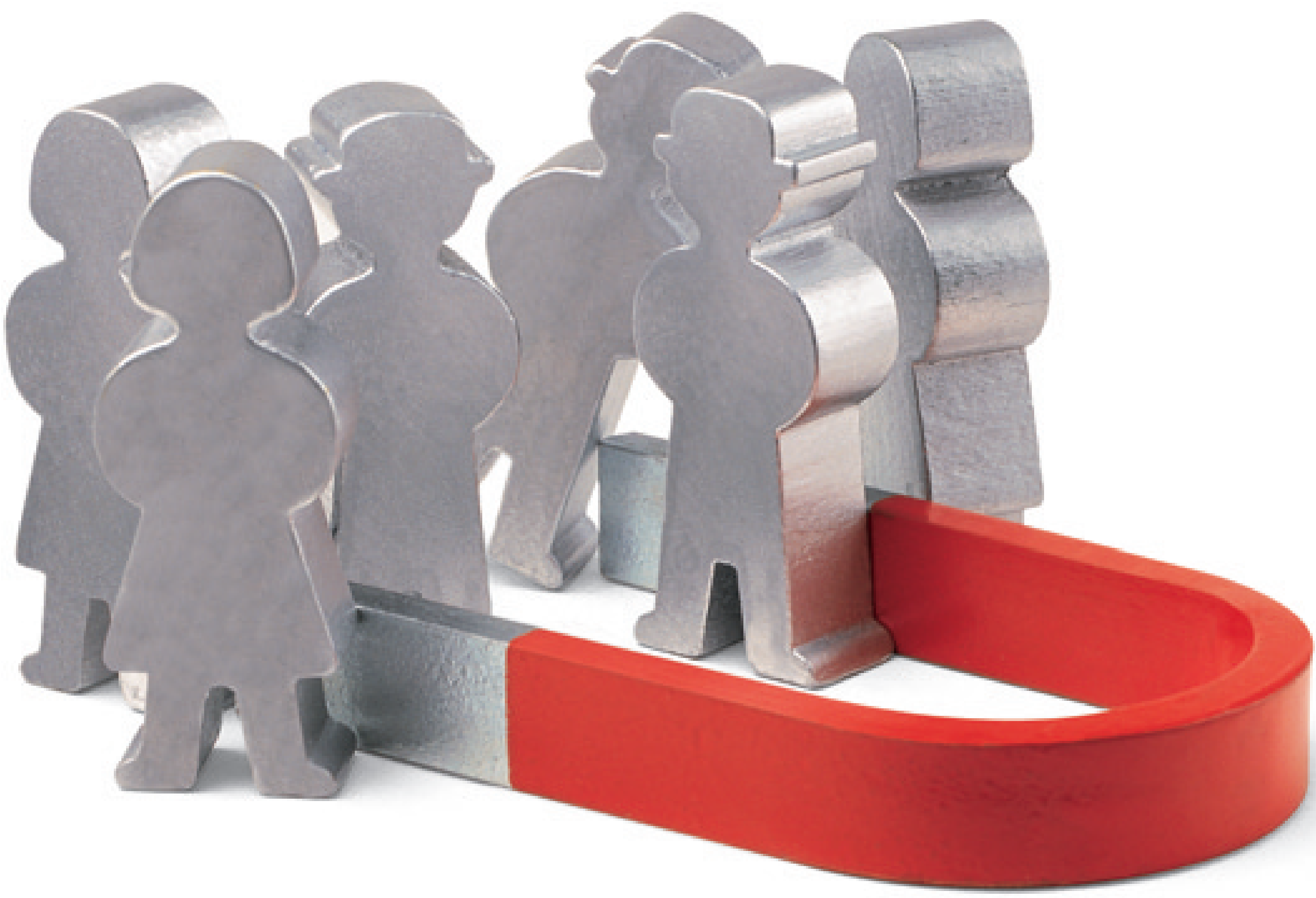
Entrepreneurs compete for people, not just profits. The Grant Thornton **Business Owners Council Survey** explores strategies for attracting and retaining top talent in a…

Grant Thornton



…labor market that demands that businesses define new approaches—and redefine old ones—to recruit the people they need and keep the people they have.

The variables that compose that equation have changed and are still in flux. Driven by the Internet company boom, stock options have been transformed from a benefit reserved for rarefied corporate air into a widespread compensation strategy. Stock options have, however, also become a new compensation concern, as option recipients have watched substantial paper profits dwindle away.

Owners and executives at entrepreneurial companies also strive to leverage their roles as organizational leaders into strategies that make their companies more attractive and their employees more loyal.

The Grant Thornton Business Owners Council Survey offers compelling insights into what entrepreneurs have done, and what they plan to do, in the constantly evolving struggle for the people that are the real fuel behind their growth.

Business owners look at the human factor

The Grant Thornton Business Owners Council is a group of leading business owners and executives representing a broad spectrum of middle-market enterprises of various sizes, in various industries, and at different stages of development.

As the leading accounting, tax, and management consulting firm serving middle-market, entrepreneurial companies, Grant Thornton established the Council to explore strategic issues affecting the growth of owner-managed companies. The Council meets twice a year to identify and discuss issues that affect the success and failure of growing companies.

After each meeting, we probe these subjects in depth with a national panel of several hundred business owners and executives, and publish findings from this research in our quarterly newsletter, *OwnerViews*, and in periodic research reports.

In this way, we hope to contribute to the body of knowledge about business owners and their companies. This survey on attracting and retaining employees is part of that effort.

