

Stock Option Accounting in Perspective

Few issues in employee rewards have had as much ink spilled about them in recent years as stock options. The headlines have seemingly come every week, from the scandals in 2000, to Coca-Cola's landmark announcement to expense in 2001, to Microsoft's summertime announcement to discontinue using options in favor of restricted shares.

Policy-makers, regulators and corporate chiefs continue to debate how stock options should be treated on company balance sheets. The debate has opened a broader discussion on the future of stock options generally.

Is There True Accounting Transparency?

Under current U.S. accounting rules — which may be in danger — companies have the choice of accounting for stock options or reporting option expenses in accounting footnotes. Proponents of APB 25 have argued that the footnote accounting provides adequate disclosure because it allows other shareholders to determine their “diluted” earnings per share (every option granted potentially dilutes the ownership of current shareholders). They further argue that this dilutive effect already is a powerful and self-enforcing way to regulate the use of stock options in companies.

Does One Size Fit All?

Even though Coca-Cola has decided to expense its employee stock options and Microsoft has made the question moot for itself by only granting restricted share units going forward, are these good solutions for all companies? The economics and psychological importance of stock options for employees can be significantly different by industry, the company's life cycle stage, shareholder profile and even the work force profile.

What about Global Competitiveness?

Multinationals are in an ongoing war for talent. Stock option practices by U.S. companies have created a strong attraction to potential employees in global labor markets. Opponents of changes to U.S. accounting rules believe that changes will negatively impact the ability of some multinationals to attract and retain the talent needed to compete in these critical global markets.

How Do You Value an Option?

The expensing of stock options requires either the adoption of a current formula, such as Black-Scholes, or the establishment of a new formula for assigning a present value to stock option grants. The problem with assigning a “fair

value” to options at grant time is that, should the stock price fall below the strike price, the options are “underwater” and essentially worthless, even though the company has taken a hit to the balance sheet. What provisions will there be for taking the “expense” off the books if (more likely when) some stock options drop below their initial “valuation”?

What about Other Unintended Consequences?

Survey data from WorldatWork and others indicate that requiring stock option expensing may result in the disappearance of stock option grants to the rank-and-file, while top executives likely will retain their allocations of options. Supporters of options say they are intended for employee motivation and to create an “ownership culture,” and these purposes are defeated if only the top executives receive them. As an offset to the elimination or reduction in the use of options, what will be the impact on cash compensation costs?

Where do you stand on some of the big issues related to this important topic?

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What's Your Perspective on the Stock Option Expensing Issue?

Determining the 'How' and 'When' of Expensing

With apologies to Warren Buffet for paraphrasing, if stock options are not compensation, then what are they? And, if compensation is not an expense, then what is it?

Stock options clearly are a form of compensation, a form that has proven to motivate employees and stoke entrepreneurial fires. They clearly represent a cost to the company and, more importantly, to the shareholders. Thus, it is appropriate that their cost be expensed. The question is: When and how should the expense be calculated?

Determining "fair value" at grant is not possible without knowing the future (something even the FASB has not yet mastered). Whatever value is assessed at grant becomes meaningless if the option is never exercised, whether due to market value, vesting or expiration. No financial model has or can be devised that will accurately and reliably predict the value to the derived from an option prior to its exercise.

As a result, the current method of valuing option expense at exercise remains the most reasonable.

— *Michael J. Corrigan,*
Diversified Compensation Group Ltd.

Stock Options Are Dead. Long Live Stock Options.

With the new focus on expensing stock options, their survival as a broad-based employee rewards strategy is far from assured. Whether stock options will

disappear from executive compensation packages likely is a separate issue.

Executive perquisites historically have outstripped the rank-and-file and, frankly, there is no evidence that this will change. In fact, an argument can be made that, since executives now face an even more precarious environment in

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which they are personally and legally accountable for company actions and performance, their compensation will increase accordingly.

