Stock Option Vesting Acceleration Increases in Advance of SFAS 123R

By now, it is generally known that the Financial Accounting Standards Board adopted SFAS 123R which requires companies to recognize a compensation for all equity-based awards, including stock options. With the effective date of the new accounting standard looming (fiscal years beginning after June 15, 2005), many companies are exploring opportunities to mitigate the accounting impact of outstanding equity awards. The most common strategy being considered and implemented by public firms is to accelerate the vesting of outstanding stock option awards. This Thoughtful Pay Alert highlights the key parameters and market trends associated with this type of initiative.

The Concept

Under the new accounting standard, companies must recognize an expense for the unvested portion of outstanding stock option awards. That is, the option expense that is currently provided in a company's footnote disclosure must be moved to the body of the income statement once SFAS 123R is effective. For many companies this will be a non-trivial earnings charge. Moreover, companies that have not taken action in the past to restructure their underwater options may recognize expense for awards that are unlikely to provide any value to the employee, or, at a minimum, significantly less than the employees' perceived value of the original grants.

Companies that have not taken action in the past to restructure their underwater options are faced with the prospect of recognizing an expense for awards that may be unlikely to provide any compensation.

By accelerating the vesting of these underwater options prior to adoption of SFAS 123R, a company may eliminate this "unproductive" expense from the income statement. Under APB 25, the equity accounting standard currently utilized by the vast majority of publicly traded firms, the acceleration triggers a new "measurement date." That is, the company recognizes an expense equal to the difference between the stock's fair market value on the date of acceleration and the exercise price). Because the exercise price exceeds the fair market value, there is no additional accounting expense.

To date more than 200 companies have implemented this strategy, and it is widely expected more firms will follow suit before the end of the year. From a planning perspective, there are four questions a company must address in connection with the option acceleration approach:

- Is the expense associated with outstanding, underwater options material?
- Should certain employees/groups of employees be excluded from the acceleration?
- Which stock options should be considered for acceleration?
- Will the accelerated options be subject to a sale restriction?

We researched the practices of ~120 companies that have accelerated stock options in the last 18 months to determine

Stock Option Vesting Acceleration

market prevalence with respect to each of these issues (see Figures 1.1–1.2).

Figure 1.1 – Prevalence by Industry

Industry	Number of Companies	Percentage
Computer Hardware	3	2%
Financial Services	6	5%
Life Sciences	21	17%
Other General Industry	36	29%
Other High-Tech Industry	16	13%
Publishing	3	2%
Semiconductor	22	18%
Software & Services	11	9%
Telecom	5	4%
Total	**123**	

Figure 1.2 – Company Size

Company Size Statistics	Last Four Quarters Revenue (MM)	Market Cap on 6/2/05 ($MM)	Number of Employees
75th Percentile	$1,178.3	$2,134.7	5,700
50th Percentile	$373.8	$567.3	1,479
Average	$2,585.2	$2,433.5	8,203
25th Percentile	$108.7	$237.8	400
Number of Companies	**121**	**120**	**121**

Materiality of Outstanding, Underwater Stock Option Expense

The first step for companies exploring the acceleration strategy is to understand the potential cost savings to be realized. As outlined in Figure 2, the median expense savings for companies implementing the vesting acceleration strategy was approximately $6 million.

Although institutional shareholder response has been fairly muted, shareholder advocacy groups (such as Institutional Shareholder Services, the Corporate Library, etc.) have expressed their displeasure with the vesting acceleration approach, suggesting that it amounts to playing games with the accounting rules. In contrast, many companies have taken the position that this approach benefits shareholders by "cleaning up" financial accounting statements and providing better visibility into future equity practices as the organization transitions to the new accounting standard. Clearly, companies must balance the expense savings against the potentially negative shareholder optics associated with this tactic. Absent a material expense savings, a company may choose not to adopt this approach.

Employee Group Participation

If a company decides to move forward with the vesting acceleration approach, it must resolve the associated mechanical issues. The first of which is to determine whether to exclude certain employee groups from acceleration. Often, this discussion will center around the acceleration of officer and board member options and whether the potential negative optics associated with acceleration for these individuals outweighs the expense savings (recognizing that for a majority of companies, including officers generates the bulk of expense savings). Based on our research, companies have generally *included* officers in acceleration programs, but 60% *excluded* board members (Figure 3).