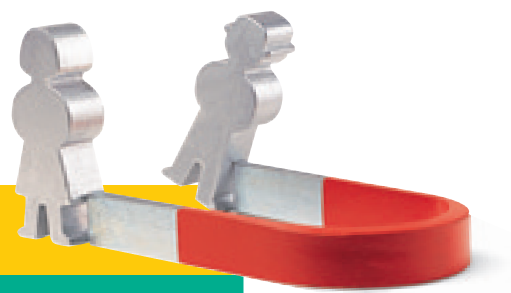
For this study, Grant Thornton conducted an Internet survey and telephone interviews in February 2001 with 417 owners and executives at entrepreneurial companies.

Of those surveyed, 55 percent were business owners and 42 percent held other senior executive positions. Three-quarters of survey respondents were owners or executives of privately held companies.

The survey focuses on three key industry sectors—technology, which includes Internet, software, and technology services companies; community banking; and consumer and industrial products (C&IP), which includes manufacturing and distribution companies. Companies in other industries are included in the "Other" heading.

The chart below offers a detailed picture of the survey respondents.

Entrepreneurial companies are the heart of American business, and people are the heart of those companies. This analysis of the survey results not only identifies strategies middle-market enterprises are using to compete for people, but also identifies strategies that will help them compete more effectively going forward.



Profile of respondents by industry

	Technology				
	Internet	Other Technology	Community Banks	Consumer & Industrial Products	Other
	%	%	%	%	%
Years in business					
Start-up (0-5)	76	23	4	3	7
Mature (5-20)	14	38	14	14	25
Well-established (20+)	6	23	73	74	65
Ownership					
Public	8	27	35	27	18
Private	92	73	59	73	81
Sales/assets					
<$20M/<$100M	73	54	17	5	16
$21-$50M/$100-$250M	4	17	48	45	36
$51-$500M/$250M-$2B	6	6	22	37	38
>$500M/>$2B	2	0	3	4	3
Number of employees					
Fewer than 50	57	15	34	11	17
50-250	31	50	45	42	38
More than 250	8	15	12	38	42

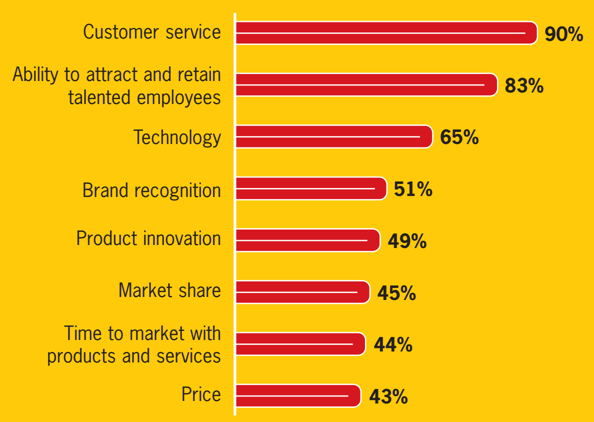
**Some columns do not add up to 100 percent because not every survey participant responded to every question.*

People power: Business owners list attracting, retaining talent as top concern

When presented with eight key factors that determine their company's competitive advantage, respondents to the Grant Thornton Business Owners Council Survey listed the ability to attract and retain employees as the second most important concern, trailing only customer service.

Importance of competitive advantage

In each of the following areas, how important is it for your company to have the competitive advantage to be successful?

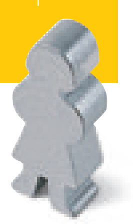


Attracting and retaining talented employees

How would you describe the issue of attracting and retaining talented employees for your company?

	Total	Technology: Internet	Technology: Other Technology	Community Banks	Consumer & Industrial Products	Other
	%	%	%	%	%	%
Single most important issue facing company	**10**	12	8	11	6	12
One of several important issues	**68**	47	67	77	71	69
Important, but not as pressing as other issues	**17**	27	21	10	19	14
Not an important issue	**3**	12	0	1	2	4
Don't know/Refused	**3**	2	4	2	2	2

Significantly higher than at least three other groups.



When asked directly, 78 percent of respondents listed it as either the most important or as one of several important issues facing their companies. When broken down by industry, however, an interesting difference is noted.

While technology companies do recognize attracting and retaining talent as an important issue, they weighed the importance of attracting talent less heavily than the other industry segments.

While 12 percent of both Internet companies and companies in other industries listed attracting and retaining talent as their top concern, far fewer Internet companies ranked the issue as their second highest concern.

A variety of issues may account for this difference. First of all, technology companies were such a popular employment choice over the past few years that they may have had little trouble, at least until the last few months, attracting the talent they need.

Second, given the precipitous drop in many technology stocks, the sudden closure of the initial public offering window, and the reluctance the investment banking community is now showing toward the sector, talent concerns may be taking a back seat to the need to scramble for financing simply to remain afloat.

Aside from the technology sector, the ranking of talent concerns is remarkably consistent across the other sectors.

Labor likely to remain tight

Over the past few years, with unemployment running at record low levels and with companies of every description scrambling for employees at every level, employment has been a major concern.

Now, the labor market has cooled somewhat. Unemployment is edging up. Hundreds of Internet companies have shut their doors. A variety of major employers have announced layoffs. For the near term at least, it seems that the labor pendulum is swinging back toward the employer.

