Taking stock of equity compensation

Jacqueline Luffman

STOCK OPTIONS GARNERED many headlines during the recent high-tech boom and bust. While media attention focused on fortunes gained and lost, little background information was offered on the nature of various plans, or the employers and employees involved. On the one hand, plans such as stock options allow employees to share company risks and rewards, in the hope that they themselves will be financially rewarded. On the other hand, companies see this benefit as a way to encourage greater employee effort, as well as to attract and retain high-quality workers.

Equity compensation is not new. The United States has had legislation governing employee ownership plans since 1974, and other countries have had similar tax and legal requirements. Canada has no specific federal legislation on employee ownership plans; however, certain situations are covered in tax legislation and several provinces provide supporting grants or tax breaks (see *Tax and legal requirements of stock purchase plans*). As a result, the terms 'employee share ownership plan' (ESOP), 'stock option,' 'stock purchase plan,' and 'equity compensation' are often used interchangeably. Without a central legislative focus, evidence on the breadth and depth of employee stock ownership has been piecemeal. In 2002, *The Globe and Mail* reported that about one-third of the 100 largest companies in Canada have some form of long-term stock plan. But do these plans extend to all employees? Do smaller companies also have plans? And what is the range of plans offered?

This article describes several forms of stock purchase plans in Canada and examines participation using the Workplace and Employee Survey (see *Data source and definitions*). Some U.S. statistics are presented as well.

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Stock purchase plans

Three types of stock purchase plans are common in Canada. They can be combinations of employee ownership and equity plans. The best known are stock options. A stock option is a legal agreement between an employee and employer giving the employee the right to buy a fixed number of company shares at a fixed price (the exercise or strike price). An option holder has no shareholder rights, such as receiving dividends or voting. A contract sets out the terms, which include number of shares, vesting schedule, exercise price, and termination date.[2] Regulations on determining the exercise price vary depending on whether the companies are publicly traded (and thus bound by the requirements of a particular stock exchange) or privately traded.

For example, consider an employee beginning a new job at company X. In addition to an annual salary, the person receives a stock option grant for the right to purchase 1,000 shares of company stock at the exercise price of $3 per share. The shares are vested but can only be purchased after a specified period of time—typically three to five years. At the end of the period, the price per share has risen to $6. The employee may now choose to exercise the option and buy the shares, which can either be held or sold immediately on the open market. Some companies may stipulate mandatory holding periods. Tax consequences arise upon both exercising the option and selling the shares.

Stock equity plans entail the legal transfer of ownership of shares. The employee is required to pay for the stock and may or may not have additional rights attached to it. The risk potential associated with investing in the company levels the playing field between the original owners and employee 'owners.' Some observers note that stock equity plans are more successful than other types of equity compensation

Tax and legal requirements of stock purchase plans

For the stock plan participant, certain tax implications arise both when the option to buy the stock is exercised and when the stock is sold. Essentially, when the fair market value is greater than the amount paid, the difference is considered an employment benefit and is thus taxed as salary and wages. Under new rules implemented in 2000, employees can defer taxation on stock options for publicly listed shares. That is, if employees exercise their option, they can defer their capital gains tax. Upon sale of their shares, they can claim the 50% employee stock option deduction to partially offset the inclusion of these benefits in their income. In a stock purchase type of equity compensation (for example, a stock equity plan), employees purchase shares from the company treasury or owner directly. When the shares are purchased, the employee pays the fair market value on the date of purchase. This amount is used by the Canada Customs and Revenue Agency to calculate any future capital gains.

Overall, Canadian plans are non-legislated and built around tax laws or provincial legislation. Six provinces have some form of employee share ownership legislation in place. In British Columbia and Saskatchewan, employees receive a 20% tax credit on the amount invested in a registered ESOP. British Columbia has had employee ownership legislation since 1989 (under the Employee Investment Act). Eligible companies that want to register ESOPs cannot exceed 150 employees and must pay at least 25% of their wages to residents of the province. Legislation in Nova Scotia and Ontario offers employees a 20% tax credit on the cost of shares purchased through an ESOP. Similarly, in Manitoba a provincial tax credit of $700 is offered. Quebec set up the Quebec Stock Savings Program in the 1970s. Here, employees get a 125% to 175% deduction on funds invested in an ESOP, to a maximum of 30% of a net income.