Figure 2 – Total Estimated Accounting Savings

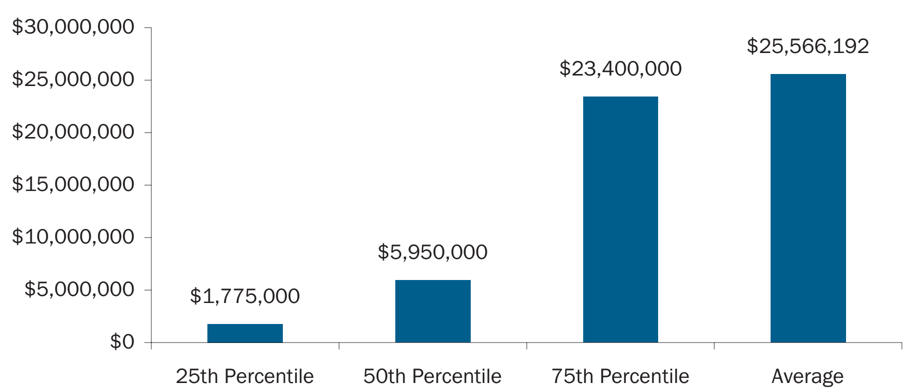

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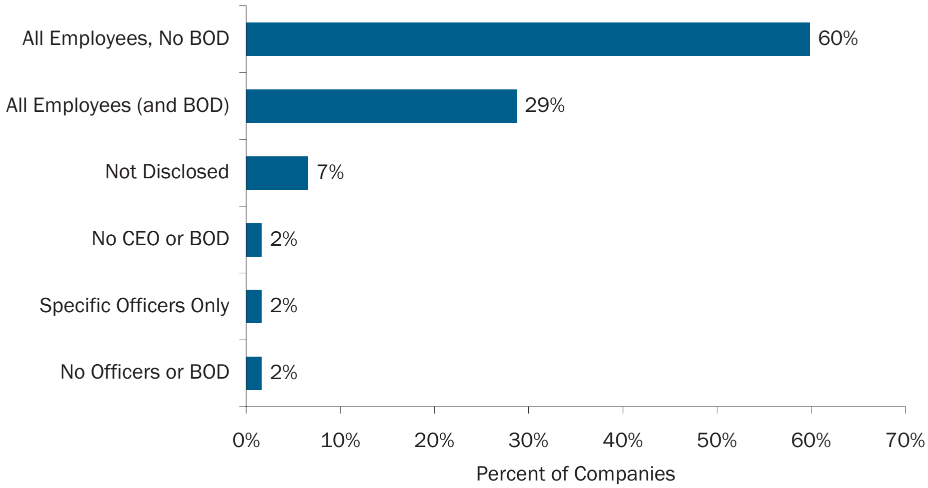
Figure 3 – Participation



Stock Options to be Accelerated

Arguably the most important design parameter is establishing which options will be accelerated. This decision will certainly impact the expense savings but may also influence the level of criticism from shareholder advocacy groups. The vast majority of companies only accelerated underwater options, but 14% of firms accelerated all options (Figure 4). Of those companies accelerating underwater options, practices are almost evenly split between accelerating all underwater options vs. establishing a threshold exercise price, in excess of the current fair market value, for inclusion in the acceleration program. Among the latter group, the threshold exercise price varies considerably as illustrated in Figure 5.

In selecting the options to be accelerated, companies should consider the potential message that will be sent to shareholders regarding management's expectations of future stock price performance as well as the lost retention value that may occur if modestly underwater options are accelerated.

Restrictions on Sale of Accelerated Options

To improve the shareholder optics and alleviate some of the concerns about lost retention, several companies have placed restrictions on the sale of shares underlying accelerated stock options. These restrictions will generally prohibit employees from selling exercised, accelerated stock options prior to the earlier of the original vesting date or termination, and in some cases also prohibit a cashless exercise if the employee terminates. The last restriction forces employees to raise the capital necessary to exercise the option and could be a deterrent to exercise by an employee who terminates prior to the end of the restriction period. To date only 12% of companies impose sale restrictions on accelerated options. Of those companies imposing restrictions, 53% of companies only subjected executive officers to the restrictions. Twenty percent (20%) of companies did permit the