A quick glance at demographics, however, demonstrates that labor will continue to be in short supply. Many experts expect the economy to continue to grow at a rate between 2.25

percent and 2.5 percent. The labor pool, meanwhile, is growing at half that rate. Top talent is hard to find, and it's only going to get harder, according to industry experts.

In a tighter economy, retaining personnel takes on added importance. Lower growth rates will mean reduced hiring demands for many companies—unless turnover requires that they constantly replace existing personnel. Companies that engender loyalty and reduce turnover, therefore, will not only minimize the human resources expense associated with unnecessary hiring, but will also avoid the learning curve associated with new personnel.

Effective compensation packages that build a sense of ownership and investment are vital to retention efforts. Stock compensation can be a part of these packages in appropriate circumstances, but incentive compensation programs that target specific operational behaviors can be easier to implement and can more directly improve results. These incentive plans are also often more appropriate for closely held businesses concerned about diluting ownership.

Whether companies seek to build loyalty through incentive programs, shared ownership, or both, a sense of investment in the enterprise by employees at all levels is the most important result.

Companies better at recognizing than meeting employment needs

Recognizing a need is one thing. Addressing it effectively is another. While companies in every industry segment consider attracting and retaining talent to be a key competitive challenge, they do not feel that their own companies are nearly as effective as they should be at meeting that challenge.

As the chart below demonstrates, a difference of 42 percent exists between the respondents' ranking of the importance of attracting and retaining talent and their ranking of their own performance on that front.

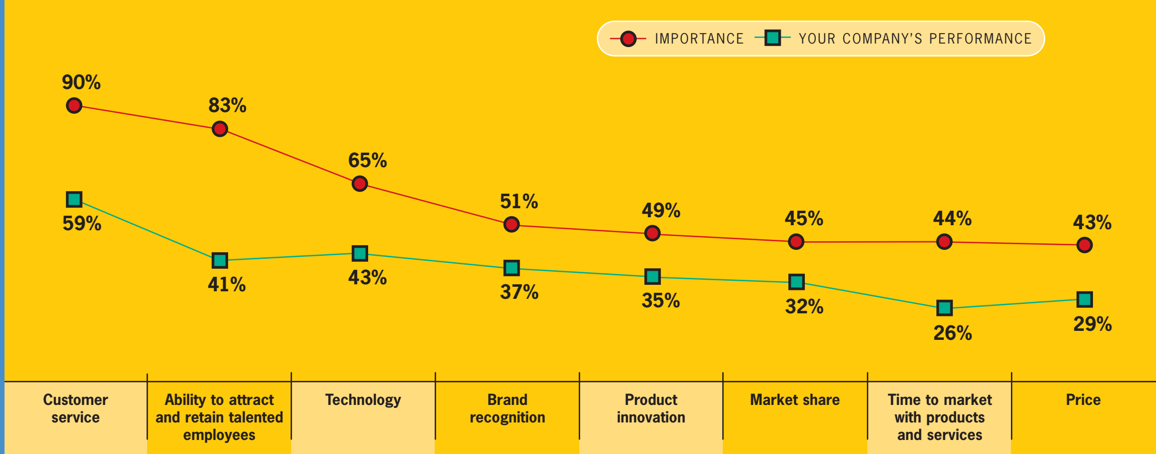
This gap demonstrates that many entrepreneurial companies have not crafted cohesive, strategic responses to the need to attract and retain talent. Companies need to augment traditional human resources-driven tactics and address finding, securing, and keeping the right people as a central corporate mission.

Human resource departments have often been very creative in helping attract employees and in structuring compensation, benefits, and working condition situations that address employees' needs and concerns.

Those efforts, however, are not enough. They must be part of a broader corporate commitment to align each employee's operational reality with the company's overall vision, and then to reward employees for their contribution to helping achieve that vision.

Competitive advantage: Gap analysis

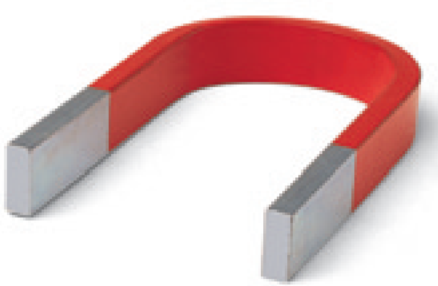
For each of the areas below, indicate how important it is for your company to have the competitive advantage to be successful, and evaluate to what extent you believe your company has the competitive advantage.



Owners, executives of midsized companies play key roles in building employee loyalty

Strategies for attracting and retaining employees are generally associated with the human resources function. These strategies, which can include offering a competitive total compensation package, setting up a system for recognizing and rewarding employees, and offering training and formal feedback, all affect employee attraction and retention.

The benefits of these strategies have been well-publicized and widely implemented. Therefore, they do not offer companies a competitive advantage as they compete for talented employees. But entrepreneurial companies do have something unique to offer—their owners.



Leading to loyalty

Owners and senior executives at middle-market organizations are more than the public faces of their enterprises. They are the leaders who embody the culture and mission of the organization in a direct and personal way to employees at every level throughout their companies.

The Grant Thornton Business Owners Council Survey clearly demonstrates that business owners and executives intuitively understand that role.

Survey results indicate that business owners and top executives play a key role in fostering loyalty. The top two responses in this category (owners and senior management who lead by example and regular communications from the owner or chief executive) directly involve a company's top management.

