

The Stock Option Expense Issue: The Tip of a Much Bigger Governance Iceberg

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A call to action for corporate boards and compensation committees.

Without question, the past two years have been rough. Few remain untouched by the ripple effect emanating from a wave of accounting scandals, bankruptcies, and sliding stocks. In search of answers, however, one may well ask whether today's problems can simply be pinned on a few bad apples in the barrel—or to the fact that the barrel *itself* suffers from systemic flaws and structural deficiencies?

Rise of Options

Let's look at the facts. Throughout corporate America, the compensation systems we have widely adopted for our executive teams and other employees have become increasingly lopsided and overly dependent upon generous stock option grants.

Over the last 10 years, option grants to CEOs and other executives have more than quadrupled, according to our research. Many companies are granting 15 percent to 20 percent of their outstanding stock in options (up from 3 percent to 5 percent 10 years ago).

This astounding increase was driven by an explosion in the stock market, a shortage of management talent, and by the belief that options would lead executives to think and act like shareholders, making decisions that were in their best interests. Compensation experts and directors

thought that if a few options were good, then vast quantities must be even better. We were wrong. Instead of giving management an incentive to think and act like shareholders, we gave them an incentive to think and act like option holders—a much higher risk and shorter-term perspective.

As the size and scope of option plans grew over the past decade, a number of serious repercussions became readily apparent. The options granted were rarely tied to performance goals and seldom evaluated by the board for either their true cost or the return on investment they may or may not generate for the company and its shareholders.

In addition, it seems that holding a vast number of stock options led many executives into extremely risky strategies. Contrary to our hopes that CEOs would think and act like shareholders, they instead behaved like option holders—often highly motivated to make rash

decisions that might spur a quick rise in the stock price. With a vast sum of options in hand, even a small elevation in price could pay off handsomely.

But with the fallout from such actions becoming clearer every day, it may finally be time to rebuild the compensation barrel and give all of the presiding “apples” a fighting chance to do the right thing—for employees, shareholders, and the business in general.

Conference Findings

To address these and other important issues surrounding stock option plans, the International Accounting Standards Board (IASB) and my company recently co-sponsored a groundbreaking conference in New York focused on “Solving the Stock Option Problem: Not Whether, But How.”

Participants in the conference included many highly respected thought leaders, including Financial Accounting Standards Board Chairman Bob Herz, shareholder value advocate Joel Stern, Nobel Laureate Myron Scholes (co-originator of the Black-Scholes Option Pricing Model), and Phillip Ameen, Controller of General Electric and a leading member of the Financial Executives Institute.

Some key ideas and proposals from the conference are summarized below:

► Options can be greatly improved as an incentive for executives or employees if they have specific performance features and/or are combined with stock ownership.

► Creating an expense for options should increase creativity in corporate incentive programs, but will likely decrease their use as an incentive for rank and file employees who have little, if any, direct impact on share price.

DIRECTOR SUMMARY

A recent conference explored the downside of options and urged solutions. Responding to the problem requires directors who ask the right questions about costs and results, and pay packages that provide the right incentives, tying options to performance goals, and adding performance-based restricted stock and stock to the package. ►

► An expense for options should be based on the fair value of the option at the date it is granted. Option pricing models such as Black-Scholes and binomial are acceptable methods to determine this expense.

► Start-up and private companies should not be immune from expensing options, although an allowance may be made to account for their lack of marketability.

Within a few days after the conference concluded, the IASB met in London and made the unanimous decision to move ahead with a recommendation to expense options. The Financial Accounting Standards Board (FASB), which determines standards for all publicly traded U.S. companies, is considering a similar recommendation and will likely follow the lead of the IASB.

Though many pockets of dispute remain, the pendulum now appears to be swinging in favor of expensing options. In recent weeks, a number of notable companies have adopted this position, including Coca Cola, General Motors, Bank of America, and General Electric. By mid-September 2002, more than 100 companies had elected to take the expense. (See box on p. 13.)

