

Trend or Foe?

By Don Delves, CPA
Strategic Finance, December 2002

Analyzing
what's
behind and
beyond the
current stock
option
expensing
movement

It's an interesting and illuminating sign of the times. Who would have thought that seemingly mundane topics like financial management, compensation packages, and arcane accounting principles would suddenly become headline grabbers on the nightly news?

Where Are We...and How Did We Get Here?

In the wake of the tech wreck, unprecedented market volatility, a string of corporate scandals, and mounting bankruptcy declarations, many companies are taking bold steps to reassure jittery investors and restore public trust. In addition to having CEOs vouch for their numbers (hmmm...should this really be a new development?), well-known companies

like Coca-Cola, Bank One, General Electric, and Amazon.com have gone the extra mile by declaring they will begin to expense stock options.

This trend naturally makes some companies—especially technology and telecom—more nervous than others. After all, they have grown quite accustomed (perhaps even addicted) to the notion that huge stock option grants were a cheap, easy way to reel in talent and keep the books looking healthy. A number of executives have even taken big “cuts” in their regular salaries while accumulating millions of stock options as primary compensation. Rising in popularity and growing in volume, it has been viewed as an upside-only proposition for years. While dissent was muted when the market was at its peak, pressure to change the system began mounting as the market declined, taking option holders’ potential profits with it.

The Financial Accounting Standards Board (FASB) has long advocated an expense for options, but it backed off from its last attempt to require such an expense in 1993-1994. It took such a concerted drubbing from a variety of constituency groups—including investors, CEOs, and Congress—that it only required the option expense to be reported in the footnotes to the financial statements. The belief at the time—or at least the rhetoric—was that our nascent technology sector would be hurt by an option expense. Now we must question whether it was hurt worse by not having the expense.

This time around, the FASB is no longer alone in its quest for fair option accounting. Joining the FASB in its pro-expense position are the Council of Institutional Investors, TIAA-CREF, Federal Reserve Chairman Alan Greenspan, Nobel Laureate Myron Scholes, numerous congressional members, and the International Accounting Standards Board (IASB), which voted unanimously in July to submit a proposal requiring the expense to be determined as of the day options are granted. And as of the end of September, 111 companies have publicly announced their intention to begin expensing stock options on their income statements in 2003 or sooner.

While this movement appears to be picking up steam, unanimity on if, how, and when the expense should hit the books hasn't been attained. Some notable—primarily high-tech—companies have at least temporarily chosen to remain on the sidelines. Intel, Microsoft, Cisco Systems, and PeopleSoft are among those not quite ready to shift this particular reporting paradigm, although nearly every corporation is at least giving the matter some serious thought.

Why is this issue getting so much attention? Size matters. The packages themselves and the ranks of participants receiving them have literally mushroomed in recent years. Millions of options have been granted to millions of people, and there are now billions of dollars in potential shareholder value that somehow slipped beneath the financial radar screen. And we're discovering that although it may be tough to reach consensus on value, the bills for our lack of true compensation measurement and management are now coming due.

Sifting for Clues in Wall Street's Ruins

WorldCom's failure to account for nearly \$7 billion is shocking due to its sheer magnitude, but we shouldn't be completely surprised at some of the lesser financial infractions taking place across corporate America every day. Though not entirely to blame, holding a massive amount of "free" stock options creates a perverse incentive for executives to take major risks. Such risks are clearly designed to prompt a hasty rise in the stock price from which the option holder can benefit handsomely while being insulated from any subsequent slide. It's a deceptively simple and unbalanced game of chance. After all, if you're invited to the poker table with the promise that you can only win or at least break even, you're much more apt to place wild bets and throw caution to the wind. More than one CEO has taken this bait.

Many factors feed into the current economic situation, but, as one prominent piece of the corporate accounting puzzle, the question as to whether (and how) stock options should be expensed is now sparking lively discussion in boardrooms, around water coolers, and on talk shows almost daily.

"Reporting stock options as expenses is a sensible and positive step toward a clearer and more precise accounting of a company's worth."

*Alan Greenspan
Federal Reserve chairman*

Frankly, it's a healthy and long overdue debate.

The Granting and Measuring of Options: At Whose Expense?