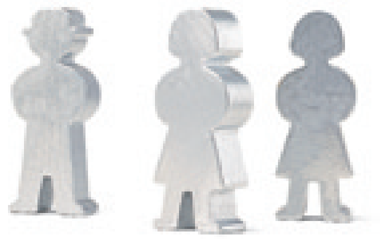
When asked what is the most effective channel for communicating, survey respondents indicate face-to-face interaction with employees as their first choice. CEOs of Fortune 500 companies can't spend time with most of their employees. Executives of middle-market entrepreneurial firms can, and they understand the importance of doing so.

The owners or chief executives of nearly 65 percent of companies in this survey make time to visit facilities on a regular basis and meet with employees at all levels individually or in small groups. They agree that these face-to-face meetings have a significant impact on loyalty, even more so than a personal letter of recognition.

Taking full advantage of the power of the leadership role is among the most effective tools that a business owner or executive has when it comes to engendering loyalty and building a corporate culture that enables a company to compete for and retain talented people.

What to communicate?

But that means more than simply showing the flag; it means leading the way. It means that, when communicating directly with employees, the executive should have a clear, compelling message that specifically relates to each audience's responsibilities and goals.



Interestingly, defining those messages and then conveying them meaningfully to the various audiences within an organization directly relates to the next two most important elements of retention, according to survey respondents—employee recognition and rewards at 68 percent and employee alignment with corporate vision at 63 percent.

The challenge, then, for the middle-market executive is to develop a strategic vision that is compelling on a macro level, but can also be broken down into discrete, identifiable goals that drive appropriate behavior at every level, across departmental and functional boundaries.

By tying those discrete goals to objective performance measures, and by giving employees at all levels a direct stake in achieving those goals, executives can transform face time into operational improvement.

Balanced scorecard systems, which help executives move away from over-reliance on lagging financial measures by focusing instead on specific operational behaviors and tying them to discrete goals, can be an effective way for owners and other key executives to refine their messages for employees at all levels.

"The owners or chief executives of nearly 65 percent of companies in this survey make time to visit facilities on a regular basis and meet with employees at all levels individually or in small groups."

Brave old world: How to lead during hard times

From a management perspective, there is an ironic downside to the uninterrupted prosperity of the last decade. Many companies are now headed up and managed by a generation of business owners who have never had to deal with a recession or even a slow-growing economy.

Yet many of the business headlines these days are more reminiscent of the 1970s than they are of the 1990s. Companies are reporting disappointing earnings, layoffs, and lower stock prices. Yet even as the American economy is undergoing a transition from a sustained period of rapid growth to, at best, a period of much slower growth, attracting high-quality employees remains a priority.

The experiences of the last decade, however, still color many of the attitudes about sharing ownership and attracting and retaining employees. Those experiences going forward are likely to be different. The appropriate responses to those experiences may be different as well.

What can executives do to maintain morale when times are tough?

First, companies needing to reduce their headcount should not use arbitrary factors such as seniority to decide who to cut. Keep the best people. Make your reductions based on performance, not time on the job.

Second, communicate clearly to your remaining workforce that the decision to retain each of them was based on an examination of their contributions to the company. Make it clear to them that they are still there because management wants them there.

Finally, a reduction in force is an excellent time to institute an effectively targeted incentive program. Such an effort makes it clear to the remaining employees that management will not be passive in responding to unfavorable market conditions.

This action reassures the remaining employees that management not only has a strategy to address those conditions, but is also committed to sharing the benefits of achieving that strategy with its people.

Targeting behaviors

Shifting the emphasis from a salary-based compensation to an incentive-based compensation offers other benefits that can be particularly useful in a tightening economy. Companies that rely primarily on salary find the fixed cost of compensation constantly ratcheting up as employees realize incremental increases each year.

It is not unusual for a company to be paying long-term employees in certain positions 33 percent—or even more—than they are paying junior employees performing the same functions.

By relying on incentive programs instead of salary increases, these companies can motivate targeted behaviors, thus increasing productivity while simultaneously holding down fixed salary costs. Such a move also gives companies some flexibility in addressing changes in market conditions, allowing them in some cases to avoid or minimize layoffs.

Taking stock of giving stock: Owners mull pros and cons of sharing ownership

During the height of the Internet boom, workers in every industry witnessed a steady stream of stories concerning employees at technology companies who became millionaires seemingly overnight because of that industry's liberal use of stock options.

And these new millionaires were not just owners or senior managers. They were receptionists, programmers, salespeople—personnel at every level.

The prospect of sudden wealth through shared ownership proved a strong lure. For a time, Internet companies were able to snatch talent away from traditional entities largely by offering stock options, even though the remainder of their compensation and benefits package was often not as attractive as that offered by traditional companies.

For the Internet companies, the tactic made sense. The stock options they were offering cost them essentially nothing.

Options after the fall

Now, the former precipitous climb in technology stock prices has ended with an equally precipitous drop. While some Internet company workers were able to cash out when stock prices were at or near their highs, many others have discovered that being a paper millionaire is a long way from being the genuine article.

Still, the intense publicity associated with stock options generated as part of the Internet story has significantly altered the compensation landscape.

While stock options and other ownership-sharing alternatives were once restricted to top management, many middle managers, skilled technical personnel, and other employees are now expecting at least a discussion of shared ownership as part of their compensation picture.

For the entrepreneurial, middle-market companies that participated in the Grant Thornton Business Owners Council Survey, sharing ownership presents a variety of issues.

First of all, only 24 percent of the respondents are associated with publicly owned companies. Of the remaining respondents, many are closely held and even family-owned businesses with strong reservations about surrendering ownership. (See the article on ownership sharing options for privately held companies on page 8.)

