

## **RESTRICTED STOCK: WHY ARE THEY SO POPULAR AND WHAT SHOULD I DO TO GET READY?**

**By Gary Scrofani, CompIntelligence**

The announcement by Microsoft in July of 2003 that it was replacing its employee stock option plan with a restricted stock unit program prompted a renewed interest by many corporations in restricted stock as an incentive compensation instrument. But it was the changes in the accounting treatment for stock option plans under SFAS 123R that caused many companies to follow Microsoft's lead and expand or adopt restricted stock programs. This paper examines several factors driving the popularity of restricted stock plans as an alternative equity benefit to traditional stock options. It also outlines a few of the major considerations you should keep in mind when analyzing whether restricted stock programs should be part of your company's compensation offerings and highlights several issues surrounding the administration and financial reporting of restricted stock.

### **New accounting for options levels the playing field**

A major driver behind the resurgence of restricted stock plans is the elimination of the highly favorable accounting treatment for traditional employee stock options currently permitted under APB 25. Under SFAS 123R, U.S. companies are required to treat stock options as an actual expense, whereas prior to SFAS 123R only a pro forma disclosure was required in a footnote to financial statements. The accounting standard gives stock options no advantage over restricted shares and may in some circumstances actually result in higher expense than if the equivalent benefit is delivered to the employee in the form of restricted shares.

### **Shareholders demand to be heard**

A perception among institutional shareholders that stock options were too liberally handed out to corporate executives throughout the booming economy of the early nineties has also prompted companies to respond. Traditionally, stock options have been used by companies as a regular part of an employee compensation plan regardless of that employee's performance or contribution to the success of the company. Shareholder groups are making demands that equity compensation rewards be clearly based on attainment of performance standards, rather than solely on the passage of time. In their view, aligning the reward with performance both adds value to the grant and motivates employees to improve efficiency and productivity. The Sarbanes-Oxley Act of 2002 (SOX) imposed a requirement that companies obtain shareholder approval when issuing new stock plans. This law gives a voice to shareholders and is another factor forcing companies to reassess their human resource goals for issuing stock options. Shareholders typically object to blanket awards of options or to plans that result in high levels of dilution.

### **Good for everyone**

Restricted awards (stock shares or units) are an attractive alternative to options because they can easily impose various restrictions that may be based not just on a service period but also on performance metrics such as share price, shareholder return, EPS, or any manner of performance target. At the same time, employers are finding they may be able to provide the same benefit amount to employees using a smaller number of restricted shares than would be required for an equivalent benefit based on options. Restricted awards are also less risky to an employee in a declining market. An underwater option is perceived by the employee to be worthless, whereas a share of stock always has some value that can be realized by selling the share. Restricted shares may also provide an additional benefit to employees of companies who pay dividends on their stock. In the case of restricted stock units, the employee may receive dividend equivalent units. Restricted awards may also carry voting rights, so the employee truly feels like a shareholder with an investment in the company.

### **Pay for performance vs. pay for pulse**

Restricted stock plans can be structured with vesting dependent on various types of performance-based restrictions, in addition to more traditional restrictions such as service periods and share price. In many companies, stock price targets do not always align with individual performance goals. Performance triggers can encompass corporate performance metrics, departmental goals, and individual goals. An effective plan requires targets that are both appropriate and achievable. If employees do not believe they can influence the attainment of the performance target, the award can actually be viewed as a disincentive to the employee.

### **Accounting considerations**

The accounting and financial reporting associated with performance-based restricted awards can be very complex. When designing your plan, seek input from your accounting advisors to get a better understanding of what to expect. Recognition of the expense associated with the restricted awards may require periodic adjustments based on the number of shares that are expected to vest during the reporting period. As an example, for shares of stock that vest purely on the passage of time, the value of the stock on the date of the grant is amortized over the restricted period. For shares that vest based on a performance trigger, the estimated number of shares that will vest must be expensed. During each reporting period, the estimate must be reevaluated and an expense true-up must be accounted for. Restricted stock units that can be paid in cash are treated as a liability and variable accounting must be performed. This means that the shares must be revalued each reporting period.

