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Technology, Media & Telecommunications

2003 Technology Stock Compensation Survey Results

Looking Beyond Options

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Overview

The Deloitte 2003 Technology Stock Compensation Survey asked companies how they are responding to the changing environment of equity compensation. We drew responses from 196 companies, 175 of which are in the technology industry (including telecommunications, media and life sciences companies) during July and August 2003. Approximately half of the companies—46 percent—are privately held. This report reflects technology companies' responses only unless otherwise indicated.

Tech executives—in a sector that has long relied on stock option plans as a way to attract and motivate employees—are being forced to deal with new constraints. These include increasing concerns about equity overhang and dilution, proposed expensing rules, a shrinking supply of shares and new rules giving shareholders more say over option plans. Broad-based option plans are still the norm in the tech industry, but companies are actively looking at ways to scale back option usage and, perhaps for the first time, considering equity alternatives such as grants of restricted stock or stock units.



Highlights:

- **Shares are running low.** Close to three-quarters of the public company respondents (72 percent) said they will run out of shares for their option plans within two years. In fact, 20 percent indicated they will probably have to request shareholder approval for additional shares at the next shareholders' meeting.
- **Option expensing is the top issue for public companies.** Among public companies, 80 percent said the anticipated "fair value" expensing rule will have a major impact on their equity compensation plans.
- **Equity overhang is also high on the worry list.** Potential dilution from employee stock options ranked second as a concern of publicly-traded firms, with 45 percent of public companies rating it either 1 (greatest impact) or 2 in importance. Forty-eight percent of private companies also rated it a 1 or 2.
- **A significant number of options are underwater.** Among public companies surveyed, 33 percent said more than half their options are currently out of the money and considered valueless by employees; 17 percent of the private companies are in a similar situation.
- **Most public firms are cutting options now.** Seventy-three percent of public company respondents said they have already reduced, or plan to reduce, the number of options granted in the next 12 months.
- **Cuts in option plans may affect many new and lower-level employees.** Among companies expecting to reduce the number of options they grant over the next 12 months, 26 percent of the public companies, and 38 percent of the private firms, said they would reduce new hire grants.

- **Companies are considering alternative plans.** Among long-term equity incentive alternatives, the most popular among public companies were time-vested restricted stock or stock units, while for private companies, the preference was for cash-based performance plans.
- **Attracting and motivating employees is still a priority.** Assessing the factors they consider in crafting compensation plans, respondents placed the greatest weight on providing a competitive pay package and linking pay to company, business unit or team performance.
- **ESPPs will also see cuts.** Among companies with employee stock purchase plans (ESPPs), nearly one-fourth (24 percent) said they would eliminate their ESPPs if forced to expense them.

Tech Firms See Multiple Threats to Option Plans

Companies are dealing with multiple issues regarding employee stock options. Those surveyed are most concerned about the Financial Accounting Standards Board's (FASB) expected "fair value" expensing rule and the need to replenish their own dwindling supply of shares available for option grants. They are also concerned about shareholder resistance to new option plans (and new rules that give shareholders more say over these programs) and employee concern over perceived worthless options.

When asked how soon they would have to request shareholder approval to replenish shares for option plans given current levels of usage, 20 percent of public company respondents said they had less than one year. Another 52 percent said they would run out of shares between one and two years. That means 72 percent of the public companies will be seeking shareholder approval for additional shares at this or next year's annual meeting. [figure 1]

New stock exchange listing rules require shareholder approval of all new equity compensation plans, including the broad-based plans favored by tech firms, and material modifications to existing plans, such as an increase in the number of authorized shares. Coupled with large shareholders' growing concern about the dilutive effect of option plans, the new voting rules suggest some tough selling ahead.

Perhaps not surprisingly, overhang (the sum of options granted and shares available for grants, divided by total shares outstanding) was rated the second most significant factor affecting option plans at publicly-traded companies.