Strong support for sharing ownership

More than half the respondents (55 percent) support sharing ownership with valued employees, with 44 percent fully supporting the practice. An additional 16 percent of respondents would prefer not to surrender ownership, but find it necessary to do so to keep key people.

While there is considerable support for the idea of shared ownership, there is less practice. Only 43 percent of survey respondents actually offer stock options in any form, and 39 percent indicate that they do not offer them and have no plans to do so in the future.

While there was substantial similarity across industry segments in survey responses dealing with the importance of attracting and retaining talented personnel, there are considerable differences among industry segments when it comes to sharing ownership. Among technology companies and community banks, 59 percent and 51 percent of respondents, respectively, fully support sharing ownership.

By contrast, only 30 percent of consumer and industrial products companies and 32 percent of all other companies share that support. Conversely,

Shared ownership, shared values

Interestingly, companies that support sharing ownership or that actually offer stock options differ from companies that do not in some important ways regardless of industry segment.

The owners of these companies look at their employees as partners, not simply as subordinates in the traditional owner-employee hierarchy. These owners place a greater emphasis on cultivating a corporate culture and aligning employees with the corporate goals than do respondents that do not share, or support sharing, ownership.

These companies are almost twice as likely to be very optimistic about the growth of their businesses. Forty-three percent of companies that support sharing ownership and 42 percent of companies that actually share ownership report that view, compared with 24 percent of companies that do not support shared ownership and 27 percent of companies that do not share ownership.

Companies that either support or actually share ownership are also significantly more likely to believe that aligning employees with corporate vision and having a strong corporate culture have a major impact on employee loyalty.

For example, 73 percent of respondents who support sharing ownership believe that aligning employees with the corporate vision is vital to employee retention, and 64 percent of those respondents also feel that a strong corporate culture is important to retention. Only 46 percent of respondents that do not support sharing ownership hold either of those views.

Owner support of sharing ownership with employees by industry

Using a five-point scale, indicate the number that best describes your philosophy for employee ownership.

	Rank	Total	Technology	Community Banks	Consumer & Industrial Products	Other
		%	%	%	%	%
Support sharing ownership	5	44	59 ●	51 ●	30	32
	4	11	15	11	11	8
Prefer not to give up ownership, but find it necessary to keep employees	3	16	10	11	24	22
	2	6	5	7	9	6
Not necessary to share ownership	1	19	7	15	26	30 ●

● *Significantly higher than at least two other groups.*

30 percent of companies in other industries and 26 percent of consumer and industrial products companies feel it is not necessary to share ownership, while only 7 percent of technology concerns and 15 percent of community banks share that view.

Even among firms that actually employ stock options, technology companies and community banks are the strongest proponents of shared ownership.

Among technology firms, 41 percent view stock options as having a strong positive effect, as do 40 percent of community banks. Only 25 percent of all other companies that offer options feel they have a strong positive impact, and only 24 percent of such consumer and industrial products entities share that view.

Options help attract, retain

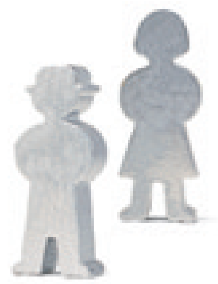
Among companies that do share ownership, belief that stock options are an effective tactic for both attracting and retaining personnel is consistently high.

When it comes to attracting employees, 77 percent of companies that offer stock options feel that those options have either a strong positive or some positive effect. When it comes to retaining employees, that figure climbs to 80 percent.

In recent years, some companies have implemented stock option programs either as a defensive measure to prevent their employees from being hired away by Internet companies or as a proactive step to compete with those entities on the open employment market.

As a tightening job market finds even employees in the technology sector focusing more on traditional compensation and job security, the retention elements of stock options may be of greater importance.

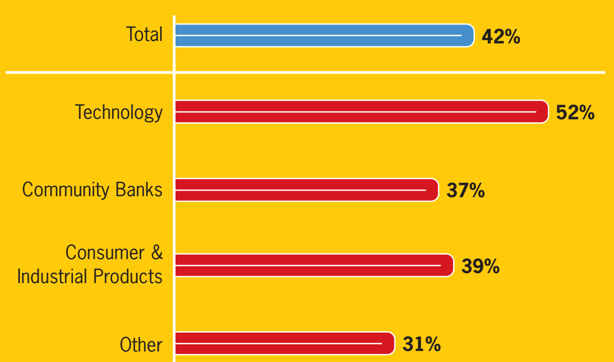
A "golden handcuff" element is inherent in stock option plan design. Unlike most bonus or incentive programs, stock options do not offer immediate payment. Employees who have not reached exercise dates for their options have a strong incentive not only to help the company's performance in order to drive up its stock prices, but also to remain with the company until they can exercise those options.



The Internet boom let the stock option genie out of the bottle. The recent steep fallback in stock prices has dampened enthusiasm for stock options somewhat, but it seems clear that stock options will play a broader role in compensation programs going forward than they have historically, and that more employees will be expecting them than did just a few years ago.

Impact of stock option plan on retaining employees

How much impact do you feel your stock option plan has had on retaining employees?



* *Percentages refer to strong positive impact.*

Sharing ownership without sharing stock: Alternatives for closely held businesses

For many closely held companies, and particularly for family-owned businesses, stock options are not an option. Owners of these entities simply are not inclined to turn employees into minority shareholders, regardless of current trends in compensation programs.