Many companies are not only taking this opportunity to revamp their accounting practices, but they are also taking a closer look at their corporate governance policies. Making the connection between corporate responsibility and executive compensation, the GE board announced their decision to expense options in a press release issued on July 31st and stated, "The company's board of directors has approved actions that enhance governance and financial disclosure, and further align senior management's personal interests with the long-term interests of shareowners."

The Problem Defined

The problem with most stock option plans is that they are not linked to performance goals or corporate objectives. Most plans reward stock price growth, but they reward absolute rather than relative performance—providing (through sheer size of the number of options) big rewards for any price improvement, no

matter how small. (Of course, options also provide even larger gains for higher stock price growth, which is what a good incentive is supposed to do.)

Historically, there has been minimal discussion at the board level about how to make such option plans healthier and more performance-oriented. This shortcoming stems less from negligence than from a failure of the system. The misalignment between option grants and actual performance is a quandary that has actually been encouraged by today's tangled web of accounting rules and by the very nature of this unmeasured, imbalanced, and overused incentive.

The True Cost of Options

The accounting expense for options is only the tip of the iceberg. For starters, the expense that most companies are adopting, and that is recommended by both the IASB and FASB, is the "fair value" of the option at the date it is granted. While this makes sense for accounting purposes, it is by no means the total cost of a stock option. The real economic cost of an option to shareholders is the total spread between the exercise price and the market price on the date it is exercised. This is critical because the board must be responsible

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for monitoring the total cost of options to shareholders.

Boards felt they were doing the right thing by authorizing enough option shares to keep pay packages competitive and allow companies to attract, retain, and motivate the best executive talent available. Their questions of managers and consultants focused on making sure their company's practices were within competitive norms.

But benchmarking is not enough. With option grants escalating at alarming rates, boards need to ask more insightful questions. They should ask, "What is the true total cost of our stock option and executive compensation package?" (See "True Cost" box below.)

TRUE COST

For example, if an option is granted with an exercise price of \$10 and a vesting period of five years when the market price is also \$10, the "fair value" will be between \$3 and \$5 for most companies (using the Black-Scholes or another option pricing model). Likely accounting rules will require this fixed expense to be amortized over the option's vesting period—contrasting sharply with the true cost to shareholders.

If, in five years, the company's stock is trading for \$50, and the executive exercises the option, he has purchased a \$50 stock for \$10—a \$40 benefit to the executive and a \$40 cost to the shareholders. (Tax law recognizes this as the actual cost and requires the executive to record \$40 of taxable income, and the company to record a \$40 deductible expense as of the date the option is exercised.)

The company sold a share of stock for \$10 that it could have sold in the market for \$50, and must now produce returns on a \$50 stock for which it only has \$10 to invest (plus the benefit of a \$40 tax deduction from the option exercise).

Someone has to be responsible for this \$40 cost, and for ensuring the company and shareholders see a return on this investment. If the company is only taking a \$5 expense, then the board must see that the rest of the cost is tracked, accounted for, and that the executives receiving this benefit are returning at least that much to shareholders in improved performance. ► **Don Delves**

How much is the total executive pay package for all executives as a percentage of net profits?

Directors should not simply settle for the cost of this year's grants, but for the total cost of the entire package over a three-to-five-year time horizon. Furthermore, the cost should include not only the Black-Scholes value of the options at the date they are granted, but the total amount of wealth transferred from shareholders to executives, and the total that could be transferred in the future as the result of option and other plans.

Once satisfied as to the true cost, directors should then ask, "What return are we getting on this investment for the company and shareholders?" The answer should not be in terms of increased stock price, since management cannot fully take credit for what the market does, but should relate to improved financial performance and achievement of strategic objectives.

If these questions are asked and answered, with management actively engaged in the discussion, corporate gov-

ernance and executive pay will become much healthier and more accountable than it is today.

Compensation and Risk Management

Executive compensation should be considered as part of a company's risk management program. How incentives are structured has a direct impact on the level of risk an executive is willing to take, and consequently, on the overall risk profile of the company.