No Rush to Resuscitate Underwater Options

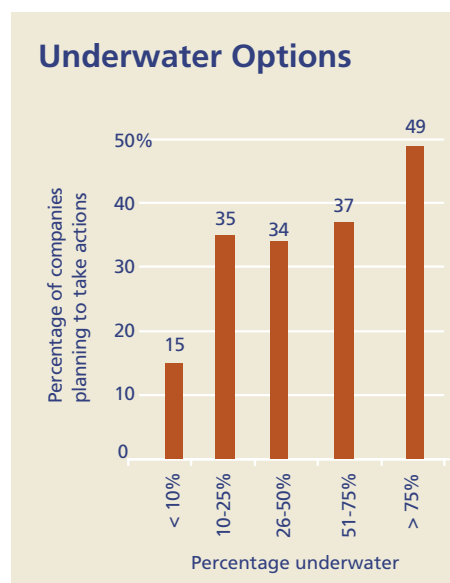
Another factor likely to be dampening enthusiasm for options, at least among employees, is the sizable number of underwater options left over from the tech stock bust. Among publicly-traded companies, 33 percent said at least half of their outstanding options were out of the money. Another 16 percent had 26 percent to 50 percent of their options underwater. Options at private tech companies were in somewhat better shape: 69 percent said they had 25 percent or fewer options underwater.

When asked how they plan to deal with their employees' underwater options, most companies said they would not be doing anything. Even among those that had more than 75 percent of options underwater, 51 percent said they planned "no action." Still, a sizeable number (46 in all) reported they were planning to take some sort of action or were still evaluating alternatives. These companies will need to consider the effect of the new shareholder vote rules for NYSE and NASDAQ listed companies. The new rules require shareholder approval for repricing transactions (including exchanges) unless specifically permitted under the existing terms of the plan. [figure 2]

[figure 1]



[figure 2]



Among those addressing underwater options, the most popular alternatives were supplemental or accelerated grants and some form of a repricing or exchange of options. The companies that reported the highest percentage of underwater options chose a repricing of existing options as the most likely strategy. Companies with lower percentages of underwater options were more likely to choose another strategy. A number of these companies indicated they are considering an exchange of options on a one-for-one basis or on a value basis. Offering employees the chance to turn in underwater options and receive fewer at-the-money options allows the company to put the retention value back in their options and decrease overhang at the same time. Most of these option exchanges are done with a six-month-and-a-day delay in order to avoid variable accounting under the existing non-expense accounting rules. The same result can be achieved with an exchange of restricted stock for options (the choice of only a few companies in the survey), but that strategy entails a financial statement charge for the value of the stock granted, regardless of how companies account for their options.

Perhaps due to the likely negative reaction from shareholders, companies seem to be more focused on emerging issues, such as expensing, rather than on reviving underwater options.

Rating the Threats: Expensing is Enemy No. 1 for Public Companies

The survey asked respondents to rate the impact of a number of factors on their equity compensation practices.

The public company respondents, as a whole, showed the most concern about the potential expensing requirement, with 60 percent rating it 1, and 20 percent rating it 2 in importance on a scale of 1 (greatest impact) to 5. As might be expected, given the possible impact of expensing on earnings, publicly-traded companies were far more concerned than private firms. For private companies,

it was rated as a top concern by only 21 percent, with another 18 percent placing it second. The private company respondents were far more concerned with high dilution levels and underwater options. [figure 3]

Companies Take a Wait-and-See Attitude to Expensing

The revised FASB rules on option expensing have not been formally drafted and are not expected to be finalized until the second half of 2004. The delay in the issuance of the new rules may be one reason why so few companies have elected to expense.

Among the public companies surveyed, 92 percent said they were not expensing and instead waiting to see if a change is mandated by the FASB. Three percent were currently expensing options, and the remaining 5 percent were preparing to adopt this method within 12 months. The respective percentages for private companies were 90 percent, 5 percent and 5 percent. [figure 4]

The effect of expensing on the bottom line varied widely. When asked what impact option expensing would have on earnings per share (EPS), 39 percent of public companies estimated a reduction in EPS of more than 20 percent and 12 percent estimated a cut of less than 5 percent. At the other end of the scale, 12 percent saw a cut of 100 percent or more (in other words, wiping out profits or creating a loss), while 22 percent did not provide an estimate of the impact. Private firms saw less of a threat, with 30 percent expecting an EPS reduction of less than 5 percent and 4 percent seeing a cut of 100 percent or more. Almost 40 percent of the private companies did not provide an estimate of the impact of expensing on EPS. [figure 5]