In fact, when respondents from companies that did not offer options and had no plans to do so were asked why, the most common response, at 52 percent, was that the business was family-owned and that only family members could own stock. A further 37 percent of those respondents do not offer stock options because their businesses are not stock institutions.

Looking outside: Using other entities' stock

Companies seeking to avoid surrendering ownership can implement a stock option plan that uses stock from other companies. This plan design has met with considerable success in the not-for-profit sector where sharing ownership is also not a viable option.

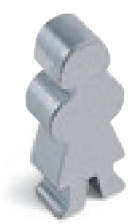
As with traditional stock option plans, the company establishing such a plan has considerable flexibility in establishing the terms of the option and vesting periods.

For employees, tax treatment on the exercise of such options is the same as it is for employer stock options. The employee exercises the option, and recognizes ordinary income for the difference between the exercise price and the fair market value of the stock at the date of exercise.

Then, on selling the stock, the employee realizes capital gain or loss on the difference between the value of the stock on the date of exercise and the date of the sale.

For employers, however, non-employer stock option plans are more expensive. Because the employer is not using its own stock, it must acquire the stock used by the plan. In addition, because such plans do not involve employer stock, the company must recognize compensation cost over the period of the employee's service.

While such concerns make traditional stock option plans unsuitable for many entrepreneurial companies, there are alternative plans they can consider to remain competitive for top talent—alternatives that most entrepreneurial companies have not considered as of yet. Again, the survey results bear this out. Only 11 percent of respondents offer restricted stock, 5 percent offer performance units, 4 percent offer phantom stock, and 3 percent offer stock appreciation rights.



Since more respondents approve of sharing ownership than have plans in place to do so, it seems clear that many companies that could benefit from equity-based plans are not pursuing all available possibilities.

Phantom stock plans

Phantom stock plans are one option.

Under a phantom stock plan, selected employees are awarded stock units equivalent in value to the company's stock on the date the units are issued. Upon conditions established by the plan (usually retirement or the completion of a predetermined period), participants redeem their phantom shares for cash.

Phantom stock plans generally follow one of two designs. Under a basic phantom stock plan, phantom stockholders are credited with the actual value of the company's common stock price, thus guaranteeing that they receive something, even if the price of the stock has declined since their units were awarded.

Under an alternative model, participants receive only the increase in value of the stock over the value of their units when awarded.

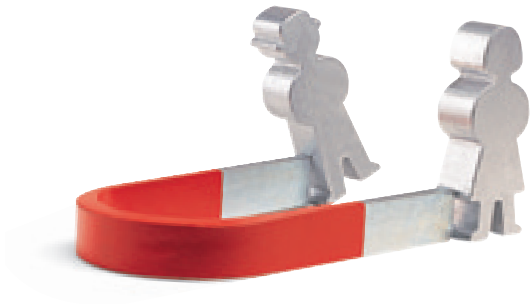
From a tax perspective, phantom stock plans are relatively simple. Employees recognize any payments made when their phantom shares are redeemed as ordinary income in the year those shares are redeemed. Employers deduct the cost of those payments in the same period.

Companies setting up phantom stock plans must decide whether to fund the plan up front. If they decide not to fund the plan, it may affect the value of the phantom shares in the eyes of the employees, particularly if the date when they can redeem their phantom shares is distant.

While not funding the plan avoids a current drain on cash flow, it also increases the company's liabilities.

Finally, the company must decide how to value phantom shares. Some companies rely on a set formula instead of a formal valuation. While a formal valuation is more expensive, it also ensures that the company is not decapitalized if the formula value is too high, or that plan participants are not short-changed on their phantom share values if the formula value is too low.

While phantom stock plans do a fair job of paralleling shared ownership, there are pitfalls. Company investment in equipment or decisions to pull cash out



of the firm can adversely affect stock prices—and their underlying phantom shares—for reasons beyond plan participants' control. An effective phantom stock plan should have mechanisms in place to ensure that participants are not harmed by such decisions.

Exits and ESOPs

Another option that closely held companies should remember does involve surrendering ownership. Employee stock ownership plans (ESOPs) offer a way for closely held business owners to create an internal market for their ownership interest in cases where there are no logical family or other successors.

ESOPs also can offer substantial tax benefits, both for S corporations and C corporations. In situations where a business owner is seeking to diversify holdings or desires an exit strategy, an ESOP is an option to consider. Owners selling shares to an ESOP also can realize tax advantages.

Closely held companies are generally afraid of surrendering control, not of offering equity-based compensation. By crafting creative solutions that do not require surrendering actual equity, or at least voting equity, they often can meet employee and prospect desires for equity-based compensation while meeting their own goal of protecting ownership.

Market downturn raises specter of getting options out from under

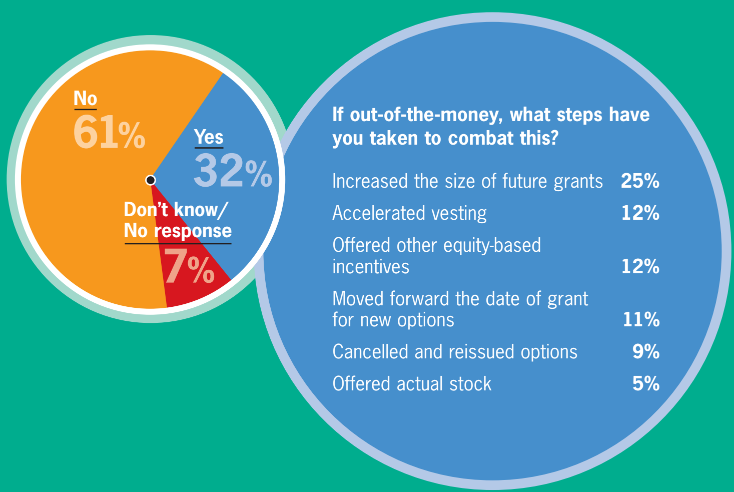
For employees, the thrill of stock options during the raging bull market of the last several years was the seemingly never-ending increase in stock values. Now, in many cases the thrill is gone.