An executive whose incentives are based on achieving specific long-term financial results may make decisions very different from those of an executive who can reap substantial rewards if the stock price temporarily rises by a few dollars.

In the first case, the executive has a stake in long-term company performance, and will not make decisions that could put that performance at risk. In the latter case, the executive has no such restraints on his or her behavior. Indeed, the option may reward highly risky decisions in which the company, not the executive, bears the risk.

Fortunately, the solution is not complicated.

Solutions

What can the board do to rectify this situation? Plenty. There are three main things a corporate board member can and should do:

► Reconsider and re-think the *total executive compensation package*. Once we have an expense for options, and they lose their special "free" status, the door will be open to more effective incentive plans.

► Start asking more probing questions about *how much CEOs and other executives should be paid*. Management, boards, and their consultants have contented themselves for too long with "competitive data," basing their decisions almost solely on what other companies do. Boards must demand more thoughtful and rigorous analysis demonstrating the value generated by executives, and the return on the amounts they are paid.

► Ask tough questions about *the true, total cost of stock options* and the rest of the executive compensation package, and what return the shareholders are receiving for that investment—and get answers.

We need to create pay plans that combine incentives in a way that:

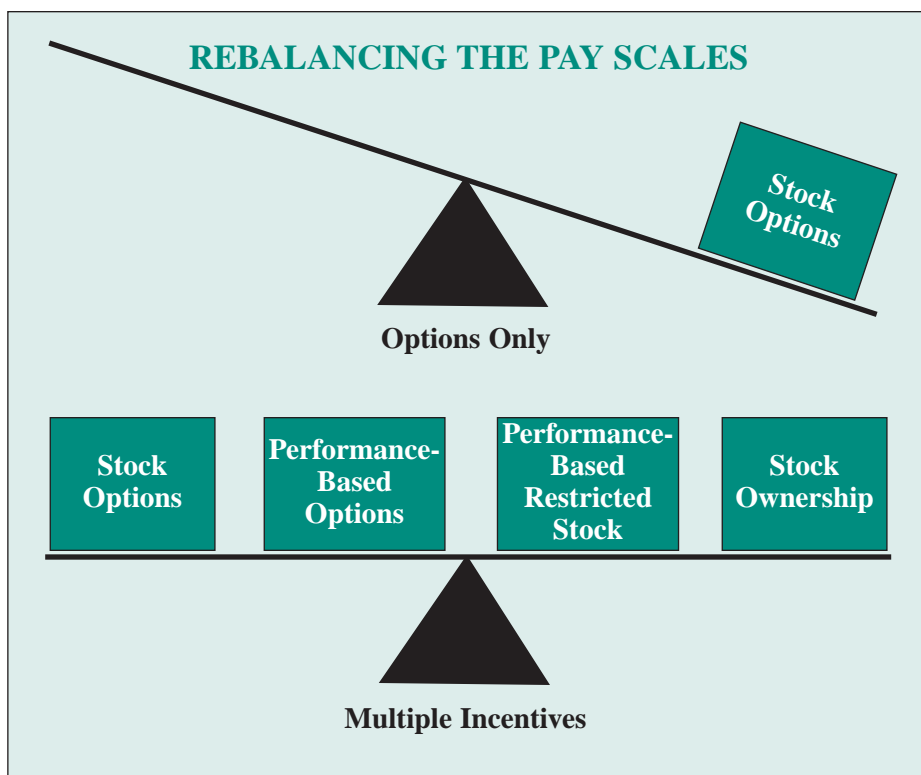
► causes executives to pursue goals that are in the long-term best interests of the company and its shareholders, and

► gives the board a way to ensure that pay is being delivered in exchange for specific performance, with a demonstrable and measurable return on the total cost of executive compensation.

This can be accomplished by augmenting performance-based incentives with stock ownership. For example, instead of 100 percent plain-vanilla options (exercise price equal to market price at date of grant), a company may grant a combination of performance-based options and a performance-based cash incentive plan.

