WHAT TO DO WITH

Executive Stock Options

New rules are needed to encourage executives to act more like shareholders.

BY LAURENCE BOOTH

With Enron, Worldcom, Tyco, Nortel and many others in hot water over accounting methods, the question of corporate governance has never been so relevant. At the top of the list of problems is what to do about, and how to account for, executive stock options. There are two key questions: how should stock options be treated in the firm's financial statements, and how should they be treated for tax purposes? Further, another key governance issue is what to do about repricing options; that is, if the stock price falls, what should you do about companies that simply lower the exercise price to increase the chances of the executive exercising the options?

In this article I argue that there is a simple solution to the problem, which is to require that companies purchase their executive stock options from an investment bank. The accounting, tax and governance issues then fall into place, removing almost all of the problems generated by their misuse. Of course purchasing options from an investment bank poses problems for private firms and small illiquid firms traded on exchanges. For this reason, private firms and public firms below a certain threshold, for example sub-S&P/TSX Composite Index firms, would be exempt. This exemption also makes sense because the major governance issues exist for large firms traded on major exchanges where there is a separation of ownership from control and more potential for mangers to "rob the shareholders," as NYSE chairman Richard Grasso so delicately put it.[1]

The Problem

Executive stock options are simply call options issued to executives where exercise, like the granting of stock, is restricted to ensure that the executive commits to the firm. For example, suppose a firm's stock trades for $40; if a new CEO is granted a million stock options at $40 exercisable over the next three years, under current accounting and tax rules there are no implications for the financial statements, since the exercise price of $40 equals the current market price of $40. The firm may or may not go into the market and buy back a million shares to offset the dilution that may occur when the options are exercised.

Suppose there are two possibilities for the stock price over the exercise period: it can increase to $60 or fall to $30. If the stock price increases, the executive can exercise the option by paying $40 for a stock worth $60. On a million shares this amounts to a $20-million profit. As the executive exercises the options, we see the amount reported as part of their compensation; the amount can also be deducted by the firm for tax purposes. In most cases this amount will not appear in the main financial statements. All the investor may notice is more stock outstanding and a dilution of their share ownership, depending on whether or not the company

Laurence Booth is CIT chair in structured finance at the University of Toronto's Rotman School of Management.

has repurchased stock to meet the exercise.

For the last two decades finance professors and governance experts have been arguing that executive stock options should be part of executive compensation. The reason is the separation of ownership from control that exists in many large corporations: with dispersed stock ownership and poor governance it is relatively easy for a corrupt or lazy CEO to use the company as their personal piggy bank. This does not necessarily mean outright theft—as was alleged with Adelphia—but does mean that decisions can be made for reasons other than what is best for the firm's owners: that is, the stockholders. Giving senior executives stock options aligns their interest with those of the stockholders. If they work hard and the stock price goes up, they exercise their options and make money along with stockholders. As a finance professor I wholeheartedly agree with the philosophy that underlines this argument, but there are two flaws that have become very evident over the last two years.

The Flaws

The first flaw is that stock prices go up for reasons unrelated to the activity of senior executives. We have just seen a massive bubble in the stock market (particularly the U.S. and technology-related stocks) with about a 60% increase in the S&P 500 from 1997 to 2000, then an equivalent decline. Clearly senior executives were not directly responsible for either the surge in stock prices or their subsequent collapse. However, the surging stock market led many firms to issue significant grants of executive stock options. This may have been because boards of directors suddenly saw the light and wanted to align the interests of senior managers with their owners, or it may have been because executives saw a seemingly risk-free get-rich strategy. Regardless, the fact that options are issued at seemingly no cost to the firm, but with the potential for great reward to executives in a raging bull market, led to an increase in executive stock option grants.

