

# Stock Options Keep the Economy Afloat

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The fallout from the Enron accounting scandal includes an invigorated crusade against the use of employee stock options as a method of compensation. Critics see such options as a device to enable managements to cheat their stockholders. Yet, if properly managed and adequately reported, their role is precisely the opposite. They are the prime incentive for management to dedicate itself to the promotion of stockholder interests.

The opposition is growing stronger. Sen. Carl Levin (D., Mich.) has now joined with Sen. John McCain (R., Ariz.) and others to introduce a bill that would require firms to charge the "expense" of stock options against reported earnings. This legislation may erase millions of dollars of corporate profits and push many high-tech companies into the red. That's fine with Warren Buffett, another consistent critic. He puts it this way: "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?"

## Target Abuses

To these critics, employee stock options not only lead to an overstatement of reported corporate earnings, but also, like the shoes in Imelda Marcos's legendary closet, are a powerful symbol of obscene excess. Critics argue that expensing the worth of employee stock options would make their cost more transparent and curb much of the extravagance in employee compensation. We agree that there may have been abuses in their utilization. But we should target the abuses and not undermine this valuable instrument.

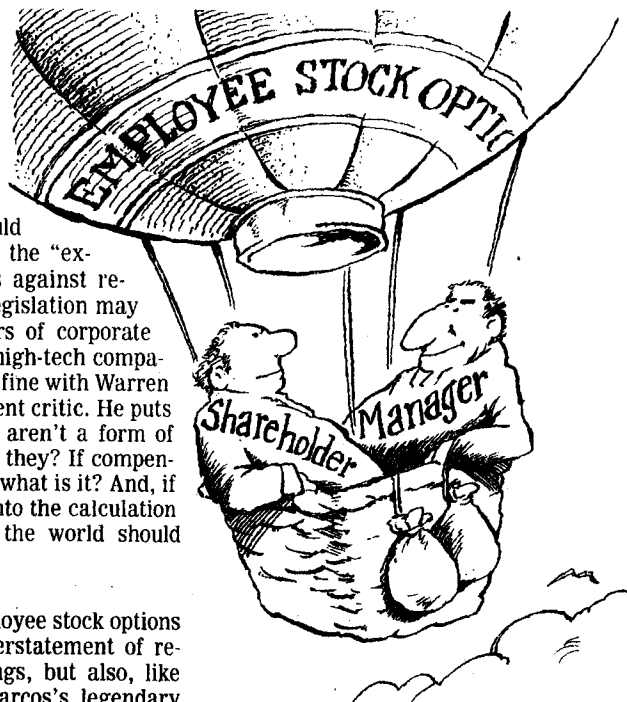
The first purpose of employee stock options is to provide a non-cash substitute for part of the wage compensation the firm must provide to attract and retain employees. A new, entrepreneurial firm may not be able to provide the cash compensation needed to attract outstanding workers. Instead, it can offer stock options.

Their second purpose is to mitigate possible divergences between the interests of management and stockholders. As early as the 1930s it was recognized that the modern corporation is characterized by separation between ownership and management. Unlike the minuscule enterprise that is overseen by its proprietor, the large corporation's managers are hired help who, if the arrangements are inappropriate, may choose to pursue their own agenda—e.g., fancy offices or private jets, rather than earnings for the shareowners. Stock options offer a way out of this dilemma, since management benefits only to the extent that the price of the stock rises and shareholder value increases.

In any event, stock options must be recognized as only a redistribution of bene-

fits between initial stockholders and the new, prospective management stockholders. It does not result in any reduction in the overall size of the firm's total earnings pie—it only affects the way in which that pie is sliced and divided up. This is markedly different from the effect of, say, a rise in wages that results in a net reduction in the firm's cash.

Warren Buffett and other critics suggest that the income statement should re-



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*Outrage is growing about fat options packages, but none of the proposed reforms add up. Options are still the best way to align managers' interests with those of shareholders.*

fect an "expense" to the firm measured by the cash-equivalent value of the options. There are two problems with this view.

First, even if we were to consider the "expense" of options to be equivalent to that of cash wages, there is no way to measure that "cost"—the value of the options at the time they are issued—with reasonable precision. The Nobel Prize winning Black-Scholes model does an excellent job of predicting the prices at which short-term options trade in the market. But the Black-Scholes formula does not provide reliable estimates for longer-term options, such as those lasting six months to one year, and market prices often differ substantially from predicted values.

Because employee stock options have durations of five to 10 years, are complicated by not vesting immediately, are contingent on continued employment and subject to various restrictions, it is virtually

impossible to put a precise estimate on the option's value. Moreover, employee options cannot be sold, violating one of the key Black-Scholes assumptions.

It is possible to adjust the Black-Scholes model for the special features of employee stock options. However, such adjustments use a profusion of variables, many of them difficult to estimate, and they yield a wide range of estimates. One can instead consider "minimum value" accounting—a method suggested by the Financial Accounting Standards Board—to ensure comparability. But it would be very easy for firms to circumvent that approach by altering the features of the option grant to produce a zero minimum option value.

There is an alternative method of accounting that avoids such valuation problems. This approach defines the "cost" as the difference between the market price of the stock and the price paid by the employee on the date the options are exercised. This "cost" can be recorded with precision. But the questionable interpretation of these figures as "costs" is made clear by the perverse results. The better the company does, the more earnings are reduced. In any event, it is not proper to subtract the total value of an equity security, which represents the capitalized value of annual returns, from uncanceled annual earnings.

The second problem with "expensing" stock options is that they can have both positive and negative effects on share prices. They tend to reduce earnings per share when measured on a "fully diluted basis," but they also can have beneficial incentive effects. A considerable body of economic literature has studied the data to measure whether the net effect of employee stock option grants on a company's stock price is positive or negative. The general finding is that stock prices preponderantly benefit from the issue of employee options. In other words, the market believes that the positive benefits of the options make the "pie" grow faster than the dilutive effect shrinks current shareholders' percentage piece of the "pie."

## Engines of Innovation

We do not defend the potential abuses of options—whether by the unwarranted size of some option grants, automatic repricing of options after management failures, or the provision of misinformation intended to inflate stock prices. Independent directors have not always met their responsibilities. And standard options may inappropriately reward mediocre performance during bull markets, when almost all stocks rise.

The solution is to institute performance-based options, but that goose has already been killed by current accounting rules requiring the expensing of such options. But by targeting all stock options rather than stock option abuses, politicians are risking destruction of equity compensation instruments that have been engines of innovation and entrepreneurship.

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