The Options on Options

Software industry compensation has changed. Organizations must consider new factors in order to create a motivational and financially rewarding incentive plan for their employees.
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Options are dead - or are they?

The FASB ruling, which took effect this year, dampened on a time-honored technology tradition: providing employees with stock options as a long-term compensation vehicle. Since companies have been mandated to expense stock options, many organizations are scrambling to provide competitive plans to their workforce while still aligning the employee's and the organization's goals.

While stock option grants may have declined they have not disappeared. Options remain a compelling and cost-effective long-term incentive method for many companies. A review of the latest pay and equity trends reveals software companies should consider a variety of factors when revamping their compensation plans.

In the 1990s, stock options accounted for more than 80 percent of long-term incentive rewards in the software industry. Options cost the employee nothing at the time of grant and resulted in no expense to the organization. During the Internet Bubble, many startups offered options in lieu of cash incentives for all of their employees due to the potential huge upside for employees. As a result, non-technology companies were forced to offer stock option plans to remain competitive with their technology neighbors.

Everything changed in 2001 as the bubble burst. Stock prices declined considerably and options were pinned far "underwater" - worth less than their exercise price - and valueless. As companies laid-off employees in droves and closed their doors, compensation plans no longer needed to offer large sign-on grants to remain competitive as options became less of a recruitment and retention vehicle. At the same time, FASB intensified their options-expensing crusade and the public outcry surrounding corporate malfeasance - often blamed on lucrative stock options plans - became deafening.

The New World of Incentives

As of April 2005, FASB mandated that companies must expense stock option grants at their fair market value at the time of grant. Also, savvy software companies are eliminating broad-based equity plans realizing that not every employee can truly drive stock performance and instead are shifting their focus to the "right" form of long-term incentives.

Very few software companies are keeping the status quo, which would be maintaining a stock option program or providing employees the full-equivalent of replacing their option plans with restricted stock - usually one-half to one-third as many shares as options. Salary.com research shows that companies, many of whom have already moved away from options, are making a variety of changes.

The majority of software companies are decreasing the size of the option grant, or providing a partial replacement of the option value. A partial replacement usually amounts to a grant of restricted stock (maintaining some value at any stock price but not allowing for the upside of potential options) or a long-term cash bonus redeemable in three to five years. Another fifty percent of companies are simply decreasing the portion of employees who are eligible for the options program by limiting eligibility to include only executives who can more directly impact earnings. A similar portion of companies are offering a mixture restricted stock and options, with performance accelerated restricted stock or options are other possible offerings.

Companies are relying on non-equity based programs as well. Annual cash incentives, long-term cash bonuses and 401(k) matching are all proven compensation vehicles that serve to provide both motivational value to the employee and a retention hook for the employer. Employee recognition awards, or "spot" bonuses are another way to recognize outstanding individual performance while professional development and training programs are proven to be of high value to employees at little cost to organizations.

New Compensation Considerations
As software companies work to adjust their compensation plans for this new era of expensed options, several trends should be considered. /li>

- **Balance Risk & Reward.** Public companies who are in the growth stage may want to consider remaining with stock options as there is more upside potential for the employee. In contrast, public companies wanting to preserve the value of their stock should consider offering restricted stock as a long-term incentive. Employees in option-driven companies are more likely to swing for the fences and hit a grand slam while companies in preservation-focused companies granting restricted stock may not take as many big-swing chances, and subsequently, will also be less likely to strike out.
- **Stay the Course.** Pre-IPO firms don't necessarily need to move away from options. Option expenses are low when the company valuation is low and for this reason pre-IPO software vendors can continue to offer their employees options. However, the company must communicate with employees in order to keep expectations in line with reality. Specifically, companies may need to explain any post-IPO changes that will occur in the long-term incentive plan well in advance of the offering to manage expectations.
- **Adopt New Equity Grant Guidelines.** The hiring market is rebounding to some degree and competition for talent is increasing. When companies consider options grants as recruitment and retention vehicles, many offer these grants only to select positions that can drive company and stock performance. Also, the vesting period for new equity grants tends to be shorter, typically three to five years rather than the previous standard period five or seven. This keeps accepted valuation methods, such a Black-Scholes or binomial, down. There is also a new focus on large one-time grants at the time of hire, rather than smaller recurring annual grants.
- **Consider "Pay for Performance."** In today's highly regulated world, "pay for performance" has become the de facto standard for software executives. Sarbanes-Oxley has management focused on measurable performance benchmarks such as balanced scorecards and MBOs (Management by Objectives). These prove effective measures against which compensation can be based and justified if need be.
- **Help the Mid- and Lower-Level Workers.** The loss of options hits the middle class of workers especially hard since these are typically the groups cut out as eligibility is pulled "up" within an organization. Companies must work to offer non-executive employees new types of long-term incentives. Use of recognition awards or spot bonuses for exceptional work are effective alternatives to options in the short term while 401(k) matches which rise as tenure increases is another proven vehicle in this area.
- **Hire a Compensation Consultant.** Executive compensation has experienced increased scrutiny in light of recent corporate scandals. Most technology firms are

hiring their own independent, third-party consultants to verify the efficiency of their compensation plans. These consultants can benchmark a company's plan against its competitors and improve the plan's credibility.

- **Communicate Reality.** The compensation message to employees must change. Instead of focusing on the absence of options, communicate the advantages of a balanced portfolio approach to compensation packages. The reality is that many employees cannot do too much to directly impact their company's stock price anyway and many were "riding the wave" without any direct control over its direction. Management should also make it clear that employees must take responsibility for their future financial well-being. Corporate long-term incentives must be balanced with 401(k) contributions, personal savings and investments and financial planning to create a holistic and managed approach to an employee's financial future.

One thing is clear: one-size-fits-all compensation plans are no longer effective. Software companies must conduct a thorough analysis of long-term incentive choices in order to deliver employees a plan that both meets their financial needs and motivates their performance.

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