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The second problem is that the bubble burst and stock prices tumbled. In our example, what should a firm do when the stock price falls to $30 from $40 and the CEO's options are now wildly out of the money; that is, there is almost no chance of them ever being exercised. Nortel,[2] for example, once had almost 60 million executive stock options outstanding at prices above $30, while its stock price bounced around the penny stock level. The solution that many firms have come up with is simply to reprice the option; that is, lower the exercise price until there is some possibility of exercise and some incentive for the executive.

The repricing of options, or the equivalent of further option grants, has governance experts up in arms. The whole point of options is to align the interests of managers with stockholders. It never is an exact alignment, since options don't share the downside the way shares do.[3] However, if even the loss of the option is taken away by repricing, the executive is in a "heads I win (big time), tails I can't lose" scenario. This is not the scenario faced by investors!

The key questions in executive stock options, therefore, are how to avoid this get-rich strategy in a bull market and how to avoid repricing in a bear market. Only then will executives have the incentive to act like shareholders. One solution is market-adjusted options—that is, have the exercise price automatically adjusted with market movements. For example, suppose the options are indexed to the S&P 500 and suppose that in our two cases the S&P went up and down by 30%. In this case the exercise price would automatically go up to $52, when the stock jumped to $60, so the executive would only gain from the $8 increase in the stock price above the S&P increase. Similarly when the stock fell to $30, the exercise price would fall to $28, so in this case the options have value since the stock has performed better than the S&P. The idea behind market-adjusted exercise prices is to hold the executive responsible only for the stock price movements unrelated to broad market movements. However, there are

obvious problems in that different sectors of the market move differently. For example, while the market fell about 30% from 2000 to 2002, Nortel dropped 99%. Should Nortel executives be held accountable for stock price movements unrelated to the market or the technology component of the market? Rather than answer these questions, the more immediate solution is simply transparency and market prices.

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How to Treat Options

On August 1, 2002, the NYSE endorsed a package of rule changes, one of which is to require shareholder approval of stock option plans. While the accounting treatment of options is still to be decided, Coca-Cola in the U.S. and TD Bank in Canada have decided to expense options for reporting purposes. Clearly this is the way to go: options are valuable, otherwise executives wouldn't want them as a substitute for bonuses and the newspapers wouldn't be full of option price quotations. The deeper question is what is the value of an executive stock option?

It is the valuation issue that has bedeviled the accounting treatment. Regular stock options can be valued using a formula developed by Fisher Black and Myron Scholes and outlined in every introductory finance textbook. This formula assumes that options are only exercised at maturity and is the one used by Coca-Cola to value their executive stock options. However, critics contend that executive stock options have a different value from their Black-Schole's value, since their exercise is restricted. The obvious solution to this is to require that any stock options given to executives have to be purchased from investment banks. This is what I refer to as a "market" solution.

Tax and financial accounting rules have long accepted that wages can come in a variety of forms, not just cash. If corporations are forced to buy their executive stock options, then their tax and accounting treatment become obvious. Firms will have to include them as an expense in their income statement for both tax and reporting purposes. In return, executives will have them included on their T4s, so they will also be included in their personal taxable income. There are a number of obvious advantages to this treatment. First, the fact that the options have to be purchased makes the transaction transparent. This makes it obvious that options are valuable and gives the stockholders something tangible to vote on if their approval is required. Second, the fact that there will be a market for executive stock options will help resolve the pricing issue, that is, whether or not Black-Scholes prices are market prices. Third, the tax treatment is clearer. At the time of issue, the cost of the options is an income item for both the company and the executive. For the corporation this is the end of the matter, since there would be no further tax consequences. If the options are exercised they are exercised against the investment bank in the secondary market unrelated to the firm. This is an important difference compared with current practise.

Currently in the U.S. if the options are exercised, they are exercised against the firm, which issues new shares. This is why firms frequently buy back shares in the open market to offset the dilution from this "mini" new share issue. The cost above the exercise price is tax deductible for the firm and regarded as executive compensation. This is why we periodically see such exceptionally high levels of executive compensation in the U.S. This is also patently ridiculous. Once the company buys options for the executive, subsequent gains and losses are a capital item and should be of no concern to the firm (from a tax point of view). The personal tax treatment for the exercise of executive stock options should then be no different to the exercise by the executive of stock options on other unrelated firms. More to the point, it should not be included as executive compensation, which is the value of the options at the granting date, not some future date when they either may or may not be exercised.

