ISSUES IN ACCOUNTING EDUCATION
Vol. 21, No. 4
November 2006
pp. 449–459

Restricted Stock versus Stock Options: The Case of Jones Apparel Group, Inc.

R. Loring Carlson and Thomas J. Vogel

ABSTRACT: In recent years, the structure of executive/employee compensation packages has focused less on stock options and more on restricted stock. The Financial Accounting Standards Board (FASB) characterizes both of these alternatives as stock-based compensation. The reasons for the shift are numerous and include increased scrutiny of executive pay after recent corporate scandals and a renewed emphasis on the expensing of stock options using the fair value method. In this case, we focus on the issues that led Jones Apparel Group, Inc. to change its focus from stock options to restricted stock in the compensation package of its Chief Executive Officer. Jones was not subject to any scandal or corporate malfeasance, but the case demonstrates how recent events have impacted companies that use stock-based compensation. The case allows students to compare and contrast the corporate governance and accounting impacts of stock options and restricted stock.

INTRODUCTION

Jones Apparel was created as a women's apparel division of W. R. Grace & Co. in 1970. Sidney Kimmel was selected as the division's President. In 1975, Mr. Kimmel and a partner bought the company from Grace and incorporated in Pennsylvania as Jones Apparel Group, Inc. (Jones). Mr. Kimmel was selected as the new company's Chairman and Chief Executive Officer (CEO). After years of growth, Jones went public on May 15, 1991 and listed its shares on the New York Stock Exchange under the symbol JNY. During the next ten years, Jones enjoyed significant growth in revenues and earnings per share through numerous acquisitions.

Mr. Kimmel stepped down as CEO on May 22, 2002, but retained his position as company Chairman. The new CEO was Peter Boneparth, who joined Jones in 2001 through the acquisition of McNaughton Apparel Group Inc. The pay package awarded to Mr. Boneparth when he assumed the CEO position included a grant of 3,000,000 stock options. Because Jones' Stock Incentive Plan did not have 3,000,000 authorized shares available on this date, the parties agreed to split the award into two separate grants: the first grant of 1,500,000 options would be awarded immediately, and a second grant of 1,500,000 options

---

R. Loring Carlson and Thomas J. Vogel are both Associate Professors at Western New England College.

We thank Anita Britt, Executive Vice President, Finance, and Wesley R. Card, Chief Operating Officer, of Jones Apparel Group, Inc. for providing company perspectives on the issues addressed in this instructional case. We are grateful for the excellent comments and suggestions received from Sue Ravenscroft (editor), Linda Thorne (associate editor), Brian Hentz (editorial assistant), and two anonymous reviewers. We also thank Hugh L. Grove and members of the North American Case Research Association (NACRA) for comments on an earlier draft of the case.

would be awarded after the Stock Option Plan was amended to increase the authorized shares in the plan.

But the timing of the package could not have been worse. Wall Street was frustrated with skyrocketing executive pay packages. In addition, many believed that large stock option grants to corporate executives precipitated the accounting scandals that occurred in 2001 and 2002. When Jones introduced the proposed plan amendment in its proxy statement, large institutional shareholders informed Jones' executives that the amendment would not be supported at the annual meeting. As a result, some other method of compensating Mr. Boneparth would need to be developed to replace the second 1,500,000 stock option grant. Jones was considering a grant of restricted stock, but many questions remained.

COMPENSATION PHILOSOPHY AT JONES

Throughout the 1990s, Jones provided its executives and key employees compensation packages that contained three basic components: salary, bonus based on performance measures, and stock options. This arrangement was similar to most other publicly traded companies. In 1999, the company had insufficient shares remaining to be distributed in its existing stock option plans. In order to continue its stock-based compensation philosophy, Jones' shareholders approved the "1999 Stock Option Plan." The plan reserved 10,000,000 shares of common stock for issuance through the granting of stock options in the plan, of which no more than 3,000,000 could be awarded to any one individual. Eligible participants included directors, officers, key employees, and consultants of the company and its subsidiaries. The plan stipulated that the exercise price of an option could not be less than the fair market value of the shares of common stock on the date of grant, and the option price, once determined, could not change during the life of the option. Because the exercise of options generally requires large cash outflows by the optionee, the plan allowed for "cashless" exercises to be made during which Jones could extend credit to the optionee to help finance the transaction.

In 2000, the Board of Directors proposed, and the shareholders subsequently approved, an amendment that permitted up to 1,500,000 of available shares in the plan to be issued as restricted stock instead of stock options. Because the plan now provided for restricted stock, the name of the plan was changed from the "1999 Stock Option Plan" to the "1999 Stock Incentive Plan."

