



## Share options and executive pay

### Coming clean on stock options

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#### Is there no accounting for them?

OF ALL the accounting problems highlighted by the collapse of Enron, the one that would seem easiest to put right is the reporting of employee share options. These days they make up a huge slice of pay, particularly for senior management. Last year, stock options accounted for 58% of the pay of chief executives of big American companies. Yet the cost to the company of providing these options is typically not deducted as an expense when it calculates its profits. As a result, reported profits are misleadingly high. Although the extent is debatable—the Federal Reserve reckons that it comes to about 2.5 percentage points a year between 1995 and 2000—the overstatement is not in doubt. So, what could be simpler than to require companies to treat share options as an employment cost?

A fierce lobbying effort by the world's biggest companies is under way against attempts to make this happen. It will probably succeed, just as it did when similar reforms were proposed in 1994. A bill introduced by Senators John McCain and Carl Levin, which seeks to remove the tax deductibility for options not counted as expenses, has little chance of succeeding.

Currently, firms count options as a cost when they calculate their profits for the government, but not for their shareholders. The Financial Accounting Standards Board, which sets the rules for American accounting, seems unlikely to act any time soon. Its chairman is to step down at the end of June, and its future shape and status are both in doubt in the light of Enron. A move to introduce a charge for options under International Accounting Standards, the chief international alternative to America's accounting principles, also faces intense lobbying, including from the European Commission.

#### Principles v greed

Those who oppose the expensing of share options thus seem to be winning. What are their arguments, or are these little more than a fig-leaf to cover executive greed?

Their first point is that the accounting treatment of options did not play a significant role in Enron's collapse. True, up to a point, but beside the point. Compared with the use of off-balance-sheet vehicles, the distortion to Enron's profits from non-expensed share options was small. Hardly a reason not to make a sensible accounting change, though, and if Enron's failure provides the spur, fine.

A more interesting argument is that the theory of efficient financial markets does away with the need to expense options. Efficient-market theory, at the heart of so-called modern financial economics, argues that a share price accurately reflects all available information relevant to the value of a company. Thus, provided all the information necessary to calculate a firm's true profits is disclosed, it does not matter what the firm reports as its profits. Even if a firm ignores the cost of options when calculating its profits, the market will not.



One problem is that economists have identified weaknesses in the efficient-market theory. Arbitrage does not work as it should. Investors who know the true value of a share do not necessarily drive out investors who are ignorant. The psychological biases of investors appear to affect share prices. Markets, in other words, are not truly efficient—and shareholders may be misled by reported profits that exclude the cost of options.

On the other hand, if markets really are inefficient, those who fear that investors might turn against the use of share options once they are expensed may also be right. Options are said to be particularly useful as an incentive for start-up companies that have little cash but want to give employees a big carrot to make the firm succeed. Expensing options may dent profits severely or (more likely) increase losses at a time when start-ups are struggling to succeed. This could make it harder to raise the capital that small firms need to grow.

On the other hand, start-ups tend to have more sophisticated investors who are less likely to be misled by accounting. What is more, the process of going public provides an excellent opportunity to explain to investors what the accounting numbers really mean. On balance, if markets are inefficient, the benefits of expensing options probably outweigh the costs.

The National Venture Capital Association argues that expensing options would actually make accounting profits more misleading, however. First, a cost would be shown for many options that are never exercised. This is certainly true if the share price falls below an option's pre-determined strike price. At the very least, though, issuing an option involves the risk of a cost. And, exercised or not, the option has a value to those who were awarded it, in the same way that a lottery ticket has value. Accounting for this is tricky. But since most options are eventually exercised, the cost should still be charged against profits at some point.

Second, says the association, the theoretical problems of valuing options means that any number expensed in the accounts is "arbitrary at best". Again, there is something to this. Work on the impact of share options by Smithers, a British research firm, uses three different valuation methods. One is the value of options issued during a given accounting year: this can be calculated using the Black-Scholes model of option pricing. Another is the cost of all outstanding options if they were "immunised" by the company buying identical options in the market. The third is "full cost": the change in the value of all outstanding options, plus the cost of those exercised during the year.

These three methods yield rather different results. In 2000, according to Smithers, the first suggested that charging for options awarded would have reduced reported profits amongst 325 large American firms by 17.1%. The second method would have reduced them by 21.6%. The full-cost method would actually have increased reported profits, by 5.1%, because falling share prices sharply reduced the value of outstanding options, particularly for technology firms that were big users of employee share options.

Robert Merton of the Harvard Business School, who won a Nobel prize for economics in part for his contribution to options-pricing theory, considers that options can be valued quite well enough to be expensed. And although there is room for debate over which pricing model is best, he also points out that the degree of precision for option pricing is orders of magnitude better than for valuing any number of things that are now expensed for accounting purposes. Think of the challenge of accurately assessing the useful economic life of a factory, machine or computer for purposes of depreciation—calculations that can have a huge impact on reported profits.

Underlying all these arguments is a fear that expensing options will discourage the use of a wonderful means of providing incentives for employees, especially managers, to maximise shareholder value. Actually, the present accounting treatment may discourage the use of better incentives, such as paying people in shares rather than share options. Brian Hall of the Harvard Business School points out that share options are a "fragile" incentive, in that they pay out unevenly: employees get nothing below a certain share price, but lots above it. Holding shares directly is a far smoother form of incentive. Share schemes are easier to understand, and they encourage managers to act more in the interests of shareholders.

All the same, awards of share options by firms dwarf awards of shares—partly because shares are expensed against profits, while share options are not. The lack of parity between these different forms of incentive creates huge distortions in the way people are paid. And that, says Mr Hall, may be the biggest cost of all from not expensing options.