A debate is emerging in Canada and the United States over the current accounting standards on stock options plans. Unlike other forms of non-wage benefits and other forms of equity plans, the value of stock options is not known. Under current accounting rules in Canada, as long as the number and exercise price of options are fixed in advance, the cost to employers is not treated as an expense. This accounting treatment has generated much controversy. On one side, some argue that because stock options are compensation and compensation is an expense, options should be a liability. On the other side, many executives counter that options are difficult to value properly and that expensing them would discourage their use.

Setting up stock purchase plans

Before setting up an equity compensation plan, an employer needs to consider the type of equity, percentage of ownership being offered, source of shares (treasury versus ownership group),[1] employee eligibility requirements, allocation amount, vesting periods, buyout provisions, share acquisition, and financing. A number of organizations and professionals will consult with companies to discuss the pros and cons of each option. The entire process, from the design of the plan to implementation can take from three to six months (Phillips 2001).

because employees who have invested money in a company are more likely to have a higher level of commitment (Phillips 2001).

Phantom stock units have rights equivalent to real stock equity but entail no legal transfer of ownership. The employee does not have legal title to any of the assets of the company. Phantom stock units are generally used when owners are not comfortable transferring real equity ownership to employees and do not want them to have a vote.

Stock purchase plans can be complex

The lack of direct federal legislation leaves companies free to develop diverse types of plans. The choice usually depends on company culture and ownership structure. For example, a privately traded firm not able to issue shares but wishing to establish some ownership culture may choose a phantom stock plan as the most practical option. Employers can give employees stock in the company through various arrangements—for example, to upper management employees only or to all employees. More and more, companies are offering their stock option plans to non-management personnel, including both salaried and hourly non-unionized employees (Brown 2002).[3] An employer can also set up various types of stock option plans with different vesting schedules, share amounts, and exercise specifications and prices. For all stock purchase plans, a company can specify eligibility requirements such as minimum length of tenure in a particular job, number of shares allocated to an employee (more shares with more seniority, for example), and buyout provisions.

Employee benefit and recruitment tool

Equity compensation is often used as a tool for recruiting, retaining and motivating employees in a competitive labour market. As Canadian companies turn more to the international labour pool, this kind of compensation is being seen as an attractive incentive. Instead of receiving just a wage, workers have the opportunity to gain financially from the increased value of the company. Equity compensation can also be used to reward good performance and to promote pride and corporate loyalty. In a survey of about 300 companies, the Conference Board of Canada found that 72% cited recruitment and retention of top employees as the number one reason for the use of stock options. In addition, about 40% used stock option plans to foster a sense of ownership.

Most Canadian research on equity compensation highlights the positive benefits of employee ownership, especially if the plan is set up with the employer's corporate structure and management style in mind (Phillips 2001, Beatty and Schachter 2002). In some instances, the financial value of equity compensation may be less important than the perception of employee ownership in influencing worker attitude. Recent case studies of companies with ownership plans show that for those in financial crisis, such plans can be the key to survival, a return to profitability, and continued growth (Beatty and Schachter 2002).

Other industry experts note the greater risk of stock options, which shift a portion of stable wages to payments contingent upon profits. Because the plan is managed by the individual employee, the investment risk could be considerably high. In the wake of corporate scandals and declining stock prices, many financial planners point to the risk of losses from insufficient financial planning information and narrow investment portfolios. One survey of high-tech companies found half admitted that many employees do not understand how their stock option plan works

Data source and definitions

The **Workplace and Employee Survey** (WES) is made up of a workplace survey on the adoption of technologies, organizational change, training and other human resource practices, business strategies, and labour turnover in workplaces; and a survey of employees within these workplaces covering wages, hours of work, job type, human capital, use of technologies and training. WES was conducted for the first time in the summer and fall of 1999. About 6,300 workplaces and 24,600 employees responded. The survey will follow workplaces for at least four years and employees for two years.