Granting stock options has long been a system lacking any meaningful checks and balances. Viewed as "free" compensation tools, unrestrained stock options have actually carried a hefty price tag. That price has been paid by shareholders relinquishing a sizable percentage of wealth, by employers unable to determine ROI on their investment in people, and by employees who decided to join a company based primarily on option comparison shopping—and ended up with underwater options and an ill-fitting job. Lack of good accounting for options has also led to inconsistencies and inaccuracies in the financial information reported by companies and relied upon by investors.

Just as salaries, benefits, office space, and computer equipment all represent actual expenses to a company, stock options also have costs associated with them—whether or not they're being captured and recorded.

But with options comprising a significant portion of many executive compensation plans (up to 90% by some estimates and at least 60% on average for CEOs), understandably there are concerns weighing on the minds of management. What impact will the expense have on the company's bottom line? Will this curtail the ability to attract and retain top talent? What will supplement or replace traditional stock options? How will the option expense be determined? The reality of the situation is that even the accountants favoring an expense can't seem to agree on just how that expense should be measured.

Admittedly, there are significant issues and challenges swirling around stock option accounting practices, and some companies will obviously fare worse than others by reporting the expense based on a reasonable measure of valuation. As it turns out, though, there are compelling reasons for companies to begin expensing options, several primary methods that have been proposed for doing so, and alternatives to leaning so heavily on this one, rather skewed compensation tactic.

Measuring Tools

The question of how to measure the cost of options raises more disputes than whether to expense them at all. The FASB and IASB basically agree, with only minor differences, that the expense for options should be determined as of the date the options are granted, and that expense—with no subsequent adjustments—should be amortized over the option vesting period. The amount of the expense, both bodies agree, should be the "fair value" of the option on the date it was granted. Fair value means the value of the option instrument if it were bought or sold in a public market. How that value is determined is the subject of major debate. (I wonder, though, whether the debate is a stalling tactic to delay the inevitable adoption of the expense since all the valuation methods result in a value that's between 30% and 50% of the exercise price of the option for most companies.)

The main alternatives for valuing options at the date they are granted are:

Black-Scholes Option-Pricing Model: Developed by Myron Scholes and Fischer Black and published in 1973 for valuing short-term publicly traded options, for which it works extremely well (and is used daily by thousands of traders in millions of transactions).

When applied to longer-term, nontraded employee options, it provides a reasonable estimate of their value. The key input variable is the volatility of the underlying stock—the higher the volatility, the higher the option value. The Black-Scholes model has been used extensively for the last 10 years by all major compensation consulting firms and thousands of companies and their boards to evaluate the value of options granted to executives and thereby to determine how many to grant.

Binomial Option-Pricing Model: Developed by John Cox, Stephen Ross, and Mark Rubinstein and published in 1979, also for valuing short-term publicly traded options. The Binomial model is preferable to Black-Scholes for high-dividend-paying stocks. Otherwise, it generates very similar values.

Coca-Cola Method: Two investment banks create a hypothetical market for the company's options—as yet untested, but endorsed by Warren Buffett, a major investor in Coca-Cola and a board member.

As to the accuracy of option-pricing models, we convened a conference in July 2002 with the FASB, the IASB, Nobel Laureate Myron Scholes, shareholder value expert Joel Stern, and several other finance and accounting luminaries (see sidebar) to discuss “Solving the Stock Option Problem: Not Whether but How?” We specifically asked Dr. Scholes about the application of the Black-Scholes model to employee options. His response was that the model is just fine if you want to be as accurate as most of the things we estimate on accounting statements every day like depreciation and pension expense. He emphasizes, however, that we should use “option-pricing models” in general—not any specific model—and that each company may require specific adjustments in terms of the model used or the inputs and assumptions to the model. The conference as a whole was also very supportive of using option-pricing models in general for determining the grant date value of options. This doesn't mean that any one pricing model is recommended. There are a variety of option-pricing models and variations in use today by traders and corporate treasury departments. While THE Black-Scholes model (there's a particular variation that is commonly used for both traded and employee option valuation) may or may not be the most accurate or most appropriate for employee options, there's a whole body of finance and mathematics dedicated to valuing all manner of options and other derivative securities—many that are far more complex than an employee option. There is no question that, by either deriving appropriate models or by making more accurate assumptions for the inputs to these models, we can develop reasonably accurate and sophisticated estimates of the value of these vehicles.