Broad-based Plans Are Still the Tech Norm

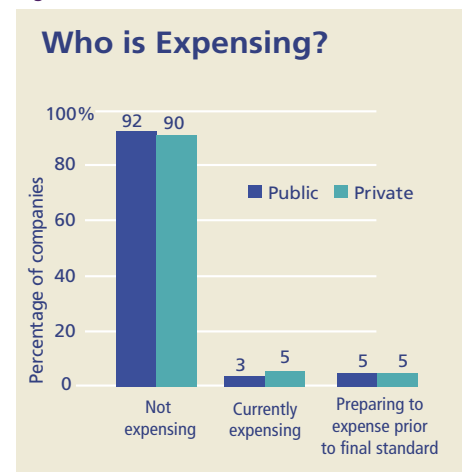
The survey suggests that most tech companies still believe in granting stock options to a majority of their workers, not just top management. Among the

[figure 3]

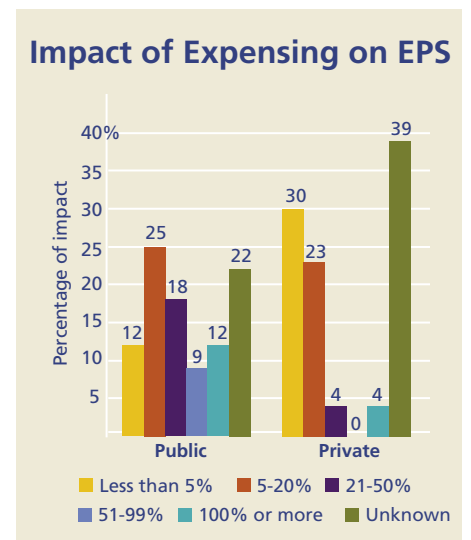
Top Issues (ranked first or second)		
Issue	Public	Private
Potential requirement to expense options	80%	39%
Underwater options	29	47
Level of overhang or potential dilution from employee options	45	48
Increased shareholder activism around equity compensation	24	16

Note: participants could select more than one answer.

[figure 4]

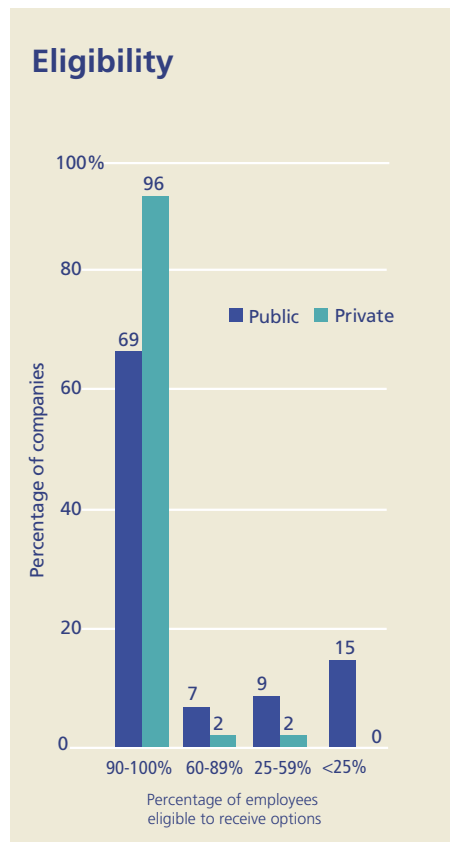


[figure 5]



publicly-traded firms, 69 percent said they offer options to 90 percent or more of their employees. Nearly all the private companies—96 percent—said this was their practice. [figure 6]

[figure 6]



In contrast, the non-tech respondents reported a much narrower range in their option plans. Only 21 percent of them granted options to 90 percent or more of their employees.