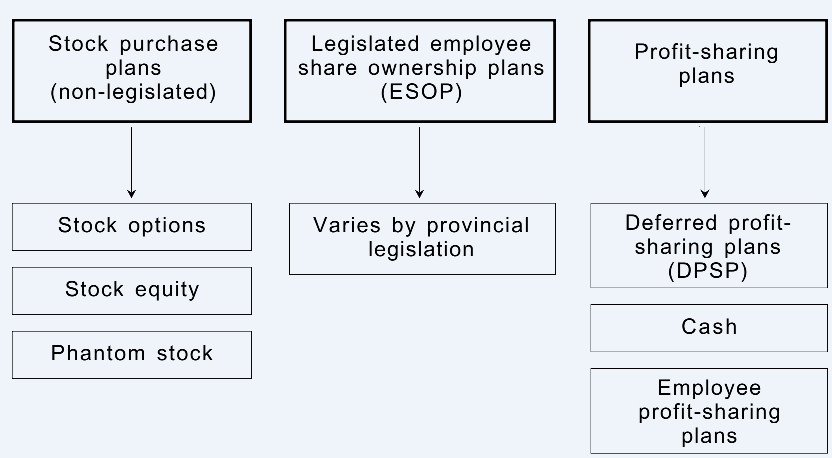
WES excludes workplaces in crop and animal production; fishing, hunting and trapping; private households; and public administration. For comparability with international research on stock options, education and health were also excluded since the vast majority of these jobs are in the public domain. (While a small percentage of health and education jobs are in the private sector, survey limitations meant the entire sector had to be excluded.) Similarly, a small proportion of public sector may be included in other sectors (such as utilities and communication).

Because of different definitions of stock purchase plans, the employee component of WES was used almost exclusively. The workplace survey did ask employers if they offered different types of equity compensation (see *Equity compensation among Canadian employers).*

Stock purchase plan participants are employees who said they participated in a stock purchase plan offered by their employer.

No standard definition exists for stock options, stock purchase plans, or employee share ownership plans, largely because of the lack of specific federal legislation. **Equity compensation** covers all forms of equity-based, non-wage benefits, including stock purchase, employee share ownership, and profit-sharing plans (see chart). In general, equity compensation plans can be classified as legislated or non-legislated. Legislated plans are employee ownership plans that meet the requirements of specific *provincial* legislation, thereby allowing both the employer and employee to obtain tax credits. Six provinces currently have such legislation. Non-legislated plans, such as stock option plans, use current tax laws and are not required to comply under any specific federal or provincial legislation. This article focuses primarily on stock purchase plans.

Forms of equity compensation



(Bloom 2001). Some U.S. companies are now reporting more education for employees on the potential effect of company stock ownership, and several bills addressing the provision of professional investment advice for retirement planning are before the U.S. Congress (Leder 2002).[4]

Who participates in stock purchase plans

According to the 1999 Workplace and Employee Survey, about 815,000 or 10% of employees had a stock purchase plan. Of this number, 81% worked for employers who contributed or offered discounts on purchases. Similar to those with other non-wage benefits (such as pension plans, life insurance, or dental coverage), participants tended to be middle-aged or older, work full time, and have permanent jobs. In addition, they were more likely to have a university degree, earn $20 or more per hour, and work in larger workplaces (Table 1).

Where stock plan participants work

Stock purchase plans are found in all private-sector industries, regions, and firm sizes. Certain industries, however, are believed to be aggressively using them in recruitment. According to one recent report, high-technology, chemical, pharmaceutical, and telecommunications industries are most likely to allocate company shares to equity compensation (Hynes and Lendvay-Zwickl 2001). Indeed, over a third of employees in the computer and telecommunications (CT) sector had stock purchase plans in 1999 (Chart A).[5] However, these plans were not limited to high-tech. About a quarter of employees in forestry, mining, and oil and gas extraction in 1999 were also likely to be participants. Some primary-sector companies initiated employee ownership plans in a time of financial crisis (Beatty and Schachter 2002). High incidence was also found in information and cultural industries (17%), while construction had the lowest incidence (3%).

Some regional variations were apparent, with proportions highest in Alberta (13%) and Ontario (11%), and lowest in Quebec and Manitoba (7%) (Table 1).