Unlike stock options where the option holder receives the right to purchase shares at an exercise price, restricted stock represents the awarding of shares to the employee. Like stock options, however, restricted stock is usually accompanied by some vesting period that must pass before the recipient takes possession of the shares. Because there is no cost of exercising to the recipient, Jones could now provide a given level of compensation with fewer shares of restricted stock compared to the number of stock options that would be required for that same level of compensation. Recipients of restricted shares were entitled to voting and dividend rights during the vesting period.

The plan amendment also required that vesting of restricted shares could occur only if a performance measure had been attained by the recipient. This requirement was added so that awards of restricted stock would qualify as performance-based compensation under Section 162(m) of the Internal Revenue Code. If the performance measures were not met during the performance period (usually the same as the vesting period), then the recipient would forfeit the awarded stock. Jones held restricted shares in custody until all vesting and performance restrictions were satisfied. During the custodial period, the recipient of

restricted shares would receive dividends on the restricted shares held in his or her name, and would keep the dividends even if the performance measures were not met.

In 2001, after Jones had completed a few major acquisitions, only 2,109,818 shares remained unissued from the permitted 10,000,000 shares authorized in the original plan. The Board of Directors proposed, and the shareholders subsequently approved, an amendment to increase the shares reserved in the plan to 15,000,000. The amendment also increased the number of shares available as restricted stock from 1,500,000 to 2,250,000.

A CHANGING OPINION ON STOCK OPTIONS

Throughout the 1990s, employees especially favored the stock option component of their compensation packages. As the NYSE and NASDAQ stock market reached all-time highs, the payoffs from stock options often dwarfed payoffs received from salary and bonus. However, stock options began to lose favor in the markets with the burst of the stock market bubble in 2000 and 2001. For companies that experienced a large stock price decline, unexercised options became underwater (the exercise price was greater than the market value of the stock) and thus no longer provided the incentives they were designed to create. Some companies attempted to alleviate this problem by repricing existing options. Those companies received severe criticism from the investors, who complained that such programs rewarded executives for poor company performance.

But, more importantly, the extensive use of stock options in compensation packages was often discussed as a major contributor to the corporate governance malfeasance that surfaced in 2001. Companies such as Enron and WorldCom went from being market darlings to declaring bankruptcy as a result of corporate fraud. Many investors claimed the fraudulent acts were the direct result of executives' attempts to manipulate their companies' stock prices in order to maximize the value of their stock options.

These fraudulent activities led to increased scrutiny of the accounting industry by regulatory agencies that included Congress and the Financial Accounting Standards Board (FASB). The impact of these organizations includes the following:

- Congress passed the Sarbanes-Oxley Act, which prevents a company from granting loans to executives to assist in the exercise of stock options and requires the CEO and CFO to certify financial statements filed with the SEC.
- FASB re-introduced an emphasis on the expensing of stock options using the fair value method. Many investors claimed that the extensive use of stock options would be muted if companies were *required* to expense the fair value of stock options issued to employees, instead of the *optional* reporting as required under SFAS No. 123.[1] In 2004, FASB issued SFAS No. 123R,[2] which mandated the expensing of stock options for all companies.

The publicity and increased scrutiny of accounting policies led companies (such as Coca-Cola and General Electric) to voluntarily begin expensing stock options. Investor advocacy groups and institutional investors also got involved. On July 24, 2002, TIAA-CREF sent letters to the chairmen of 1,754 major publicly traded corporations, urging them to adopt voluntary expensing of stock options. John H. Biggs, Chairman of TIAA-CREF, wrote that stock option expensing "contributes to clear, straightforward, and high-quality

[1] SFAS No. 123 (FASB 1995).
[2] SFAS No. 123R (FASB 2004).

financial reporting, enhancing credibility that surely will be highly valued in the post-Enron market."[3]

Jones was not subject to any allegations of corporate governance malfeasance, but, like most companies, this dynamic environment impacted its compensation packages to executives and key employees.