Performance-based options. Two methods for making options more performance-based are:

► performance-vesting options—options do not vest and become exercis-



able until specific long-term financial targets have been achieved, and

■ accelerated exercise price options—options with an exercise price that increases over time—either with the stock market, or at some rate of interest (like the risk free rate or the cost of capital). This requires that the company earn a minimum return for investors before options pay off.

Another way to help balance a company's incentive risk profile is to require that executives hold all or a portion of the shares acquired from exercising their options. If executives cannot easily cash out their option positions and have to hold the stock they acquire, they will have a longer-term risk orientation than with traditional options.

Performance-based cash incentive. This type of plan is nothing new, but has long taken a back seat to options except at privately owned companies. This is basically a long-term bonus that pays out a range of awards for achieving a range of specific financial (or non-financial) goals over a three-to-four-year period. It can pay out in cash or stock. The point is that it requires management to set and quantify specific long-range goals, and be held accountable to them by the board. It sounds simple, but many companies have avoided such simplicity in favor of the illusive magic of stock options.

Pay Levels

Many consultants will say it is not a question of "how much" but "how" executives are paid that matters—but there must be more deliberative thought around this aspect. Merely looking at competitive data to gauge executive pay only exacerbates the problem. Since virtually all companies want to pay at the median or better, the bottom half are continually leapfrogging to the middle, or to the upper half, without really looking at relative performance.

Relative pay levels should be based on relative performance. If performance is at the 25th percentile, then pay should be as well, and vice versa. To their credit, a number of companies make this calculation and follow it. However, they tend to be above-median performers.

In addition to looking at relative performance, boards should also establish standards for the total cost of executive pay relative to the company's financial performance. How much is the total executive pay package for all executives as a percentage of net profits?

This is not a difficult question. For the answer to be meaningful, though, we need a basis for comparison—some way of establishing a norm. We can begin by making comparisons to other companies, by establishing norms in various industries, or for different stages in a company's evolution.

While there is no ideal database for this information today, we would have one quickly if boards began asking for the information. The calculations are not difficult. Someone just needs to start making them.

Lastly, the notion of optimal relative pay levels within a company has been around for a long time. Originally attributed to Plato, the concept of an ideal multiple of CEO pay to that of the average or lowest paid worker may have some merit. While it sounds socialistic and un-American, it may be a good measure of the overall health of a company, and of how well a company spreads responsibility and accountability throughout the organization. Again, we do not know if we do not make the calculations—and the calculations will not get made unless board members start asking for them.

Needed: Better Data and Analysis

This point cannot be over-emphasized: The executive compensation field is sorely lacking in sophisticated study and analysis.

Companies and universities spend far more money developing new products, technologies, and computer systems than in figuring out how to reward and motivate their leaders. In fact, significantly more attention is given to the science of getting more production from factory workers than getting more from corporate executives.

The vast majority of analyses commissioned from consulting firms are traditional competitive pay studies performed the same way for the last

30 years. Universities and business schools have not brought their resources to bear either, and there is no separate discipline dedicated to studying this subject. It falls in the cracks between finance, accounting, and corporate governance, touched by all, but fully addressed by none. Again, this would change if boards started demanding in-depth, critical analysis and creative thinking on executive pay.

How we evaluate, motivate, and pay the leaders of our country's businesses is one of the most important issues in our economy. It is an area requiring our best and brightest minds to examine the issue and propose new solutions. And it is America's board members that will drive the inquiry by asking tough, penetrating questions and demanding thoughtful, well-researched, cutting-edge answers. ■

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TRACKING A CORPORATE TREND

By mid-September 2002, more than 100 companies had adopted the position of expensing options. Following is a partial list of companies:

Amazon.com	General Motors
American Express	Goldman Sachs
Bank of America	J.P. Morgan
Bank One	Chase & Co.
Citigroup Inc.	Merrill Lynch
Coca Cola	MetLife Inc.
Computer Associates	Morgan Stanley
General Electric	Wal-Mart
	Washington Post