Most Companies Plan to Trim, but Methods Vary

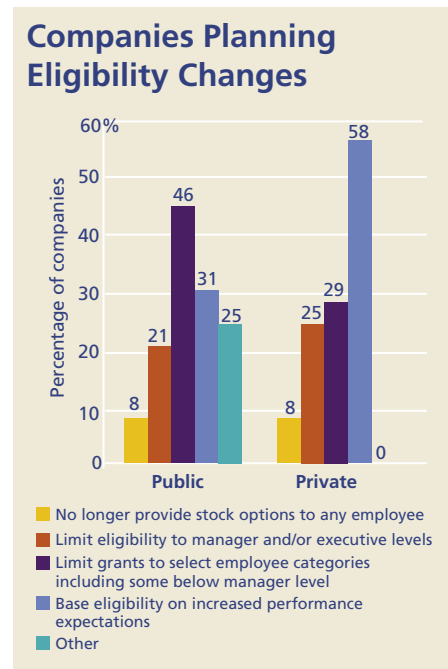
Planned cutbacks in option awards are of two types (not mutually exclusive): Changes in eligibility and reductions in the size of grants. Change looks more likely at public companies; 55 percent said they will alter their eligibility. Private companies were more likely to retain current policies, as only 30 percent

planned a change in eligibility. Of the public companies planning eligibility changes, 21 percent said they would limit eligibility to manager and/or executive levels, and 8 percent said they would no longer provide stock options to any employee. Of the private companies looking at eligibility changes, those numbers were 25 percent and 8 percent, respectively. [figure 7]

In responding to the question of how they would reduce grants other than by changing eligibility, most respondents (73 percent of public companies and 52 percent of private) said they would reduce the number of options granted.

Among public companies, 60 percent favored across-the-board reductions. Private companies were less inclined to favor across-the-board cuts, with 38 percent opting for them. Thirty-eight percent of the private companies also indicated they would reduce new hire grants; 26 percent of the public companies agreed.

[figure 7]



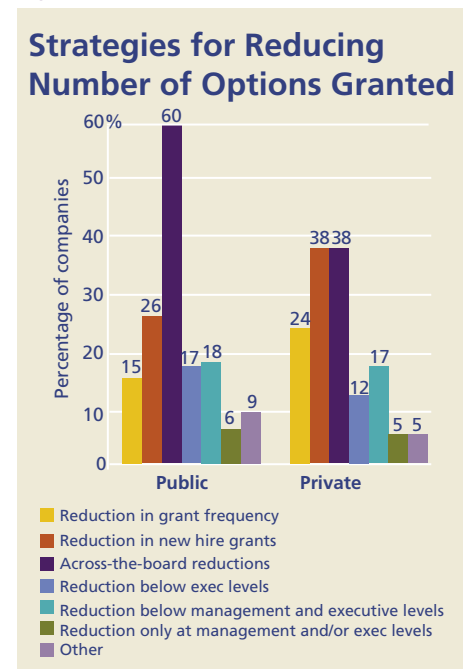
Note: participants could select more than one answer.

A significant minority of the public companies—35 percent—indicated their grant reductions would primarily impact lower level employees. Seventeen percent said they would reduce grants below the executive levels, and 18 percent said they would reduce grants below management and executive levels. Only 6 percent said they would make reductions only at management and/or executive levels. Private companies reported similar views. [figure 8]

Companies Are Mulling Alternatives, Especially Restricted Stock

The search is on for plans that could serve as at least partial replacements for broad-based options. Out of the tech respondents in the survey, 73 percent said they were considering, or were willing to consider, some alternate form of long-term incentives to compensate for reductions in option grants. The percentage was higher among public tech companies (83 percent) and lower (63 percent) for private tech firms.

[figure 8]

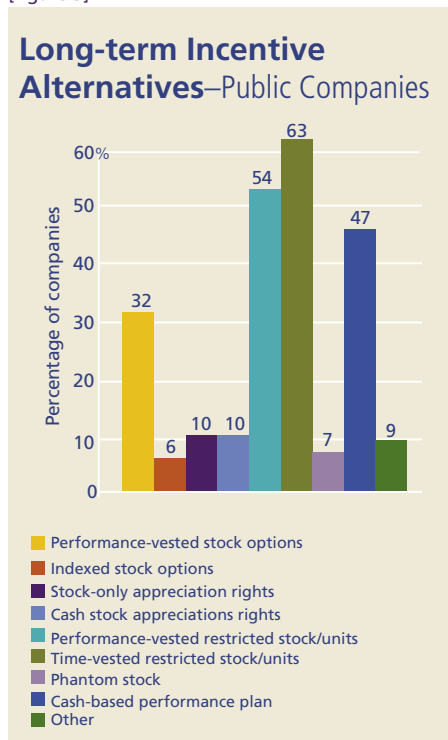


Note: participants could select more than one answer.