Figure 4 – Extent of Options Accelerated

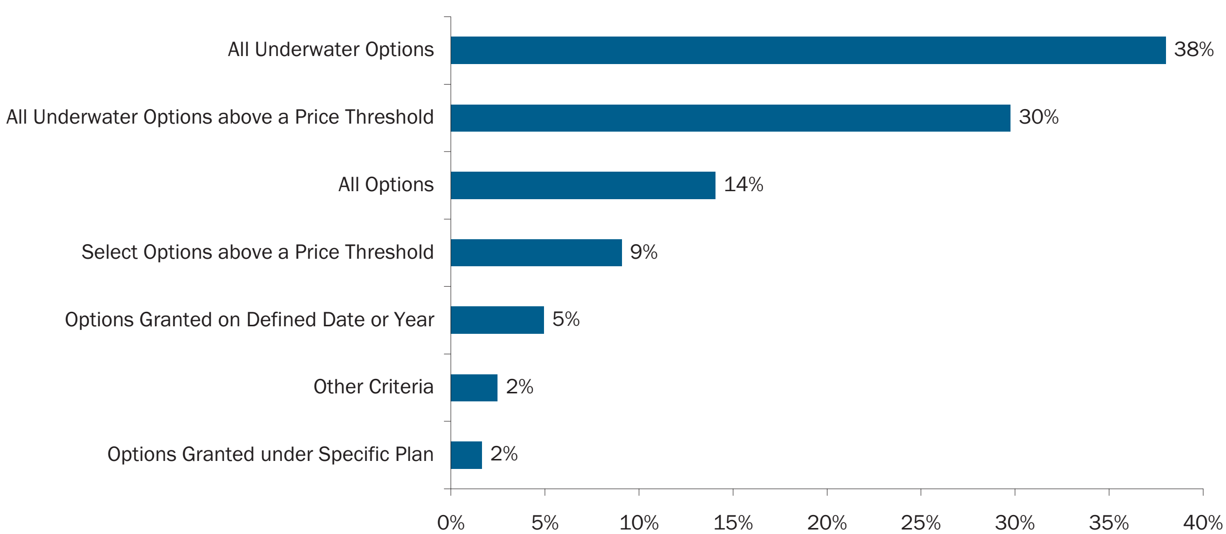
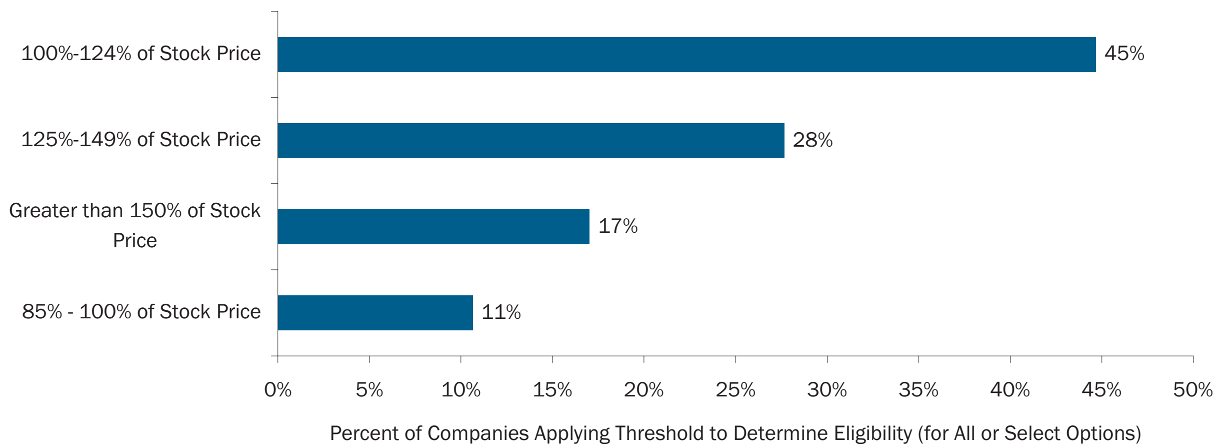


Figure 5 – Threshold Exercise Price of Accelerated Options vs. Stock Price on Date of Acceleration



sale of enough shares to cover taxes on the exercise, but did not allow the sale of the shares prior to the original vesting date. A company seeking to impose sale restrictions should review its equity plan and award agreements to ensure this action is permissible.