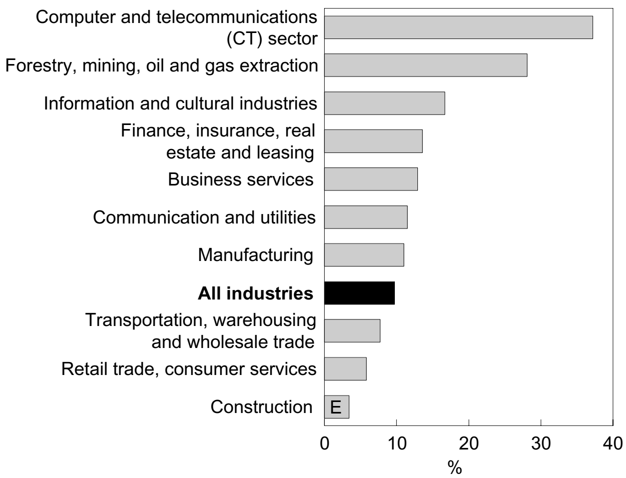
Larger employers in 1999 were more likely to report the availability of different compensation programs. Although two-thirds of private-sector employees worked in environments with less than 100 employees, these workplaces were less likely to have stock purchase plan participants than those with 100 to 499 (13%) or 500 and over (20%).

Table 1: Characteristics of stock purchase plan participants

	Have stock purchase plan*	Employer contributed or offered a discount
	%	
Canada	9.7	81.0
Atlantic	7.6	93.6
Quebec	6.4	72.7
Ontario	11.4	81.5
Manitoba	6.6E	77.9
Saskatchewan	7.8E	75.4
Alberta	13.1	81.4
British Columbia	9.7	85.9
Company size		
1 to 19 employees	5.0	79.6
20 to 99 employees	8.4	80.2
100 to 499 employees	13.2	79.5
500 employees or more	19.6	84.4
Sex		
Men	10.0	80.4
Women	9.3	81.8
Age		
Less than 25	3.2E	94.7
25 to 44	10.8	80.5
45 or over	10.1	80.3
Hourly earnings		
Less than $12.00	3.2E	87.4E
$12.00 to $19.99	8.7	74.1
$20.00 or more	17.7	83.6
Union status		
Member	8.2	71.1
Not a member	10.0	83.0
Education		
Less than high school	3.4	75.9
High school graduation	8.2	84.2
Some postsecondary or certificate	9.7	80.5
University degree	17.5	80.5
Work schedule		
Full-time	10.8	81.1
Part-time	2.1E	79.8
Job tenure		
Less than 1 year	7.8	88.3
1 to 5 years	9.5	82.9
6 to 10 years	9.6	82.2
More than 10 years	11.0	71.5
Job status		
Permanent	10.4	81.5
Temporary	1.7E	50.6E

Source: Workplace and Employee Survey, 1999
** Employees in the private sector only.*

Chart A: Proportion of employees with stock purchase plans by industry



Source: Workplace and Employee Survey, 1999

Most stock purchase plan participants had higher hourly wages

The median hourly wage of stock purchase plan participants was $22, about $7 more than those with no stock purchase plans. Overall, the prevalence of stock purchase plans rose with wages and salaries. Those earning $20 or more per hour were over 5 times as likely as those earning less than $12 to be participants. Over one-half of plan participants earned $20 or more per hour, compared with 30% of all private-sector employees.

Almost a third of computer-related professionals participated in stock purchase plans

With computer programmers and analysts in hot demand at the end of the 1990s, many employers in the high-tech industry sought to attract workers through equity compensation. Not surprisingly, 32% of people in these professional occupations reported having a stock purchase plan in 1999—more than triple the rate for all employees.

Professional occupations in natural and applied sciences had the same participation rate as computer programmers (Table 2). These occupations include engineers, scientists, chemists, architects and mathematicians. Many of these jobs were in specialized research companies where stocks can be a key component of recruitment.

Not surprisingly, those in professional occupations were more likely to have their employer contribute to or discount their stock purchase plans (83%). Occupations in sales, service and marketing were the least likely (68%). The high incidence of stock purchase plans among professional occupations likely coincides with the high education levels of plan participants. Fifteen percent of private-sector employees had a university degree in 1999, compared with 28% of stock purchase plan participants.