Among those looking at alternatives, three types of long-term incentives stood out as the most popular. For 63 percent of the public tech companies, the winner was time-vested restricted stock or stock units (stock units are a promise to grant stock at a later date). The second most popular choice for public tech companies was performance-vested restricted stock or stock units, with 54 percent looking at this type of plan. Cash-based performance plans were also popular, with 47 percent of public tech companies considering them. [figure 9]

Among the private tech companies, the types of long-term incentives being considered varied from the public companies. Fifty-three percent favored a cash-based performance plan while another 49 percent liked performance-based options. Thirty-five percent are considering performance-vested restricted stock or stock units. One of the factors that accounts for the continued preference for options over restricted stock among private companies may be the tax effect. The general rule is that

[figure 9]



Note: participants could select more than one answer.

taxes are due on unrestricted stock as the shares vest. For employees in start-ups, it can be a burden to have to pay taxes on shares that can't be sold on the open market. Options allow employees more control over when they trigger a tax event, as taxation occurs upon exercise.

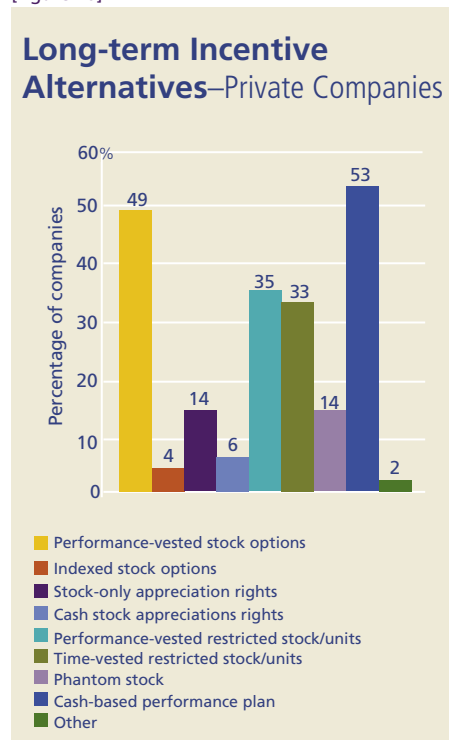
[figure 10]

Whatever alternative companies settle on, they will need to review their plans and determine whether they need to go to their shareholders for approval. A change in the types of award allowed under equity compensation plans is one of the material modifications that now require shareholder approval for companies listed on the NYSE or NASDAQ.

Pulse or Performance?

The most popular long-term incentive alternative, time-vested restricted stock or units, has the highest retention value of all awards. There's a sense of immediate value and downside protection as well. But these awards are often criticized as a poor incentive, a system that rewards employees merely for staying with the

[figure 10]

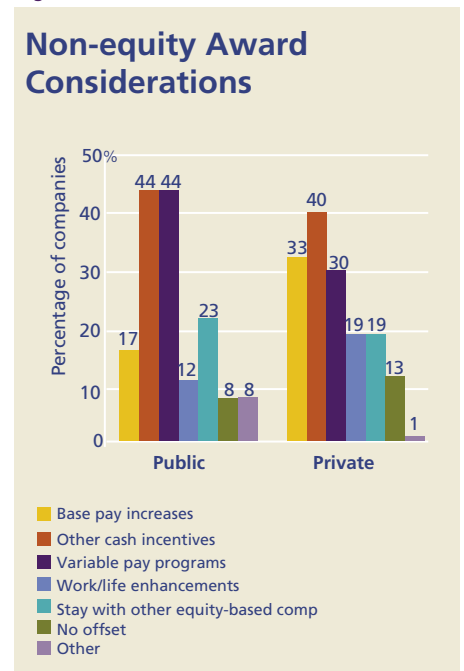


Note: participants could select more than one answer.

company. Performance-vested stock or units would, of course, avoid this problem, but they are more difficult to implement than stock options or time vested restricted stock or units as appropriate performance criteria must be developed. They are somewhat less popular, but still being widely considered, especially for the more senior ranks—those people seen as being better able to impact the performance of the company.