MR. BONEPARTH'S COMPENSATION AGREEMENT AND SUBSEQUENT TURMOIL

Peter Boneparth served as CEO of McNaughton until that company was acquired by Jones in 2001. Effective March 11, 2002, Mr. Boneparth agreed to serve as President of Jones. On May 22, 2002, he became the company CEO as well. As outlined in the Jones' 2002 proxy statement, Mr. Boneparth's compensation included the following components:

- Mr. Boneparth would receive a salary of $1,500,000 for the period of March 11, 2002 to December 31, 2002, $2,000,000 for calendar 2003, and $2,500,000 for calendar 2004.
- Mr. Boneparth would receive a minimum bonus of $1,000,000 per year for 2002 and 2003. He was also entitled to receive an additional bonus in accordance with the Executive Annual Incentive Plan.
- Mr. Boneparth would receive stock options for 3,000,000 shares. On March 11, 2002, he received an initial grant of options to purchase 1,500,000 shares of common stock, which vested ratably on the first three anniversaries of the date of grant. The exercise price of these options was $36.54, the market price of Jones' common stock on the date of issuance. Mr. Boneparth was also eligible to receive a second grant of options for the balance (1,500,000 shares of common stock), subject to shareholder approval of another plan amendment.

It appeared as though the hiring agreement was completed. The only remaining hurdle would be to have the shareholders approve a plan amendment to increase the number of shares reserved for issuance. In April 2002, the Board of Directors proposed amending the 1999 Stock Incentive Plan to increase the number of shares reserved for issuance under the Plan from 15,000,000 to 22,500,000, and increase the maximum number that could be issued to any one individual from 3,000,000 to 6,000,000. This amendment also prohibited option repricing and/or option exchange programs.

Unlike prior plan amendments, however, this proposed amendment met with opposition. Exhibit 1 contains an article that appeared in *The New York Times* on April 14, 2002, regarding these proposed amendments. Large institutional investors claimed they would not support the amendment. In addition, investor advocacy groups, such as the Institutional Shareholder Services (ISS), recommended that shareholders vote against the amendment. The dissension was effective. Although this proposed amendment was included in the 2002 proxy statement, it was subsequently withdrawn from consideration by the Board of Directors and never voted on by the shareholders.

The Directors had to restructure the pay package to ensure that it compensated Mr. Boneparth fairly and would not be considered excessive by external investors. Structuring

[3] The letter from TIAA-CREF is more fully discussed in "TIAA-CREF wants Options Seen as Expenses" (*Wall Street Journal* 2002). TIAA-CREF is an institutional investor with $340 billion in assets. It serves as the principal retirement system for the nation's education, research, and health care communities, serving 3.2 million individuals.

EXHIBIT 1
Article from the *New York Times*
"Pushing The Pay Envelope Too Far"
By Gretchen Morgenson
April 14, 2002

Just when you think you've seen it all in executive avarice, a new greedmeister struts across the stage.

Today's actor is Peter A. Boneparth, president of the Jones Apparel Company, a clothing and footwear company in Philadelphia. Mr. Boneparth, 42, joined Jones last year and is to be anointed its chief executive when the company holds its annual shareholder meeting on May 22.

He may be new to the company, but he has made quick work of befriending the important people on the board: the members of the compensation committee. How else to explain his outsized compensation package, which includes a minimum salary of $1.5 million this year that rises to $2.5 million in 2004, $2 million in signing bonuses spread over two years and options this year on three million shares.

As a comparison, Paul R. Charron, chief executive at Liz Claiborne Inc., was given a base salary of $1 million and 50,000 stock options last year. And while Mr. Charron's options vest in four years, Mr. Boneparth's vest in just three.

But what has some Jones Apparel shareholders really steamed is that the company hasn't enough options to give Mr. Boneparth what the board promised. As a result, Jones is asking shareholders to approve the addition of 7.5 million shares for stock option grants. It is the second time in two years that Jones has gone to the shareholders to authorize a new option grant. Last year, the company asked for five million new shares, saying the amount would last two years. Obviously, it changed its mind.

Anita Britt, the company's spokeswoman, says the options are necessary to attract and keep talented employees. But 1.5 million of the newly allotted options, if approved, will go to Mr. Boneparth.

Most amazingly, Mr. Boneparth's contract states that if shareholders do not approve the option increase, he will receive the equivalent of the 1.5 million-share grant in "nonequity," corporate-speak for cash. So Mr. Boneparth is sure to get his, even if the shareholder vote fails, shutting out the 499 other Jones employees who are entitled to options.

Patrick S. McGurn, director of corporate programs at Institutional Shareholder Services, said that if companies were forced to deduct the costs of options as an employee expense, the heads-I-win, tails-you-lose option grant given to Mr. Boneparth would not have happened. "Saying we're going to do it regardless of what you think about it is not the sort of choice that shareholders should be presented with," Mr. McGurn added.