Some other important ideas and decisions that arose from the conference are:

- Creating an expense for options should greatly increase the creativity in corporate incentive programs, breaking the “one-size-fits-all” stock option solution that for years has dominated executive compensation.

- Although they may lower the value of the options, future option grants are likely to have more performance-based features than in the past. Options can be greatly improved as an incentive if they have specific performance features or are combined with stock ownership.
- Creating an expense for options will likely decrease their use for rank-and-file employees who have little or no direct impact on the company's stock price. Far more cost-effective incentives can be introduced for employees that are tied directly to the critical business results they can influence and control.
- Start-up and private companies shouldn't be immune from expensing options, although an adjustment may be required to their value because of the company's lack of marketability.

Exploring Other Routes

So far, most of the discussion about stock options has been focused on whether or not to adopt an expense and how that expense should be determined. Yet the stock option expense issue is just the tip of the iceberg. There are much deeper issues to be dealt with concerning executive compensation and corporate governance. Once we adopt an expense for options, it will start to become painfully clear that the only reason we granted them to so many people in such fantastic numbers was that they had a very special accounting treatment—they were basically free. So when this once unusual and arcane financial instrument loses its special status, companies will—I hope—start re-examining the effectiveness of their incentive systems and ensuring they are really getting what they are paying for.

As we finance professionals have learned, options didn't create the motivational risk profile we had hoped for. Starting in the early 1990s, companies granted options in ever-increasing numbers (rising over 400% between 1994 and 2001) in an attempt to "align management interests with shareholder interests." Unfortunately, instead of making executives think and act like shareholders, we induced them to think and act like option holders—a much higher-risk and shorter-term orientation. While options aren't necessarily a bad incentive, in very large numbers they create an extremely lopsided and imbalanced risk orientation. This can induce suboptimal decision making that's clearly not in the best long-term interests of shareholders.

What is needed is a mix of incentives that creates the optimal risk and motivational profile for each company's executive team—or what my firm has been calling the Balanced Incentive Portfolio™. Just as we strive to create an optimal diversified portfolio of investments, so we need to create optimal portfolios of incentives. For example, an executive who holds both options and a significant amount of company stock will think and act differently from an executive who only holds options. In the same vein, options whose exercise price goes up as the stock market goes up will cause executives to strategize more creatively than traditional options that pay off even for small and unsustained stock price increases.

As options begin to lose their luster, companies should consider creating Balanced Incentive Portfolios™ that may include outright stock ownership, performance options, performance vesting restricted stock, and long-term plans that pay out in cash or stock based on achievement of strategic financial and nonfinancial objectives. In the early 1990s, before the tech boom, corporate America was

beginning to re-examine the quality of performance measurement with tools like Economic Value Added (EVA™) and the balanced scorecard. Unfortunately, we got sidetracked with the illusion of vast riches provided by a seemingly magical stock market. Now that the bubble has burst, it's time to return to the core fundamentals of business—creating value, generating excess returns, and making money—and our incentive systems should reflect that shift in values.

Implications for Corporate Governance

As mentioned earlier, the stock option expense is just the tip of the iceberg. This is particularly true for corporate boards who are responsible not only for the long-term success of the company but also for representing and safeguarding the interests of the shareholders. This is important because the expense being proposed by the accounting profession doesn't fully capture the ultimate economic cost of stock options to shareholders. The true economic cost of an option is the spread between the exercise price and the market price on the date the option is exercised. This is typically much larger—often many times larger—than the likely accounting expense. (Conversely, the true economic cost can be much smaller if the stock price goes down—as far too many companies are painfully aware.)

For example, if an option is granted with an exercise price of \$10 when the market price is also \$10, the likely "new accounting" expense will be somewhere between \$3 and \$5. But 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.

Top 10 Questions Directors Are...or Should Be Asking

- ◆ What is the true total cost of our stock option and executive compensation package?
- ◆ What return are we getting on this investment in terms of increased performance for the company and for shareholders?
- ◆ If we expense options, what impact will this have on the company's bottom line?
- ◆ If we don't, what impact will it have on investor confidence?
- ◆ Will an expense curtail our ability to attract and retain top talent?
- ◆ What will supplement or replace traditional stock options?
- ◆ How will the option expense be determined?
- ◆ How does our current compensation package align with organizational and shareholder objectives?
- ◆ For our company, what is the optimal mix of incentives that should be included in a Balanced Incentive Portfolio™?
- ◆ Should stock options be granted to all employees—regardless of rank?

