Expensing Stock Options: Fact and Fiction

by Mark Gressle and Richard McGinley

The public furor over excessive management compensation has led Congress to consider legislation that would require companies to expense the value of options granted to employees on the income statement. The "new think" from Congress is that by charging earnings for the value of options granted, directors will think twice about awarding large grants. In essence, substitute rules for governance. Before legislation is signed this year or another oversight group such as the Financial Accounting Standard Board (FASB) or its international cousin, the IASB, enacts new regulations, there is important insight that can be gained from the analysis of the nearly 50 companies that preemptively announced their intent to expense the value of their stock option grants against earnings.

The evidence from these early movers (which include Coca-Cola, Banc One and Iomega) indicates that in this highly distrustful environment, the action is viewed positively by the stock market. The average excess return surrounding the announcement day is 1.4 percent. In other words, the companies increased in value 1.4 percent more than what would be predicted given the change in the market and the risk of the stock. For Coke alone, the change in value represents $2.3 billion in market capitalization over and above market-wide changes.

The strong positive market reaction raises some interesting questions. Should all companies volunteer to expense the value of their option grants? Is Congress acting wisely to improve corporate governance? And, will expensing options improve shareholder returns by curbing management excesses?.

The debate about expensing is not a new debate. In the mid-1980s there was an attempt by the FASB to require companies to record the value of options granted as an expense on the income statement. This proposal was quashed by business leaders who argued that expensing the value of stock options would impair companies ability to attract and retain talented managers. While the talent drain argument may be true, it is more difficult to make in an environment that has recently witnessed two of the largest bankruptcies ever recorded, the loss of tremendous pension and individual wealth of small investors, and the demise of one of the largest accounting firms in the world.

Another argument against expensing options is that it mixes two distinct types of financial statements. The income statement records the "flows" of a finite time period (quarter or year); the balance sheet records the asset value and ownership interests (debt versus equity) accumulated to a point in time (end of quarter, etc.) Granting an option on equity to an employee is giving him a share in the value of the business; it is not giving him a share in the earnings of a particular period of time. The "cost" of an option is in its dilutive effect on the other owners. In an efficient market, where share prices are based on the level, risk and duration of expected cash flows, a non-cash accrual on the income statement (the amortization of stock options) should have no effect on share price. Conversely, in a market where only accounting earnings matter, the announcement to expense options (lower earnings) should drive share price down. Since the initial evidence indicates otherwise and there is little reason to believe markets are not efficient, the answer may lie in how the financial statements, and in particular the income statement, is perceived by a wider audience than a financial investor.

The income statement is read and interpreted by a wide range of constituents: investors (both sophisticated and not so sophisticated) and, both debt (can they pay us back?) and equity (is the potential reward justified for the risk taken?); employees (managers, non-managers, union members, recruits and retirees); customers (is the company a real player?); suppliers (will they pay their bills?); business partners and regulators. Parts of the income statement become the “30-second sound bite” in larger databases that track earnings per share or sales and growth rates for a sector or group (i.e., the S&P 500). It can be the pride or shame of executives and boards of directors. In essence, the income statement is a “stakeholder statement” because it is crafted and presented to a wide range of constituents with different and often competing interests.

If one of the significant problems facing markets today is a lack of confidence in the financial statements and the managements and boards that sign off on them, then anything management can do to assuage the fears of investors should be good for investors. So if Coke commits to its investors and other stakeholders that management can’t award egregious levels of options to itself without some big fat expense showing up on the income statement (something most managements and boards are reluctant to do), then management has voluntarily given up a potential course of action that could harm investors. Management has in effect “signaled” to stakeholders that it has voluntarily reduced its own degrees of freedom ("wiggle room") to abscond with the owners' wealth. Under this scenario, Congress, regulators and others (including Alan Greenspan, Warren Buffett and finance academics) are correct in encouraging managers to behave in a way that builds stakeholder trust. Yet, is regulation a good substitute for effective corporate governance (such as independent boards, etc.)?

If the announcement to expense share options is merely management signaling shareholders that it is acting in shareholder's interests, then the strength of the signal (namely, the effect on share price) should be commensurate with the degree to which there is a potential for management to abscond easily and unfairly with shareholders' wealth. Put another way, if the drivers of shareholder value and the role share options play in aligning interests of—and perhaps resolving conflicts between—owners and managers differ among companies, then a rule that requires *all* companies to expense their options makes little sense and could in fact be detrimental to value creation. Let's consider three types of companies where we would predict different signaling effects to have different impacts on share price. Type 1 is Predictable Cash Flow. Type 2 is Unproven High Potential. Type 3 is Manager/Owner or Active Investor.

An example of Type 1 (Predictable Cash Flow) is Coca-Cola. Coke's earnings, or more likely its free cash flow, for which earnings is a close proxy, is a good indicator of the value it creates. To a large extent, Coke's cash flow is predictable and is based on its ability to execute a proven strategy. A stock option rewards managers for superb execution. It rewards senior executives for effecting a well-crafted strategy (former CEO

Roberto Goizueta directed Coke out of wine-making and movie-making and refocused on core beverage growth and shareholder value). Large option grants could prove dilutive because the option (granted at the money) would likely be rewarding managers for value that is highly predictable. An indexed option or performance-based (an option whose exercise price is adjusted for market-wide changes or for performance targets) would reward economic performance that exceeds some base level.