For a number of companies, stock options are now "underwater" or "out-of-the-money," meaning that the current stock price is now below the price at which the stock can be exercised. Since stock options are meant to be part of a motivating compensation package, the prospect of out-of-the-money options runs counter to the purpose of offering options to begin with.

Of the 179 respondents from companies offering stock options, nearly a third (32 percent) report that their options are currently out-of-the-money. Those respondents have pursued a number of strategies in attempts to combat that status, the most popular being increasing the size of future stock grants.

Out-of-the-money stock options

Are any of your company's stock options "out-of-the-money," that is, the current price is below the price at which the stock can be exercised?



Out-of-the-money options and morale

Companies with out-of-the-money options frequently fear that these options will erode employee morale and lead to increased turnover. Those companies, therefore, frequently use one or more of a variety of methods to attempt to move those options back into positive territory or to otherwise make their stock option program meaningful to its participants.

Those attempts, however, are meeting with opposition on some fronts. Since stocks are inherently risky, shouldn't employees who participate in stock option plans bear that risk, just as other investors do? After all, none of the beneficiaries of the dramatic increase in technology stock values are looking to give back the wealth they gained through stock option programs.

Companies looking to fix out-of-the-money options need to consider accounting ramifications

Changes spelled out in Financial Accounting Standards Board Interpretation 44, *Accounting for Certain Transactions Involving Stock Compensation (FIN 44)*, directly affect the accounting treatment resulting from many efforts to address out-of-the-money stock options.

A key area of interest in FIN 44 deals with which stock options qualify as fixed awards. Since fixed awards are easier to account for than variable awards and also do not create open-ended compensation expense, fixed-award treatment is preferable.

To qualify as a fixed award, the award must include a measurement date when both the number of shares awarded and the exercise price of those shares is known. If, after the award is given, either of those conditions changes, the award becomes variable.

If the term of the award is extended or the award is renewed, the award remains fixed; however, the compensation cost of that award must be recalculated.

Three possible changes to fixed awards will result in a profit-and-loss effect:

- *reduction in the exercise price;*
- *increase in the number of shares awarded;*
- *extension or renewal of the option term.*

One effect of these changes will be to discourage repricings of stock options. Since a traditional repricing would reduce the exercise price of the award, the award would have to be accounted for as variable compensation from the date of that modification until the award is exercised, forfeited, or expires.

FIN 44 not only addresses traditional repricings, it also deals with attempts to reprice awards by canceling or settling an outstanding award and replacing it with a new award at a lower exercise price.

Should an award be canceled or settled and another award be granted within six months either before or after that event, then that combination of events will be treated as a repricing of the initial award, and the award must be accounted for as variable compensation.

Companies can, however, take measures to address the issue of out-of-the-money options without offering overly preferential treatment to their stock option “investors.”

One method is an economic exchange. Under this approach, the company establishes the fair value of the options that employees currently hold. The company then replaces those options with lower priced options of equivalent value.

The employees are, consequently, left with fewer options. But instead of being essentially worthless, as were the out-of-the-money options they traded in, the replacement options would have value.

In addition, because the options are now set at a lower price, they have significant upside potential.

The economic exchange strategy is especially palatable to investors opposed to repricing options because the lower number of replacement shares actually reduces dilution concerns.

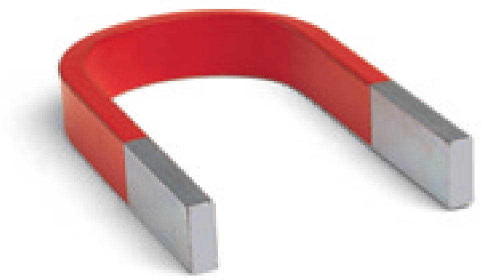
Another strategy is to increase the number of options granted when stock prices are low. In essence, this allows employees to “buy low,” thus positioning them to benefit should their future efforts turn the company’s stock price back up.

Similarly, some companies are choosing to make smaller but more frequent options, mirroring a dollar-cost-averaging approach to investing.

> “Companies with out-of-the-money options frequently fear that these options will erode employee morale and lead to increased turnover.”

Companies addressing out-of-the-money options might want to consider other steps as well to ameliorate investor concerns.

Excluding officers and directors from repricings or exchanges is one step. Restarting vesting periods so that employees cannot cash out immediately is another. Ensuring that the rationale for, and the mechanics of, any repricing or exchange efforts is accurately described in Securities and Exchange Commission filings is still another.