Most respondents (74 percent of public companies and 84 percent of private companies) said they were also considering other forms of non-equity awards. "Other cash incentives" was the leading choice, followed by "variable pay programs." Private companies appear much more inclined to increase base pay as compared to public companies. This may be driven as much in part by the increasing unwillingness of potential employees to accept options in lieu of cold, hard cash. [figure 11]

[figure 11]



Note: participants could select more than one answer.

Linkage, Competitive Pay Are Top Compensation Goals

Companies want to link compensation to company fortunes, thereby giving employees a direct stake in business outcomes. The requirements of the labor market also ranked high on their list.

Respondents were asked to rate nine factors, on a 1 (very important) to 5 scale, for their importance in considering alternative pay strategies. "Providing employees with a competitive pay arrangement" was rated 1 or 2 by 84 percent (57 percent gave it a 1) and the "ability to link pay to company, business unit or team performance" got the top two ratings from 88 percent, with 51 percent rating it 1.

Also significant was "cash-flow consequences for the company," rated "very important" by 37 percent, and the "ability to differentiate pay opportunity or zero percent payouts" based on individual performance, also with 37 percent giving it the top rating. "Accounting consequences for the company" was given the top rating by only 22 percent of respondents. While the accounting treatment doesn't rate as one of the top factors for designing alternative compensation strategies, it seems clear that a requirement to expense stock options will have a profound effect on future long-term incentive awards. [figure 12]

Leaner Days Ahead for ESPPs

Our survey suggests that a chill may be on the way for ESPPs. Seventy-one percent of the public companies in the survey said they have an ESPP.

When asked what they would do if they were required to record an expense for ESPPs, 37 percent said it would not impact their current practices. Among the 63 percent who said they would have to make some changes, most said they would be willing to make changes to reduce costs. Twenty-four percent said they would stop providing an ESPP. Forty-

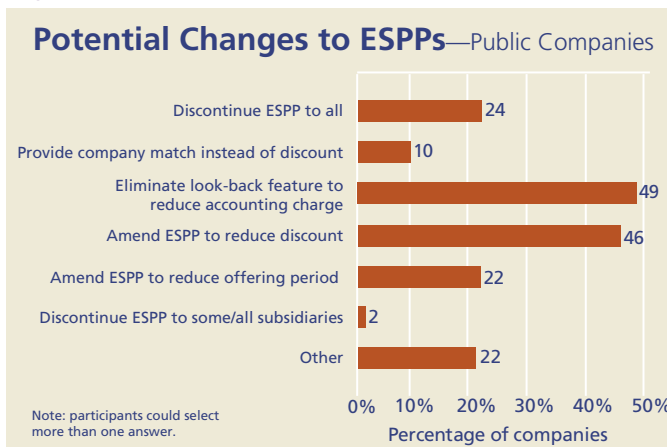
[figure 12]

Primary Compensation Design Considerations	
Issue	
Providing employees with a competitive pay arrangement	57%
Ability to link pay to company, business unit or team performance	51
Ability to differentiate pay based on individual performance and expected future contribution	37
Cash-flow consequences for the company	37
Shareholder acceptance of the particular strategy	24
Accounting consequences for the company	22
Ability to ensure a proper "line of sight" between pay and what employees control or influence	20
Tax consequences for the company	14
Tax consequences for the individual	12

Note: participants could select more than one answer.

nine percent said they would eliminate the look-back feature to reduce the accounting charge, while 46 percent said they would amend their ESPPs to reduce the discount. Twenty-two percent said they would amend the plans to reduce the offering period and another 22 percent checked the box for "other," with most indicating they were still evaluating alternatives. [figure 13]

[figure 13]



Companies may be reducing or eliminating discounts, and eliminating the look-back, in a bid to avoid expensing by meeting the safe harbor under the current SFAS 123 rules (i.e., 5 percent discount and no look-back features). But the final rules may eliminate the exemption for broad-based plans, based on the most recent decisions by the FASB. Companies that want to conform their ESPP plans to whatever exemption (if any) survives in the final standard should keep a close eye on developments at the FASB.

Will Options Chill Be Felt Abroad?

About three-fourths of public company respondents (74 percent) and one-fourth of private company participants (25 percent) said they have extended stock awards to employees outside the United States; of the former, 58 percent do so on the same basis as for U.S. employees, while 71 percent of the private companies mirror U.S. plans.