Table 2: Stock purchase plan participants by occupation

	Have stock purchase plan	Employer contributed or offered a discount
	%	
All occupations	**9.7**	**81.0**
Management	14.1	81.7
Senior managers	13.8	74.8
Professional	20.5	83.4
Natural and applied sciences	32.0	75.2
Computer programmers/analysts	31.7	81.8
Technical and trade	8.3	80.0
Sales, service and marketing	3.5	68.2
Clerical and administrative	8.5	81.7
Production workers	4.3	83.8

Source: Workplace and Employee Survey, 1999

Union membership had little effect

In 1999, about 8% of union employees (or those covered by a collective agreement) and 10% of non-union employees were stock purchase plan participants. Those in a union were more likely to work in manufacturing (41%). Most of the non-unionized were in manufacturing (22%), retail trade (20%), and business services (17%). Some research suggests that employee ownership and other equity plans foster better co-operation between unions and management. A few case studies found them useful in aligning management and employee goals as well as improving worker motivation (Beatty and Schachter 2002).

Stock options: the U.S. situation

In more and more U.S. companies, employees are receiving stock options—the new currency of employee compensation (Parker and Gore 2001). Whereas in Canada 'employee share ownership' is a generic reference to stock options and other equity plans, in the U.S., ESOP (employee share ownership plan) has a specific legal meaning. Originally designed to promote investment in company securities, an ESOP is essentially a stock bonus plan—but with two important distinctions. First, it is required to be invested primarily in the securities of the sponsoring employer or one of its affiliates. Second, it may be leveraged—that is, borrowed money may be used to acquire employer stock. Over time, tax-deductible employer contributions to the plan and often dividends paid on the stock are used to repay the loan. As the loan is repaid, shares are released and allocated to employee accounts. ESOP participants generally have the same rights, such as receiving dividends, as other shareholders.

Two types of stock options are available in the United States. Incentive stock options (ISOs) allow employees not to pay taxes at the time of the exercise and to pay only capital gains tax on the entirety. Companies issuing ISOs cannot deduct the spread between the grant and the exercise price from their earnings. Employees who exercise non-qualified stock options (NSOs) are taxed on the difference between the grant and exercise price, regardless of whether the employee actually sells the shares. Companies however, can deduct the difference from their earnings as a compensation expense.

The National Center for Employee Ownership (NCEO) estimates that up to 10 million U.S. employees received stock options in 2000, up from 1 million in 1992. About 8 million employees were included in legislated ESOPs (up from 3 million in 1980). Survey statistics on the actual granting of stock options, however, are much lower. In 1994, the Bureau of Labor Statistics collected information on stock options . At that time, less than 0.5 percent of private-sector workers received stock option grants. By 1999, the figure was 1.7%, some 1.5 million workers (Table).[6] The NCEO reports that employees with stock options work mostly for publicly traded companies and large employers (over 100 employees). Employees with access to equity-based plans tend to be professional or managerial, non-unionized, and with higher incomes.

Incidence of equity compensation in the United States

Compensation type (private establishments)	%
Stock option grants	2.4
Other equity compensation*	6.7
Establishments granting stock options	
100 employees or fewer	2.1
More than 100 employees	10.1
Employee characteristics (private employees)	
Received stock options	1.7
After-hire**	1.6
Executive	4.6
Other employee	1.6
Salary	
Less than $35,000	0.7
$35,000 to $49,999	1.5
$50,000 to $74,999	4.2
$75,000 and above	12.9
Establishment size	
100 employees or fewer	0.9
More than 100 employees	2.5
Reason for receiving after-hire stock option grants	
Individual performance	14.4
Salary or pay grade	52.4
Occupational type	7.9
Other†	25.3
Average years needed for full vesting	3.0
Average years before grant expiration	8.9
Average number of shares granted	2,931
Average number of shares granted to executives	15,533
Average number of shares granted to other employees	1,967

Source: Bureau of Labor Statistics, 1999

* *Other programs include, stock purchase plans, phantom stocks, stock bonus plans, employee stock ownership plans.*

** *After-hire grants are stock options granted during an employee's normal tenure on the job, after the initial hiring (or signing) phase of employment.*

† *To qualify as providing a stock option, an establishment had to grant an option to at least one employee who was not an owner in 1999.*

Summary

Nearly 1 in 10 private-sector employees were stock purchase plan participants in 1999. Equity compensation plans are extremely varied, as are their financial costs and benefits. Research in this area is further complicated by the lack of a clear definition of what constitutes a stock purchase plan or other equity compensation plan.