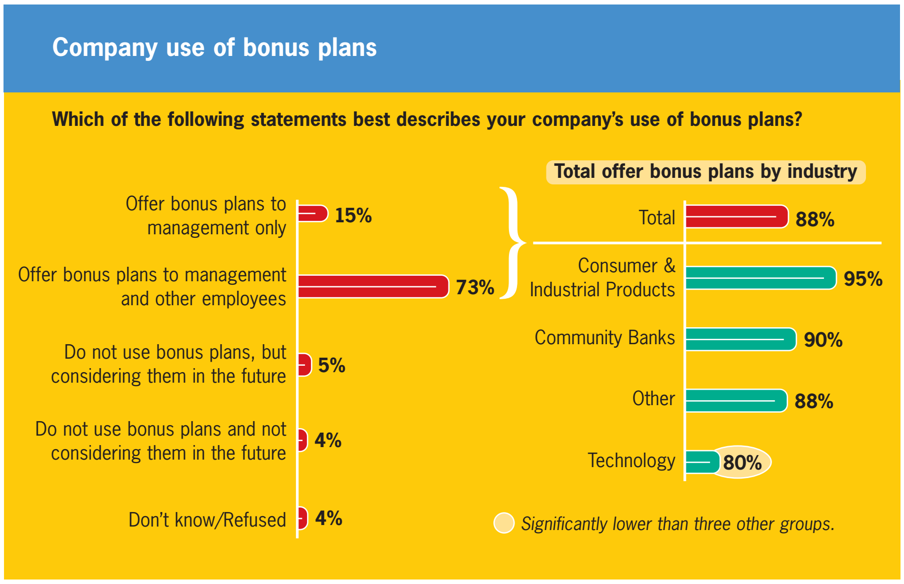


Pulling it all together: Leaders, owners, and incentives

Whether a company rewards its employees directly with ownership is, at a certain level, immaterial. Regardless of whether they own stock, employees are investors in the companies for which they work. They invest their time, their effort, their ideas.

It is the company's job to offer those employees a return on that investment that is fair, and that engenders loyalty, inspires effort, and makes the most of the company's human assets.

Increasingly, companies are recognizing that incentive compensation is a vital component to that effort. The results of the Grant Thornton Business Owners Council Survey bear that out. The vast majority, 88 percent, of respondents employ bonus plans, and 73 percent of respondents offer these plans not only to management, but to employees in general.



Bonuses still important

Again, there are differences among industry segments. Technology companies are the most aggressive segment when it comes to stock option plans, but they are the least aggressive when it comes to bonus arrangements. In some ways, that is to be expected.

First of all, bonuses are frequently based on profits, and many technology companies are still in formative growth stages where profits are not possible. Second, one of the reasons that technology firms employ stock options is because those options do not strain their limited cash resources. Bonus plans generally require current cash outlays.

Another meaningful aspect is the relationship between survey results regarding bonus plans and profitability. Companies with average or below-average profitability were almost twice as likely to confine bonus plans solely to management as were companies with above-average profitability.

That finding is instructive. Management alone cannot achieve results. Employees at all levels must be motivated and directed toward behaviors that support corporate goals. Effective bonus incentive plans are one of the most effective ways to accomplish that end.

Stock options are effective on one level. Owners of companies, public or private, can offer no more concrete endorsement of a sense of partnership with their workers than to offer stock. On another level, however, stock options are not as effective.

Clearly, employee efforts are, at best, only part of the story behind a company's stock's performance. Economic conditions, market conditions, the overall psychology of investors all do as much or more to drive stock values as do employee efforts.

The further removed an employee is from significant decision-making authority, the less connection that employee is likely to sense between his or her daily activities and the company's stock value.

Hitting the target

Therefore, while stock can play an important role in a company's compensation mix, more narrowly targeted incentive efforts are at least as important.

Gainsharing programs are one example of such initiatives. Gainsharing programs provide regular monetary awards to narrowly targeted groups of employees for meeting specific, objective performance goals for which they are directly responsible.

Recent efforts at one company to improve performance in its customer service operations offer an example of the benefits of these incentive efforts, as well as the potential pitfalls that must be considered in designing these programs.

In this case, the company wanted customer service representatives to handle a higher volume of calls, so it implemented a program that provided financial incentives for representatives that met new call volume targets.

While representatives did handle more calls, the company soon noticed that many customers

were having to call back repeatedly to have problems resolved. In an effort to turn calls around more quickly, customer service representatives were not adequately addressing customers' needs.

The company then revamped its incentive program. It provided representatives with training on how to handle service calls and adjusted the incentive formula to reduce incentive payments when customers had to call back.

In the end, the program did increase the volume of calls that customer service representatives handled without eroding the service delivered to each customer.

Understanding criteria

This example underscores one of the keys to a successful incentive program of any kind at any level. The bonuses employees earn should be based on clear, objective criteria that is consistently communicated to everyone involved. Employees involved in such a program should have a good idea at any time how well they are doing against their goals and what their likely bonus will be.

This need for a clear understanding of the program, and a larger need to understand the program within the strategic framework of the company as a whole, lead back to the need for clear leadership and focused communications from business owners and executives.

Keep options open

In the end, flexibility is a key concern. Many companies either began or expanded stock option programs to compete with technology companies, but now find these programs less effective as the stock market declines. Yet these programs are not likely to retreat back to pre-Internet levels.

Incentive programs are effective, but must constantly be evaluated against current strategic needs to ensure that they remain appropriately targeted.

Changes in recent years raise non-compensation issues as well. Internet companies not only emphasized shared ownership, they also, in many cases, emphasized quality-of-life issues. Flexible scheduling, virtual work arrangements, egalitarian workplace designs, and other initiatives are also enjoying renewed attention not only at technology enterprises, but at traditional companies as well.

No one issue spells the difference between success or failure in attracting and keeping the talent entrepreneurial companies rely on to compete. But neither can any one issue be ignored.

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