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. (My option trader friends remind me that corporate treasury departments frequently engage in "dynamic hedging" where they buy call options and company stock and even sell put options to offset the risk and cost of employee options. These transactions, if properly executed, can reduce or even eliminate the economic cost of the options.)

Someone has to be responsible for this \$90 cost and for making sure that the company and the shareholders are getting a return on this investment. If the company is only taking a \$5 expense, then the board must make sure that the rest of the cost is tracked and accounted for and that the executives who received this benefit are returning at least that much to the shareholders in improved performance.

Boards of directors have felt that they have been doing the right thing by authorizing enough option shares to keep pay packages competitive so their companies can attract, retain, and motivate the best executive talent available. Their questions of managers and consultants have focused on making sure their company's practices were within competitive norms. But with option grants escalating at alarming rates, and with many companies granting 15% to 20% of their outstanding stock in options (up from 3% to 5% 10 years ago), boards need to be asking more difficult questions, such as, "What is the true total cost of our stock option and executive compensation package?"

And they shouldn't simply settle for the cost of this year's grants. They should demand 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're granted but the total amount of wealth that has been transferred from shareholders to executives and that could be transferred in the future as the result of option and other plans.

Once the directors are satisfied as to the true total cost, they should ask, "What return are we getting on this investment in terms of increased performance for the company and for shareholders?" The answer should not just be in terms of increased stock price, since management can't take full credit for what the market does, but should be in terms of improved financial performance and achievement of strategic objectives. If boards are asking and getting answers to these questions, and if management is also actively engaged in the same questions, corporate governance and executive pay will become far healthier and more accountable than it is today.

Carpe Diem

It's a new day on Wall Street and on Main Street. The "irrational exuberance" of the '90s has definitely worn off for investors, regulators, and the public at large. The blindfold is off, the magnifying glass is out, and the numbers have nowhere to hide.

Where stock options are concerned, changing the current accounting rule is only part of the equation. The rest is enabling management and boards to collectively create more balanced and effective executive compensation programs and to create better evaluation tools for measuring the true cost of compensation, understanding return on stock option investment, and improving corporate governance.

The Delves Group-sponsored conference, "Solving the Stock Option Problem: Not Whether but How?", was attended by some of the most influential financial professionals in the world today, including:

- ◆ **Jane Adams**, senior analyst, Maverick Capital, Ltd., and vice chairman of the Financial Accounting Policy Committee of the Association for Investment Management and Research.
- ◆ **Philip Ameen**, vice president and comptroller, General Electric Company, and chairman of the Committee on Corporate Reporting of Financial Executives International.
- ◆ **Mary Barth**, Atholl McBean Professor of Accounting at the Graduate School of Business, Stanford University, and IASB member.
- ◆ **Stephen Henning**, academic fellow, Chief Accountant's Office, Securities & Exchange Commission.
- ◆ **Robert Herz**, chairman of the Financial Accounting Standards Board.
- ◆ **Ravi Jagannathan**, Chicago Mercantile Exchange Distinguished Professor of Finance at the Kellogg School of Management, Northwestern University.
- ◆ **David Larker**, Ernst & Young Professor of Accounting at the Wharton School, University of Pennsylvania.
- ◆ **Jim Leisenring**, board member, International Accounting Standards Board.
- ◆ **Pat McConnell**, senior managing director Accounting and Tax Research, Bear, Stearns & Co. Inc.
- ◆ **Myron Scholes**, Nobel Laureate in Economic Sciences and co-originator of the Black-Scholes option-pricing model. He is the Frank E. Buck Professor of Finance Emeritus at the Stanford University Graduate School of Business.
- ◆ **Joel Stern**, president, Stern Stewart & Company.

The time has come to finally seize the data, report reality, and build a more balanced and mutually beneficial pact among executives, employees, and shareholders. It's time to restore a sense of stability, trust, and rationale to corporate America, particularly to the way we construct and account for executive compensation packages. And while we're at it, it's also time to reject the plain vanilla, one-size-fits-all stock option plan and inject some conceptual creativity into executive pay.