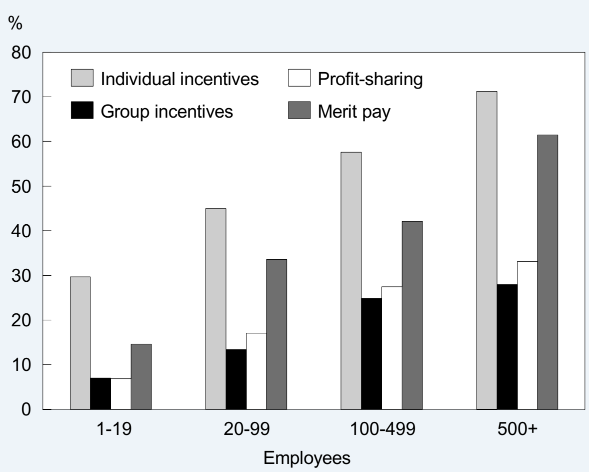
Stock purchase plans are not mandatory, but they are a benefit that employees must manage themselves. As a result, the associated risk, with stock option plans in particular, can be high; employees can either gain or lose an income source. Employees decide when or if to exercise stock options and then sell the shares on the open market.

Equity compensation among Canadian employers

A 2002 World at Work survey of about 529 Canadian companies found that over half of firms who offered stock options were publicly traded and most often found in manufacturing and high-tech industries. While many positives are associated with equity compensation, such plans may not hold all the answers for recruitment or sense of corporate loyalty. For example, if a company's stock price declines, options may become worthless, and improved employee performance may be questionable. In addition, shares set aside for option plans could lower a company's earnings per share when they are exercised.

The employer portion of WES asked about the use of four broad categories of compensation schemes. Most entail some form of equity compensation. Individual incentive practices (including bonuses, piece-rates, commissions, stock options, employee stock purchase plans) were the most popular and were reported by just under a third of Canadian private businesses. In addition, merit or skill-based pay was used by about 17% of private businesses. Less popular were profit-sharing plans (8%) and productivity gain-sharing (8%).[7] While almost 90% of private workplaces had fewer than 20 employees, these workplaces were less likely than mid-range and larger workplaces to use all schemes, although this varied from industry to industry (Chart).

The use of various compensation schemes increases with workplace size.



Source: Workplace and Employee Survey, 1999

Stock purchase plans in 1999 were more heavily concentrated among employees with higher earnings; in certain professional occupations such as computer programmers and analysts, and occupations in natural and applied sciences; and in industries such as CT and forestry, mining, and oil and gas extraction. Stock purchase plan participants also tended to work in larger workplaces (particularly those with 500 or more employees).

The use of stock purchase plans is still a relatively small phenomenon but government legislation, accounting practices or tax modifications could mean a change. The year 1999 was particularly good for employment and stock market growth; however, more recently, stock purchase plans may have lost their initial allure, especially as stock prices continue to decline.

Perspectives

Notes

1 Shares from treasury are owned by the company. Shares that are owned by current owners and can be sold directly to employees are shares from the ownership group.

2 Vesting refers to any calendar restrictions a stock option holder may have before being able to exercise their stock options. 'Exercise price' or 'strike price' refers to the price at which shares can be purchased.

3 Twenty-five percent of companies surveyed (529) in 2001 indicated that they offered stock options to non-management, non-unionized hourly employees, 49% to non-management salaried employees, and 80% to management salaried employees.

4 An example of such a bill is HR 2269, *The Retirement Security Advice Act of 2001*.

5 The computer and telecommunications (CT) sector is a sub-sector of the information and communication technology (ICT) sector. The CT sector can be seen as a sub-sector or core component of ICT using 12 4-digit NAICS categories (Bowlby and Langlois 2002).

6 Only those establishments who responded yes to the question "Did the establishment grant stock options to at least one employee who was not an owner during 1999?" Employees may have been granted stock options other than in 1999, and they are not included in the incidence of stock option granting (Crimmel and Schildkraut 2001).

7 Profit-sharing plans refer to a type of compensation program that makes payments to employees over and above their base salaries or wages. The level of the corporation's profits determines these bonus payments. Productivity gain sharing schemes refer to bonuses for group performance, small team rewards, employee stock ownership plans and stock options.

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