One of the biggest shareholders in Jones Apparel is Plaza Investment Managers, an investing subsidiary of Berkshire Hathaway, which holds 8.6 million shares. Louis A. Simpson, president of Plaza, said: "We don't have a problem with people getting paid for performance, but this package provides Mr. Boneparth with substantial rewards at the expense of shareholders even if the business performs modestly over the next few years. What the board has given him doesn't make a lot of sense."

Over at Chieftain Capital, Jones's largest shareholder, Thomas D. Stern, managing director, said: "Peter is a capable executive, but he hasn't proven he can create value for the Jones shareholders. To award him $35 million in options and guarantee him $10 million in compensation, after nine months at Jones, is egregious. It appears that this company is continuing to be run more for the management than for the shareholders. This is unacceptable." Both Chieftain and Plaza say they intend to vote against the option plan.

At last, it seems that a shareholder revolt over executive excesses is brewing. For now, it is limited to a couple of hot spots. Let's hope it spreads.

Copyright © 2002 by The New York Times Co. Reprinted with permission.

a deal that would be favorable to the shareholders and Mr. Boneparth would require significant planning in areas of corporate governance and company profitability.

JONES GAINS INVESTOR CONFIDENCE AND MODIFIES MR. BONEPARTH'S PAY PACKAGE

Throughout the remainder of 2002, Jones' Board of Directors attempted to regain the confidence of the market and restructure the pay package for Mr. Boneparth. The parties agreed to replace the second issuance of 1,500,000 stock options with shares of restricted stock. The Board believed that a focus on restricted stock would be less dilutive to existing shareholders than stock options, and would provide the necessary incentive to management. In the negotiation process, the parties agreed to both a service requirement, or vesting period, and a performance requirement of an operating cash flow target. The Board believed the operating cash flow requirement helped gain the support and confidence of institutional investors.

But gaining the confidence of investors in these turbulent times would take more than just reducing management pay. When reporting Jones' second quarter results on July 31, 2002, Mr. Boneparth announced, "We have reviewed our policy relating to the accounting treatment of stock options and have elected to record compensation expense for all stock option grants effective January 1, 2003. Given the prospective treatment required by SFAS No. 123 (*Accounting for Stock-Based Compensation*), we anticipate that an annual stock option grant at past levels would have a nominal 1–2% dilutive effect on 2003 earnings per share." With this announcement, Jones became the first company in the industry to voluntarily expense stock options.

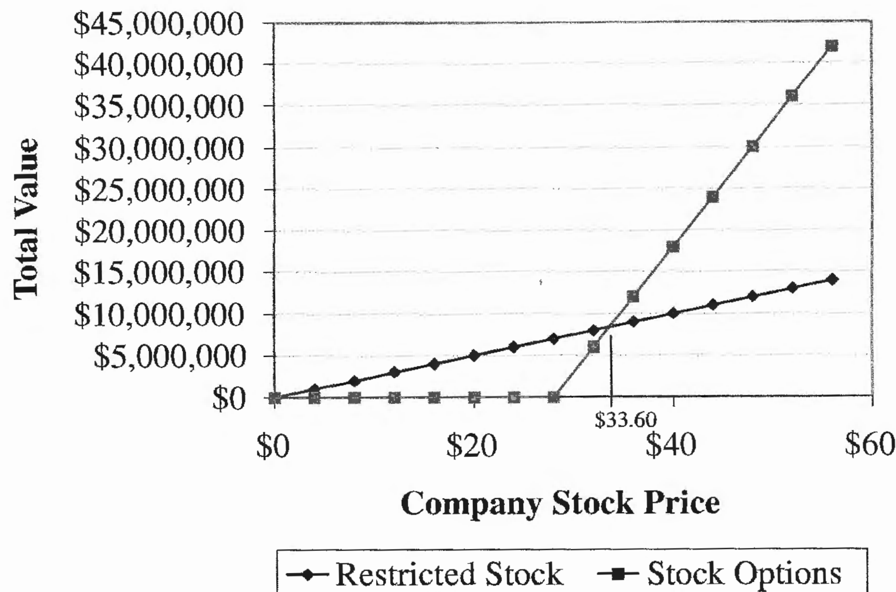
In late 2002, after much negotiating, Mr. Boneparth offered to forgo the contractually mandated 1,500,000 options in consideration of 250,000 restricted shares of stock. Figure 1 shows the intrinsic value, or potential income to Mr. Boneparth, of 1,500,000 options with an exercise price of $28.00 (an approximation of share price during the period of negotiations) versus the 250,000 shares of restricted stock. The potential payoff from stock options was much more volatile and provided the opportunity for larger income. But from Mr. Boneparth's perspective, the restricted shares would provide a more secure source of wealth. These restricted shares would continue to have value to Mr. Boneparth even if Jones' stock price declined after the date of issuance.