Fourth, the value of repricing is evident. Currently, as a stock's price declines, companies either make further

option grants or lower the exercise price. In essence the value of the option is much greater than the Black-Scholes price because of this implicit guarantee. By forcing the firm to repeatedly buy more options and seek shareholder approval, the transparency of executive compensation is improved. Further, the shareholders and executive compensation committee are aware of the true cost of executive stock options.

Fifth, under a market scheme some executives will undoubtedly not want to receive options, since they will have to pay tax on the value of the options at the granting date even though they have received no cash. This puts them in a similar position to share purchase schemes, where they can either get a loan from the corporation or carry them from their own resources. Further, in a bear market, executives may not want options at all, since they will have immediate tax consequences. However, rather than being a negative, this just recognises that the incentive value of options may be much smaller than people realize; that is, that most of the share price behaviour is unrelated to the actions of senior executives.

Sixth, a huge inefficiency in the operations of cash-poor firms is removed. During the tech bubble significant managerial talent was sucked into the tech field partly due to the treatment of executive stock options. Fortunes were to be made in Ottawa and Silicon Valley, because stock options were so liberally awarded due to their "zero" cost to the firm. This zero cost was a mirage, but it severely affected the labour market. Treating stock options correctly allows effective wage rate comparisons and makes the labour market more efficient.

Seventh, the argument so far focuses on executive stock options as a compensation, and not a corporate financing tool. This is why the investment bank can sell secondary market options to the firm to pass on to the executive. As well, the firm may be interested in primary financing by using options—that is, on exercise, new shares are issued and the proceeds used to fund new activities. These forms of options are called warrants and can be valued using a minor variant of the Black-Scholes formula. More to the point, it is highly unlikely that warrants can be a significant source of financing and if they, more than ever, would need shareholder approval, since there will be dilution issues.

Finally, this market solution is only intended for larger companies, where the separation of ownership and control has created governance problems. I would still recommend the same accounting and tax treatment as for larger firms, but the requirement to purchase options is clearly not feasible.[4] Further, if firms are worried about the tax consequences for themselves and their executives they can simply offer deep out-of-the-money stock options. If the current stock price is $40, then the value of the option is dramatically reduced if the exercise price is set at $50. This would allow smaller firms to continue to give options, while the personal and corporate tax consequences are much reduced due to the lower option value.

Conclusions

Markets require full information to arrive at fair prices. This holds for all markets, but particularly security markets where valuations are based on future values. This requires transparency in executive compensation for the efficiency of the labour market, as well as the stock market. It is obvious that this requires the expensing of executive stock options at the time of issue. Further, once this is accepted it becomes clear that the way to remove the asymmetries between stock options and other forms of corporate compensation is to require that stock options be purchased from an external source and then given to senior executives. As in so many areas of economics, creating a market solves the pricing, transparency and governance issues and puts all markets on an equal basis. ■

Foot Notes

1. Nicole Maestri, "NYSE Board Backs New Rules," Globe and Mail, August 2, 2002.
2. Annual Report 2001.
3. The Brascan group pioneered executive loans to buy shares in the 1980s and trumpeted the fact that their executives shared the downside like stockholders. Unfortunately, this is a leveraged investment, which is much riskier than regular share ownership; when stocks fell in the 1992-4 recession many senior Brascan executives had borrowed large sums to purchase devalued shares. Stock options (often in affiliated companies) were used to get them out of this mess.
4. The genius of Black-Scholes is not so much in the pricing formula, but the hedging argument that was used to derive it. They showed that the option could be replicated, and thus created by a portfolio of the stock and a debt instrument. This means that investment banks can create and mange their exposure to executive stock options on large liquid firms.