

STOCK OPTION EXPENSING: PREPARING FOR CHANGE

By Don Delves, CPA

[The views expressed here are those of the author and are not necessarily shared by the NASPP's management, Advisory Board or Executive Advisory Committee.]

In the March-April 2002 issue of this newsletter (at pg 6) I contributed an article entitled "Why There Will be an Expense for Options...and How to Prepare Now." Technically, the jury still may be out, but the only issues left to resolve are *when* the expense will become mandatory and *how* it will be calculated. As stock plan professionals, our challenge is to stay on top of the issue as it unfolds, anticipating the implications and next steps associated with the change. An options expense WILL result in dramatic structural changes to executive compensation plans, MAY cause companies to re-think broad-based employee option programs, and SHOULD cause boards to scrutinize option grants and executive pay far more rigorously.

Where Are We And How Did We Get Here?

A year ago, none of us would have guessed that we would be on the brink of requiring an expense for stock options. Indeed, until mid-July, only two companies (Boeing and Winn Dixie) had chosen to adopt FAS 123.

What's different now? With the demise of both Enron and Andersen the world changed, almost overnight. Public sentiment is markedly anti-corporate and people are looking for culprits. A major and longstanding loophole—current option accounting treatment—is increasingly viewed as causing runaway option grants that spawned undue risk taking and manipulation of the books. In the world of corporate reform, the option expense is low hanging fruit.

Moreover, our Federal Reserve Chairman, Alan Greenspan, has become a very vocal advocate of expensing, and the Council of Institutional Investors, major investors like TIAA-CREF and investment bankers such as Bear Stearns also are voicing their support. Standard & Poor's announced early this summer they would deduct the option expense in calculating companies' earnings per share. And, on July 14 the damn finally burst with an announcement from Coca Cola that it would expense stock options. The Washington Post, Bank One and a host of others followed quickly, and now over 100 companies have announced that they will expense their stock options.

Finally, on July 15, the International Accounting Standards Board voted unanimously to develop an exposure draft for an option expense, which is expected to be released this October. The IASB could adopt an expense requirement as early as next summer. We predict the FASB will follow suit and that an option expense will be required for US companies starting in 2004.

Meanwhile, the FASB is preoccupied with implementation and transition rules for the companies choosing to expense now. (Questions remain as to whether the expense

should be adopted prospectively for future grants only, or retrospectively, including all prior grants. So far, a company may choose either alternative.)

How Will The Expense Be Determined?

The FASB and the IASB agree that the expense should be determined as of the grant date, and that the amount should be the "fair value" of the option as of that date. Once set, fair value should not be adjusted in the future, and should be amortized over the option's vesting period. [At a recent conference co-sponsored by the Delves Group and the IASB, Nobel Laureate Myron Scholes (who developed the Black-Scholes Option Pricing Model) confirmed that, while the Black-Scholes model is not designed for valuing employee options, if the objective is to be as accurate as a company is with, say, depreciation or pension expense, or anything regularly estimated for accounting purposes, the model is fine.]

What The Stock Plan Professional Must Do

There are five things a stock plan professional needs to do to be well positioned and prepared on this issue:

1. Know how your company's option expense is determined. All public companies with stock options already calculate and report an expense in the footnotes to their financial statements. If you don't know already, you should know what the expense is, *exactly* how it is calculated, the option pricing model used, the assumptions that go into that model, and how those assumptions affect the valuation and expense.
2. Know how your option expense stacks up against other companies. Both Bear Stearns and Standard & Poor's provide excellent data on what the option expense would be for hundreds of companies across several industries.
3. Consider how you could lower the expense if you had to. Would you grant fewer options, grant them to fewer people, make them more performance-based, change the valuation model or assumptions?
4. Read FAS 123 as well as the IASB exposure draft, when it's published. Stay abreast of developments from the FASB and IASB. Putting the rhetoric and Congressional chest pounding aside, this is where the meat is. Any accounting change for options will come from these two bodies.
5. Prepare for broader change to executive compensation and board governance.

Prepare for Change—Executive Compensation

Despite the hubbub over the accounting expense for stock options, it is only the tip of the iceberg. The implica-

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tions for executive compensation and board governance go much deeper and may have profound consequences.

