

The Real Cost of Not Expensing Options.

Every year, when we teach our students how to value stock options, a few will claim that awarding employees stock options with an exercise price equal to the market price does not cost the firm anything. If exercised immediately the options would be worth nothing. Hence, they claim, the options have no value. These are not the most financially sophisticated students in our class. To convince them of the contrary, we challenge them to engage in a similar transaction with us. If these options are worth nothing, these students should be happy to personally give us a lot of them for free. Immediately, they realize their mistake. By giving the right but not the obligation to buy the stock at a predetermined price, the company is giving employees a one-way bet, which they cannot lose. Since there is no free lunch, the flip side of this benefit, is the cost borne by the shareholders.

That stock options represent a cost to firms is not controversial in academia as any professor of accounting or finance in a reputable school will agree. So why did it take 10 years and the current atmosphere of legislative zeal prompted by corporate scandals to convince the accounting board to take an unequivocal position on this issue? And why do so many intelligent managers question the soundness of this change?

Is it, as Craig Barrett CEO of Intel wrote in a recent Wall Street Journal op ed, that the cost of these options is so hard to estimate that a CEO will be unable to certify that financial statements “fairly present in all material respects the financial conditions, results of operations, and cash flows”? No. Stock options are not the only expense that needs to be estimated. Every year a company has to expense the cost of future pension liabilities it has accumulated during the year. This cost is estimated on the basis of a lot of actuarial assumptions. The margin of reasonable error in computing this cost swamps that incurred in estimating the cost of employee stock options. So why worry only about the latter? Furthermore, if Mr. Barrett feels so uncomfortable in estimating the value of stock options, should he not feel even more uncomfortable in paying his employees (and himself) an amount he is unable to estimate with a reasonable degree of confidence? His argument, if true, speaks in favor of stopping the use of stock options altogether, not stopping the decision to expense them.

Is it, as declared by John Chambers CEO of Cisco, that expensing stock options would lead to a massive loss of jobs – in a recent speech, he labeled the proposed requirement that stock options be expensed “the engineering and high-tech job export act of 2003”? Hiring and firing employees is ultimately a CEO’s decision, which should be based on a comparison between the cost of these employees and the revenues they generate. If expensing stock options would lead Mr. Chambers to fire some of his employees, should we infer that all these years he ignored the cost of stock options in deciding how many people to hire? And is he suggesting that a simple change in reporting requirement will change his way of computing the cost of his employees? We doubt this. But if this is what he means, his argument speaks in favor of the new requirement. Without it many companies might destroy value by hiring workers that cost more than they produce.

Is it, as suggested by many commentators, that expensing stock options will heavily penalize the stock prices of the already beaten-down high-tech sector? Once again, we

are skeptical. Under the current regime, the cost of these options is not hidden. Companies are required to disclose it in a footnote to the annual report. Any sophisticated investor who wants to calculate the true earnings, net of the stock options' cost, can read that footnote and back out the information in seconds. Since stock prices are largely driven by sophisticated investors who already factor in this information, formally expensing stock options is unlikely to have any impact on prices.

So why is expensing stock options so controversial? Because this is not an accounting issue, but a corporate governance issue. Many directors do not have PhDs in accounting or finance. Hence, they can be easily confused, as some of our less financially sophisticated students are, on the cost of these options. TIAA-CREF, the fund management firm, recently retained as consultants two retired CEOs who sit on compensation committees of major American companies. One of the major facts these former CEOs uncovered is that the argument that stock options "do not cost anything" is often used in board meetings to justify bigger awards to the CEO and top management. If directors might suffer from this illusion, many individual shareholders are likely to suffer as well. Hence, expensing stock options might change their attitude toward management compensation and thus their vote at shareholder meetings.

Note that we are not arguing against stock options. We strongly believe that CEOs are very important and should be compensated appropriately. We also think that stock options are a powerful incentive to align the interest of CEOs with that of the shareholders. We are only arguing in favor of transparency and due process. Stock options, like any form of incentive, are costly. To use them appropriately the people awarding them have to appreciate this cost. Expensing them would help make this cost clear.

Yet, expensing stock options, as Holman W. Jenkins Jr. has reminded us in the pages of this journal, is not a panacea. It would not avoid the problems uncovered at Enron, Worldcom, or Tyco. But this should be an argument to do more on the corporate governance front, not less. The ideal of free markets is not the anarchy of the jungle or the Wild West, but a transparent level playing field where everybody has a fair chance of participating and those who provide the best value for money prevail. In order to become a level playing field, however, markets need rules and transparency. In this case, the right rule was emerging naturally. In 1993, the Financial Accounting Standards Board wanted to make expensing of stock options mandatory. But Congress, under heavy lobbying by the hi-tech sector, blocked it. The battle is being replayed today. What is at stake in this battle, however, is not just this issue, which may turn out to be a storm in a teacup, but people's faith in the overall system. In their short-sighted battle to defend their current privileges, CEOs who oppose stock option expensing do more than damage their companies, they damage the integrity of the very system that has made this country great.

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