

Breaking News

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Looking for an Alternative to Stock Options: Graef Crystal

Las Vegas, March 11 (Bloomberg) -- A sense of inevitability is starting to pervade the financial community over the issue of charging earnings for the cost of stock options. People are talking not about "if," but about "when."

As a result, planners are already beginning to think about two key issues. First, in a world where earnings are going to be charged for every form of compensation, with no "get out of jail" free card issued to stock options, should a company continue to use those beasts, or should it think about alternative forms of compensation? And second, if a company does stick with options, how can it, legitimately, engineer the lowest possible charge to earnings?

In the last few weeks, I have held discussions with two groups, both of which have given intensive thought to these issues.

On the "Should we keep options or do something else?" front, we have Stephen O'Byrne, the head of Larchmont, New York- based Shareholder Value Advisors Inc. A mathematician, lawyer and accountant all rolled into one, O'Byrne was one of my proteges when I headed the compensation consulting practice at Towers Perrin back in the 1980s. He was a most unusual protege, however, because I ended up learning much more from him than he did from me.

One Alternative

O'Byrne has spent a lot of time thinking about an alternative to conventional stock options that is favored by the vast majority of academic economists.

In a conventional option, the strike price is fixed, almost always being set equal to the market price at the time the option is granted. If the stock price increases, the optionee makes money. If it doesn't, the option becomes worthless (unless, as in Silicon Valley, the strike price is retroactively lowered through a so-called option repricing).

Academic economists have long contended that a conventional option rewards an executive simply because his boat was lifted along with other boats on a rising tide of stock prices. The academics want to replace the fixed-price option with one where the strike price is initially set to equal the market price at grant, and then moves up and down over time as a function of an index, for example, the Standard & Poor's 500 Index or a custom- built index of a number of companies in the same industry.

By reconfiguring options in this manner, the proponents contend, the executive will be rewarded only for outperforming the market.

Suffice it to say that indexed options are not at all popular with executives. They understand intuitively that indexing raises the bar they must hurdle to make any money.

Indexed Options

Not to worry, say the proponents of indexing, we'll handle that problem by giving you considerably more indexed option shares than you would have received in conventional option shares. The company's costs will be same, because, after all, an indexed option, share-for-share, is worth less than a conventional option.

True, says, O'Byrne, but all that analysis overlooks the worth of various alternatives in the eyes of the executive. For many forms of compensation -- take cash, for example -- cost to the company and value to the executive are the same. But that's not the case, he insists, with stock options, where the value to the executive is almost always less than the cost to the company.

The reason, he points out, is that executives are, for the most part, terribly non-diversified. They have the equity in a home or two, but most of their remaining assets are in company stock or in company stock options they have already received. So giving them another stock option is somewhat akin to

pushing refrigerators on Eskimos.

Cash and Free Shares

Looking at the nexus between company cost and executive value, O'Byrne proves mathematically that a more efficient alternative to a combination of cash compensation and fixed-price stock options -- that is, an alternative that provides the strongest incentive consistent with not increasing company costs -- is a combination of cash compensation and free shares of company stock. More important, his analyses show that by far the least efficient pay combination is that of cash and indexed options. To be sure, that latter combination may offer more executive motivation, but to make things even for the executive, the company would have to incur a far greater cost.

His rigorously intellectual reasoning will be welcomed by most executives, who, in their gut, react to indexed options in the same manner as a cobra does to a mongoose but who, up to now, may not have understood why they are reacting the way they do.

Turning from value to cost, we have another group, **NERA Economic Consulting**, a Cambridge, Massachusetts-based unit of Marsh & McLennan Companies, Inc. Their work is aimed at those companies that decide to stick with options, and their objective is to help them achieve the lowest possible charges to earnings, consistent with prevailing accounting rules.

Expected Life

NERA consultants, **Algis Remeza** and **Daniel Abrams**, have developed an elaborate mathematical model that companies can use, at least as a first cut, in assessing what their charges to earnings might be when new rules go into effect. The model is available for test runs by going to <http://www.nera.com>.

Although current accounting rules call for options to be valued using an option pricing model, such as the Black-Scholes, some flexibility is afforded the company in determining the expected life of the option to input into the pricing model.

The company is also allowed to consider the possibility that the option will be forfeited or have its term shortened, because the employee is fired, quits, retires, dies or becomes disabled. Expected life, in turn, is apt to be influenced by the restrictions on exercise -- the so-called vesting restrictions that companies impose as ways of retaining employees and discouraging them from joining the competition. NERA's model takes account of both differing vesting restrictions, as well as the option's expected life and the way in which vesting restrictions operate to increase or decrease the probability that the employee will end up forfeiting his option altogether.

'Blackout Periods'

NERA's model also factors in the impact of so-called "blackout periods," which typically occur prior to the release of company earnings, when even a vested stock option can't be exercised by an insider.

NERA says that, in most cases, the use of its model will result in charges to earnings that are some 5 percent to 10 percent lower than those that are obtained by using the Black-Scholes model with no adjustments. In various simulations I ran using their model, I found a number of scenarios where the downward adjustment was significantly higher even than the 10 percent NERA refers to in its literature.

Up until now, most economists have all agreed that there are flaws in employee stock options that make them less valuable than publicly traded options. But when asked to say how much less valuable they are, they have contented themselves with sticking their finger in the air and naming a nice round number, like 20 percent less valuable.

NERA, in its sophisticated modeling, has offered a much more thoughtful way to determine just how big that haircut ought to be.

Assuming that a charge to earnings will be imposed for the cost of stock options, the work of people like O'Byrne, Remeza and Abrams will become increasingly important in the days that follow. Companies can use resources such as these to determine whether they want to continue doing business as usual out of the same old options stand. And if they do determine that's the way to go, they can explore legitimate means for minimizing the impact on their income statements.