### **Anticipate changes in administrative processes**

Stock options and restricted stock plans are complex financial instruments. It has taken some time for both company administrators and employee/plan participants to understand options. Many people today have a basic understanding of what options are and what their value is. Options are talked about in the news and even in the movies.

But do most people understand restricted awards? A full communications plan should accompany the rollout of a major new benefit program such as restricted stock. It is important that you communicate clearly what restricted awards are, what type of awards you are issuing to your employees, why they are valuable, and how they earn them. It is critical for employees to understand their awards if they are to truly value receiving them. When options vest, employees will exercise and sell their shares when there is a good return on those shares. Vesting time periods will be spread out across all your employees. With restricted awards, the restrictions on the shares may all lapse at the same time. You'll need to work closely with your transfer agent and brokers to ensure that the shares are issued within the required settlement time and taxes and fees collected. Are you prepared for that volume of work in one day? Is your payroll ready? Are the transfer agent and broker ready? How will you address these processes for international employees? You'll need a plan to collect taxes from your participants. The more alternatives you give employees to pay for taxes, the harder it will be to administer the process. If employees are using shares to cover taxes, make sure processes are in place with the plan administrator, the broker and the transfer agent to calculate and remit the correct amounts. If you are accepting checks, communicate to participants in advance so they can prepare a check before they can receive the shares; thus you may need to implement new processes whereby employees must elect in advance how they wish shares and payments to be handled. Federal tax law permits employees to pay taxes within 30 days of an award (rather than when the restrictions lapse) of restricted stock (but not restricted stock units) using an 83(b) election. Check to ensure that you have processes in place for tracking these elections. Rolling out a major new plan design presents an opportune time to reassess plan management practices.

### **Administering the plan**

Companies that are considering rolling out a restricted plan should consult with outside experts on how to best administer the plan for their individual company's needs. It may be best to consider whether the task of managing the restricted stock plan is better left to a service provider that specializes in equity plan administration. Outsourcing providers can often offer a host of value-added services such as web based employee portals, access to brokerage services, document processing, and financial reporting, and at the same reduce the need for scarce internal IT resources to support in-house administration.

It may also be to a company's advantage to administer the plan in-house. Automation is the key to a successful implementation. Considering all of the tasks that need to be performed; grant agreement letters, grant acknowledgments, 83(b) elections, participant advanced elections, collecting taxes, and delivering shares or payouts, are just a few of the things that can be automated to make administering a restricted plan manageable. Having the plan administration system interface with your payroll system, broker, transfer agent, and participant website are essential.

## **Conclusion**

Restricted stock programs are becoming a very effective tool in the compensation mix, offering a means of aligning the needs of many stakeholders and functions within a corporation: employees, shareholders, finance and accounting, and human resources. Careful attention to plan design, to a broad range of stakeholder interests, and to the processes of managing the plan will help ensure that the program meets the goals of incentive compensation: to attract, motivate, and retain key talent. There are many companies that have already implemented restricted plans and you should seek their advice and expertise on how to best implement your plan in your environment.

## **About the Author**

Mr. Scrofani has over 24 years of experience in software, support, and education. Prior to joining CompIntelligence, Mr. Scrofani was with Computershare for over 7 years serving as Director of Product Management for the Transcendive Web Platform and the Equity Suite, the company's core product offerings. Before that, he was the Director of the Education Service group and served as dean of Transcendive University, the company's education and training institute. A frequent speaker at conferences and workshops, Mr. Scrofani has presented at several National Association of Stock Plan Professionals (NASPP), Global Equity Organization (GEO), and American Electronics Association (AeA) chapter meetings on the latest industry changes and trends that involve stock plan administration, insider filings, and financial reporting. He is a member of the NASPP.

## **About the CompIntelligence**

CompIntelligence delivers custom solutions and application consulting for Finance, Human Resources, Payroll, Accounting, Equity Compensation, and Information Technology departments. We bring a business intelligence discipline to compensation management and technology for total visibility across your company. We offer a multitude of services and solutions that can be tailored to fit your exact needs. You can leverage our experiences in Equity Compensation, Business Performance Management, and Technology Solutions. Our expertise can assist your company in the financial analysis, compensation analysis, equity compensation, and technology development arenas.