Such a situation likely will lead to the continuance of executive stock options at the price of a more broad-based equity compensation strategy, especially in a

slow economy in which the added expense must be offset with savings elsewhere. Therefore, the conclusion seems apparent: The demise of broad-based stock option programs is imminent.

Can Stock Options Be Saved?

The most ironic factor that does not seem to be addressed is that option grants at the executive level historically have been a significantly larger number of shares in the aggregate than the rest of a broad-based options plan. Therefore, the greatest cost of expensing options lies with the executive option grants, and not smaller grant total of the rest of the option-receiving employees. The net result of option expensing and the culture of increased scrutiny and personal responsibility seems to be that the executive population will continue to receive the same or increased compensation, and the rank-and-file may be the ones who lose out in the end.

Should Stock Options Be Saved?

The value of stock options is based on the concept that employees with stock options have a stake in company performance and will be motivated to increase that performance through an "owner's perspective." There are, however, several flaws with this view.

First, options granted at levels below the executive are most often not granted in sufficient number for them to become more than a small supplementary portion of the employee's total

compensation. This dilutes the link between individual performance and company performance. A second flaw is reliance on the stock market to directly respond to an individual company's performance. Simply, the stock market is not a good tool for measuring an individual company's performance. The price of a company's stock may have been a direct correlation to the company's performance at one time in the past, but that is no longer the case. With the vast increase in individual investors personally making their own investment decisions in the stock market, there has been a progression to stock prices that resemble more of a fashion boutique than any objective measure of company performance. Can an employee truly see a correlation between his or her personal performance, or even between a collective performance of his or her company, and the resulting stock price? Is a company's stock price really an objective measure of performance? In an era in which stock prices often change dramatically based on nothing more substantive than rumor and conjecture, it is increasingly difficult to answer "yes" to that question.

Another Approach

For many years, long-term cash incentive plans have been in place for various executive levels. Developing such plans to encompass a broader population may be the answer. A plan developed for a three-year period or longer would engender considerably more long-term motivation for employees, especially if the terms of the plan dictated truly objective measures. Such a plan would allow for deliberate planning for expenses, rather than the unpredictable

stock market fluctuations that may realize tremendous actual expense in one quarter and none in the next. Also, such a plan could be developed with criteria that far exceed any expected company performance, preventing a windfall for employees without a fundamental windfall for the company.

— *Doug Lohse, Banknorth Group Inc.*

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The More Things Change, the More They Stay the Same

Doug Lohse makes some good points. Some of his statements reflect the "Theory N" versus "Theory B" stock options practices. Those companies that have narrowly distributed options to the executive ranks probably will limit their stock option grants even further. But the broad-based stock option companies likely will continue to use options.

I agree that the current economic lull is taking its toll on rank-and-file compensation and benefits — in addition to stock option grants drying up or being severely cut back it's now typical to defer annual merit increases, going two and even three years between raises. 401(k) matches are being cut back or eliminated, severance benefits are even being cut. But there will be a rebound — at least, we all better hope there is!

Lohse makes a good point that Sarbanes-Oxley and the intimidating regulatory environment likely will drive up executive pay packages in the future — stay tuned for this unintended consequence. It's the equivalent of sports and entertainment compensation — they will only have a few years in their prime, so pay is front-loaded and the consumer is happy to pay. Again, the rank-and-file cutbacks are only magnified by the contrast with increasing executive packages.

Lohse's final points about the imperfect incentive created by stock options reflects the legitimate need for all compensation professionals to be careful to avoid the herd mentality. Options are imperfect as motivators or true reflections of company performance for large established, stable firms — yet lots of big companies imitated the dot-coms and tech sector firms in the '90s by increasing their utilization of options. The startups and tech sector in general likely will continue to use options — the ones who depend on an entrepreneurial knowledge work force need a broadly based incentive that transparently connects all to the firm's success.

— *Jim Stoeckmann, CCP, WorldatWork*