Other Considerations

Because the acceleration of unvested options is a modification to an outstanding equity award, companies should be aware of certain administrative issues. The modification may impact holders of Incentive Stock Options (ISOs) by violating the $100,000 per year vesting limit of ISOs. As such, the company may want to provide ISO holders the choice to opt out of the acceleration. Similarly, the company may want to exclude international employees where the acceleration of the options may have adverse tax impacts. Finally, the company may consider excluding performance-based/accelerated stock options and discounted stock options from the acceleration.

Companies must disclose the parameters of the acceleration (i.e., who it includes, total options accelerated, options held by officers (if any) and estimated accounting savings) in an 8-K or contemporaneous SEC filing. Furthermore, the SEC requires that this disclosure explicitly outline the rationale for taking this action, including but not limited to, stating the company's desire to reduce compensation expense. It is also worth noting that while acceleration of the expense recognition for these awards will reduce compensation expense in the income statement after SFAS 123R is effective, the expense recognized in a company's footnote disclosure under APB 25 will increase in the quarter the options are accelerated.

Several companies are also exploring a technique that "piggybacks" on the option acceleration – an exchange of underwater options for new restricted shares (i.e., share subject to vesting). Under SFAS 123R, a repricing or replacement of an existing equity grant with a new award results in an additional compensation expense only to the extent the fair value of the new award exceeds the fair value of the original award. Thus, if a company accelerates underwater options prior to the effective date of SFAS 123R and then enters into an exchange after the effective of the new standard, it can replace underwater options with no to minimal additional compensation expense. Companies are considering this action as a way to reduce overhang and increase the retention value of underwater options in conjunction with the expense savings from the acceleration. As always, there are potential equity plan limitations and shareholder approval requirements that need to be considered in connection with this strategy.

Companies should consult with their auditors, legal counsel and compensation advisors before entering into any of the strategies discussed in this alert. ♦

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Stock Option Vesting Acceleration

The following companies have accelerated stock options in connection with SFAS 123R in the last 18 months:

24/7 Media
Acxiom
ADESA
Administaff
Agile
AMD
Amkor Technology
Andrew Corporation
Andrx
Applera: Applied Biosystems
Applera: Celera Genomics
Armor Holdings
August Technology
Avocent
BankUnited Financial
Boston Communications Group
Brooks Automation
Cabot Microelectronics
Capital Senior Living
Captiva Software
Casual Male Retail
Catalina Marketing
Chemed
Cholestech
Clarcor
Clark
Comcast
Cooper Cameron
Corning
Cray
Cygnus
Cymer
Digene
Digimarc
Discovery Partners
Dow Jones
Echelon
Electro Scientific
Encore Medical
Entegris
Entrust
EPIQ Systems
ESPEED
E-Z-Em Inc
Fairchild Semiconductor
Flextronics International
Friendly Ice Cream
Frontier Airlines
FSI International
Gannett
Gentex
Greg Manning Auctions
HCA
Healthextras
Heska
Hooper Holmes
Horace Mann Educators
ICU Medical
IDT Corporation
InFocus
International Rectifier
IVAX Corporation
Jabil Circuit
JDA Software
Keithley Instruments
Kforce
Learning Tree International
Leapfrog Enterprises
Ligand Pharmacueticals
Linear Technology
LKQ Corp
Martek Biosciences
McKesson
Merit Medical Systems
Metro One Telecommunications
Microchip Technology
Micron Technology
Millipore
MKS Instruments
Monster Worldwide
Mykrolis
NCRIC Group
NeoWare
New York Times
Noven Pharmaceuticals
NVE Corporation
Osteotech
Pacific Premier Bancorp
PCTEL
PEC Solutions
Performance Food Group
Performance Technologies
Plantronics
Power One
Provident Financial
PSS World Medical
Radisys
Remington Oil & Gas
RF Micro Devices
RF Monolithic
Sanmina-SCI
Sharper Image
Shufflemaster
Simtek
Solectron
Sonic Innovations
Standard Register
Sun Microsystems
Sykes Enterprices
Tech Data
Teradyne
Timberland Bancorp
TriQuint Semiconductor
Ultratech
UT Starcom
Viacom
Vivus
Waters Corp
Whole Foods
Wisconsin Energy
XOMA

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management. Formed in 2003 by a group of leading executive compensation experts with more than 60 years of experience, our mission is to offer Thoughtful Pay™ solutions in an ever-changing executive compensation landscape.

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