Will we see fewer option plans and smaller option grants? If we sat down with a blank sheet of paper (and no preconceived notions) to design the optimal executive compensation plan, would we determine that stock options are the optimal incentive for all executives at all companies?

Stock options have some unusual, and not always desirable, incentive characteristics. Because they reward only upside stock price movements, and do not penalize stock price decreases, they provide a lopsided incentive that doesn't necessarily align with shareholders' interests. Options reward any increase in the stock price, no matter how small, so executives can get paid for producing relatively low returns to shareholders. This is not to say that options are a bad incentive. Clearly, they helped drive the prolonged market expansion and the technology boom. In very large quantities, however, options dominate all other forms of pay and can create perverse incentives to take risks that circumvent long-term shareholder interests. We sought to make executives think and act like shareholders, but instead gave them an incentive to think and act like option holders—a far riskier and shorter-term orientation.

So what does this mean? Once the dust settles and it's clear an option expense is here to stay, companies and boards will begin to evaluate their total executive compensation packages and question the effectiveness of options alongside other incentives. They may determine that options aren't the ideal incentive for every situation, and that each company should develop its own optimal solution to support its goals, culture and desired risk orientation.

Balance is Key. We suggest each company determine its own balanced mix of options and other incentives to create the ideal risk and motivational profile for its executives. Just as each person has his/her own ideal investment portfolio, so each company should have its ideal incentive portfolio.

If a company's management and board believe options are still effective for their purposes, they may choose to balance them with stock ownership, and/or a long-term performance-based plan that pays out in cash or stock for achieving specific financial objectives. They may also determine that options should be performance-based and vest only if specific long-term financial objectives are achieved.

Alternatively, a company may decide that the option exercise price will rise with the stock market or at a rate of interest, thereby requiring a minimum return to shareholders before the options pay off. In the past (and under current accounting rules) few companies used such performance-based features because they would incur a potentially high variable accounting expense. Under FAS 123, however, performance-based options have the same fixed grant date expense measurement as "plain vanilla" options, making them perhaps a more palatable and common alternative.

Prepare For Change—Board Governance

Although it's a step in the right direction, the expense for stock options proposed by the accounting profession (*i.e.*, grant date fair value) does not completely capture the true cost of options to shareholders. The true *economic* cost of an option is the spread between the exercise price and the market price on the date it is exercised, a figure often many times greater than the accounting expense.

For example, if an option is granted with an exercise price of \$10 when the market price is also \$10, the grant date expense will be somewhere between \$3 and \$5. However, if the option is exercised five years later when the market price of the stock is \$100, then the true total cost of the option is \$90. The company has sold a share of stock for \$10 that it could have sold in the market for \$100. And the company now has to produce returns on a \$100 stock for which it only has \$10 to invest (plus the benefit of a \$90 tax deduction from the option exercise). It is up to the board to account for this \$90 cost, and for ensuring the company and shareholders receive a return on this investment. If the company is only taking a \$5 expense, the remainder should be accounted for to ensure that option recipients return at least that value in improved performance.

Beyond clarifying the actual cost of options, senior management and boards should ask probative questions to determine what they're really getting in exchange for stock options or other incentive investments they make in executives and other employees. Leaving aside the movements of a fickle market (since a rise or decline in stock price may be due to wholly extraneous factors) boards should focus on fundamental improvements in financial performance and achievement of strategic objectives. Clearly understanding the costs and benefits attached to their compensation structure will allow boards to create a more equitable relationship between executives, employees and shareholders.

Summary

While well-meaning stakeholders may disagree on exact methods, measuring the value of stock options is not rocket science...and showering executives with options that appear invisible on financial balance sheets is not a nifty magic trick. There are healthier alternatives to the unmeasured and unmanaged stock option packages we've grown so accustomed to. It's time to let go of our one-size-fits-all stock option paradigm and create compensation programs that restore a sense of balance and accountability between executives, employees and shareholders.

Mr. Delves is the President and Founder of The Delves Group, a consulting firm that strives to help companies improve the effectiveness and performance of their people by assessing and redesigning the way they are organized, directed and rewarded.

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