Type 2 (Unproven High Potential) is the classic Silicon Valley Start-up. For these companies, the share price reflects great prospects for the future, but these companies generate little cash today. Investors evaluate performance through a combination of industry-specific metrics (book-to-bill ratio for a technology manufacturer) and near-term financial (did they turn a profit this quarter, i.e., is anybody buying their product?) and non-financial (did the beta version ship, i.e., are they on schedule to build this new technology?). Shareholder and manager can have potentially severe if not fatal conflicts. Managers have “big” ideas but they are unproven; shareholders know big ideas can create great new wealth but they also know it takes gargantuan energy, bright people and some luck to make it come to reality. And there’s a lot of snake oil for sale. Hence, shareholders want managers in the same boat and to experience the same effects, both upside and downside of the outcome. The option resolves a conflict between a manager/entrepreneur and an investor about the real prospects of a highly attractive but highly risky business plan. The stock option makes a “believer” of the manager; otherwise, they don’t come to play.

In this situation if managers are paid big cash bonuses to deliver near-term earnings, managers could act to destroy the future prospects of the business by harvesting current cash flow (cut R&D, reduce marketing etc). More likely shareholders want and encourage managers to take stock options in lieu of salary and cash bonuses. An award of options is compensating a manger for value creation, not earnings generation (except where earnings is a near-term indicator of the realization of future growth). Hence expensing options on the income statement makes little sense. First it is a mismatch between an earnings flow (current income) and a valuation (discounted free cash flow of near- and long-term cash flow). Second, to the extent it discourages the use of stock options (either an earnings hit), it places managers and shareholders at odds over how to build value and may seriously impair the business.

In general, the purpose of a stock option is to more closely align the interests of managers and owners, and to reduce potential "agency costs" that arise when a non-owner manager runs the business for his/her gain, at the expense of the owners (the corporate jet and other perquisites are often cited as the classic examples). Consider the Type 3 (Manager/Owner or Active Investor) companies where managers are significant owners (many family companies that have issued shares are in this situation) or there is an active investor or group on the board. Will expensing the value of options increase their share value? Is there any value to signaling the intent not to hurt shareholders in the future? If the market thinks all family-controlled, publicly traded companies are like the Aldelphia and the Rigas family, the reaction could be sheer exuberance. But many manager-owned businesses have a solid record of acting in the interests of all shareholders.

The empirical evidence indicates a predictive pattern that supports the signaling effect argument. Where there is a significant ownership interest among managers (Type 3 Owner Manager), indicating a high trust factor, there is little or no value to signaling. Among this group, there is on average little or no impact on share price on the announcement date. For Type 1 companies (Predictable Cash Flow), there is value in signaling. On average these companies increased in value by 1.9%. And, finally, for Type 2 companies (Unproven High Potential), there are, somewhat predictably, no companies in the group of 48 that announced between mid-July and mid-August 2002 their intention to expense options. It would appear that smart managers aren't volunteering to destroy the wealth of their own companies.

	Share Price Increase	
	All Companies	Pure Announcement
Type 1 Predictable Cash Flow	1.9%	2.2%
Type 2 Unproven High Potential	NA	NA
Type 3 Owner Manager	0.7%	0.02%

On average, all 48 companies announcing the expensing of stock options realized an excess return of 1.4 percent over and above market changes and the relative risk of the stock. Many companies announced their intention to expense options at the same time they announced their quarterly earnings (a compounding event). Among the Type 1 and Type 3 companies there is a smaller sample that had no compounding event at the time of their announcement to expense options. This group is termed "Pure Announcement" and the results are similar to those of the larger sample.

What is our conclusion? The impact on share prices of expensing stock options is directly related to management's ability to put its interests before shareholders' interests and get away with it. In a word, trust. Increasing the level of trust increases the share price. In situations where the trust between owner and manager is resolved through high management (or active investor) ownership, there is little reaction. Management is already acting in the best interests of shareholders, including themselves. Finally, in the situation where the option helps resolve a management –investor business plan conflict (Type 2 Unproven High Potential), there are no companies in the sample, which makes perfect sense. Why would any management voluntarily commit to something it knows is detrimental to them and their shareholders.

Companies shouldn't have to expense options to build trust with shareholders. Investors, both debt holders and equity holders, do not need another non-cash accrual on the income statement to further cloud the assessment of the credit quality or investment quality of a company. Good governance policies, independent directors, CEO-certified financial statements, and fuller disclosure of the option economics will do more over the long run to build trust and enable investors to make a complete and accurate assessment of the company.

Finally, if the question is really about a free-rider problem in compensating managers (getting paid for value they didn't create), then let's address the problem by placing the accounting treatment of various forms of options (performance-based options, indexed options, out-of-the-money options and standard options) on an equal footing for both financial reporting and tax purposes.

Type 3 (Owner Manager/ Active Investor)

Amazon.com
American International Group
Charter Communications
Contango Oil & Gas
Dole Food

Ford
Gabelli Asset Mgmt
Iomega
iStar Financial
Lee Enterprises
Neuberger Berman

Papa John's
Premcor
PriceSmart
Tarragon Realty
TB Woods

USA Interactive
Vornado Realty
Washington Post
World Fuel

Type 1 (Predictable Csash Flow)

AMB Property
Bank One
Cinergy
Coca-Cola
Comerica
Computer Associates
Cooper Industries
Duke Realty
Emerson Electric
Fannie Mae
Freddie Mac
General Electric
General Motors
Jeffries Group
Marathon Oil
Plum Creek
Porcter & Gamble
Quest Diagnostics
Realty Income
Scotts Co.
ServiceMaster
Sovergn Bancorp
Sun Life
Temple-Inland
Tupperware
Valley National Bancorp
Wachovia
Webster Financial

Companies shaded are part of the "Pure Announcement" sample in that they did not announce their quarterly earnings and the intent to expense options simultaneously.