What would happen to overseas stock option plans under a fair value options expensing rule? Two-thirds of the public companies said they would change their practices, while 33 percent of private firms foresee a change.

Among companies altering plans, the leading choice is to make the same changes overseas that they make in the United States. Forty-seven percent of the public companies said they would

do this while 100 percent of the private companies would. A significant number of the public companies—44 percent—said

[figure 14]

Global Equity—Effect on Option Grants to Non-U.S. Employees		
Issue	Public	Private
Take the same measures to reduce the accounting charge being considered for U.S. employees	47%	100%
Consider local country practices in developing new equity or alternative compensation plans	44	14
Explore charge-back arrangements to reduce the net tax cost of overseas grants	27	0
Discontinue providing options to employees outside the United States	20	0
Offer smaller option grants to non-U.S. employees than to U.S. employees	13	14
Make option grants less frequently to non-U.S. employees than to U.S. employees	9	0

Note: participants could select more than one answer.

they would also consider local-country practices in developing new equity or alternative compensation plans. [figure 14]

Conclusion: Watching, Waiting, Worrying

The bloom may be off the rose for traditional option plans, but the need to attract and retain qualified employees remains. As these survey results show, most companies realize that they must widen their menu of compensation methods to deal with current stock market conditions (and its impact on options), the threat of option expensing and dilution concerns. At the same time, they must continue to deal with needs that have traditionally been addressed, especially in the technology sector, by option plans.

Looking forward, effective compensation plans will be those that will:

- Attract and retain the best employees, while aligning employee rewards with corporate, unit and/or team

performance. The main objectives of equity compensation plans haven't changed. What has changed is the regulatory and investing climate. Companies are being nudged in the direction of alternatives such as restricted stock grants, but the choice of tools must still reflect the over arching need to meet the demands of the labor market (in both attraction and retention) and align pay with performance.

- Maintain cash flow and manage the impact on earnings per share. The expensing of options will create at least a perceived problem for many young, growth-oriented tech companies. These are firms that have traditionally used stock option grants to preserve cash and speed their path to profitability, as a major part of their compensation cost did not have to be reported as a current expense. If the FASB rules go into effect, as is widely expected, equity-based compensation will continue to be a cash-preserving strategy, but profitability will tend to be slower in arriving, and EPS will be lower. From the survey results and through discussions, we know that companies are considering and implementing changes to manage the negative impact on earnings that comes with expensing. But the change from the investor's standpoint may be less dramatic. The impact options have on EPS can already be found in the notes to financial statements. Thus, some experts believe that the effect of option expensing is already reflected in stock prices.
- Be acceptable to large investors, who will play an increasingly important role in deciding compensation policy. The most serious threat to the future of option plans may lie less in accounting rules and more in investor attitudes. The SEC recently approved new rules requiring companies listed on the NYSE and NASDAQ to get

shareholder approval for all new equity compensation plans, and for material modifications, including share increases, in existing plans. Shareholders typically frown on companies that, in their view, have granted too many options. Companies will need to address these concerns—and do a better job of making the case that options and other types of equity compensation help motivate employees to create shareholder wealth—if they want to win the needed votes.

Facing all the changes that seem to be headed their way, especially the FASB expensing rules, tech companies seem to be reacting with a mix of realism and concern. Most are getting ready to partially shift away from option-based compensation and to cut back award sizes and participation levels. But few seem happy doing so. If they end up not having a choice but to accept the new regime, they still question the accounting premises behind it—and they worry that young growth companies will be losing a crucial tool for attracting and rewarding top talent without having to report big losses.

Some say that even the investor (in whose name the change is being proposed) will lose. "I think the whole issue is merely political," said one survey respondent. "It is a shame that expensing stock options will only further cloud the ability of the lay person to understand financial statements of publicly traded companies."

Said another of the expensing rules: "This is a political witch-hunt against greedy CEOs and expresses the pain of the average American who lost lots of stock money in the past three years. It's not good accounting. Everyone will just look through it anyway." While investors may look through the accounting charges, most companies aren't taking a wait and see approach. Whether driven by concerns over expensing or increasing pressure from shareholders, they're planning and taking action now.

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