately expensive for shareholders."

Don't worry. Even if indexed options were accepted universally tomorrow, there still would be plenty to debate regarding excessive executive compensation. The topic is as rich as the optionees – option repricing, seven-figure salaries, supplemental executive retirement plans (SERPs), golden parachutes and severance payments. □

About the Author – Fred Whittlesey, *ACA* faculty member, is the founding principal of Compensation and Performance Management Inc., a human capital investment advisory firm, in Newport Beach, Calif.

The views expressed in the Viewpoint column are solely those of the authors and do not represent an official position of *ACA*. If you would like to respond to this column or other articles in *ACA News*, please e-mail your comments to aca-news@acaonline.org. Correspondence may appear as Letters to the Editor in upcoming issues of *ACA News*.