On February 28, 2003, the renegotiation between Jones and Mr. Boneparth was finalized. The stock price of Jones' common stock on this date was $28.36. The 250,000 shares of restricted stock awarded would vest at a rate of one-third of the shares in each of 2004, 2005, and 2006, provided that Mr. Boneparth remained an employee of Jones and pre-established operating cash flow targets were achieved. If the operating cash flow targets were not met, then the shares would be forfeited. The new pay package was received with favor by institutional investors.

In April 2003, the Board of Directors proposed an amendment to the 1999 Stock Incentive Plan to increase shares reserved for issuance by 1,500,000 (to 16,500,000), of which no more than 750,000 shares could be issued as restricted stock. The major institutional investors and the ISS subsequently endorsed this amendment, which shareholders approved in April 2003.

Over a four-year period from 2000 to 2003, the emphasis in compensation packages at Jones had switched from stock options to restricted stock. Whereas 6.2 million stock options had been issued to employees in the 2000 calendar year, just 300,000 stock options were issued in 2003. Conversely, there were no restricted shares issued in 2000, but in 2003, 626,500 restricted shares were issued to 31 employees and six executives.

FIGURE 1
Intrinsic Value: Stock Options versus Restricted Stock



The income to Mr. Boneparth from either stock options or restricted stock is based on the subsequent stock price of Jones' stock. The above chart represents the intrinsic value, or potential income to Mr. Boneparth, of 1.5 million options with an exercise of $28 and 250,000 shares of restricted stock as the value of Jones' common stock increases. For stock prices of $28 or below, the stock options have zero intrinsic value. At a stock price of $33.60 the intrinsic value of these alternatives is equal.

DISCUSSION QUESTIONS

In addition to the information provided in the text of the case, students are encouraged to read the referenced articles in an appendix and use other information available in SEC reports such as Jones' proxy statements and 10-K reports. These reports are available at no cost on the SEC's EDGAR research database located at the following address: http://www.sec.gov/cgi-bin/srch-edgar.

Questions on Corporate Governance

1. Which of the three components of Mr. Boneparth's compensation package (salary, bonus, and stock-based compensation) is likely to be the most important to Jones' shareholders? Why?
2. In Exhibit 1, *The New York Times* article claims that Jones awarded Mr. Boneparth $35 million in stock options. How do you think this figure was determined? What has to happen for Mr. Boneparth to receive this level of compensation?
3. Discuss three factors that should be considered by Jones' Compensation Committee when determining the size and content of Mr. Boneparth's pay package. Do you believe the pay package offered to Mr. Boneparth is excessive? Explain.
4. As noted in the case, Mr. Boneparth forfeited his right to receive 1,500,000 options in return for 250,000 shares of restricted stock. How do you think the potential payoffs

for the restricted stock will impact Mr. Boneparth's performance as an agent for company shareholders? Which compensation component would you prefer if you were a shareholder of Jones? Why?

5. Discuss the pros/cons to Mr. Boneparth of receiving either of these two potential pay package components (1,500,000 stock options or 250,000 shares of restricted stock). Which compensation component would you rather have if you were Mr. Boneparth? Why?
6. The original provisions of the 1999 Stock Incentive Program included the opportunity for a "cashless exercise." Why were these company loans strictly prohibited by the Sarbanes-Oxley Act? How does this prohibition impact the decision of companies like Jones that are distinguishing between stock options and restricted stock in compensation packages?
7. Why do restricted stock awards often include performance requirements, such as the operating cash flow requirement for Mr. Boneparth, in addition to service requirements? Why are stock options usually awarded without performance requirements? What factors should the Compensation Committee consider when determining the required levels of operating cash flows necessary for Mr. Boneparth's restricted shares to vest?
8. When announcing second quarter results on July 29, 2003, Jones initiated a quarterly dividend stating that "the Board of Directors has declared our first-ever quarterly cash dividend of $0.08 per share to all common stockholders of record as of August 15, 2003 for payment on August 29, 2003." How might the switch from stock options to restricted stock in the compensation packages of Mr. Boneparth and other employees have impacted the Board's decision to start paying dividends?