Stock Options Expensing AND Corporate Governance

WHEN WILL THE DEBATE END?

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General Electric, AT&T, Citigroup, Amazon.com, and Ford do it. IBM, Sears, Nike, Gillette, and Merck don't. The expensing of executive stock options (ESOs), the "invisible" compensation of executives, has become much more visible and extremely controversial. And most disputes over the accounting treatment hinge on a misunderstanding of modern finance lessons.

The debate on whether to expense or not has heated up because, as we all are aware, at the end of March the Financial Standards Accounting Board (FASB) issued an Exposure Draft, "Share-Based Payment," that would amend Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," and SFAS No. 95, "Statement of Cash Flows." The new rule would mandate that companies must recognize as an expense in their financial statements the fair value of employee stock options when granted. At present, the relevant information for this type of transaction is available in the footnotes of the financial reports. Moreover, instead of relying on the Black-Scholes model to price such options, the FASB says it prefers the more flexible binomial option-pricing model to estimate the options value because of the various restrictions in the options contracts (e.g., vesting requirements). The comment period for the Exposure Draft ended June 30, 2004.

THE DEBATE

In the October 2002 issue of *Strategic Finance*, we analyzed the debate based on economics and the effects of expensing on cash flows in our article "Deducting the Options Expense: Much Ado about Nothing." We concluded that since expensing ESOs doesn't affect cash flows and thus the company's valuation, it will have little, if any, impact on corporate behavior and price. Since then, many articles have argued for expensing ESOs, with some even explaining the proper way to expense them. Meanwhile, many firms have decided to expense, even though most continue to argue that expensing makes no sense.

The reasons for the controversy often depend on which parties you talk to—investors, legislators, companies, lobbies, and the like. These parties tend to place an undue reliance on accounting earnings as the key source of value, and some suggest a company must take an expense to properly account for the cost of management to the company. While this rationale for accounting may be true, savvy investors value the company based on cash flows—not reported accounting earnings. After all, investors already have the information necessary to calculate cash flows since companies disclose details of ESO grants in the footnotes to the financial statements.

Given that the information on stock option awards is already available in the footnotes and in light of market efficiency, we predict that there will be no stock price response when mandatory expensing begins.

To back up our prediction, we'll roll out empirical evidence based on real economic effects, not the imagined effects of one side of the debate or the other. We offer two types of evidence: the direct effects of expensing on the expected cash flows and share prices, and the factors affecting the likelihood of firms choosing to expense.

SAMPLE SELECTION CRITERIA

Our **expensing firm sample** consisted of 122 firms that voluntarily announced the expensing of stock option awards between July and December 2002 with the expensing announcements beginning in earnest only after July and virtually none before that time. We chose December 2002 as the cutoff date because that's the latest date for which the financial data are available in the databases we used. We obtained the sample of expensing firms and their corresponding announcement dates from Oxford Metrica, which identified the announcement dates from public sources and press releases. Some expensing firms include General Electric, AT&T, Citigroup, Amazon.com, and Ford.

Our **nonexpensing firm sample** comes from the October 2002 edition of the Execucomp database and contains 1,306 firms that use stock options as a part of executive compensation. The Execucomp database is based on the S&P 400, the S&P 500, and the S&P 600 indexes that comprise mid-, large-, and small-cap firms, respectively. Therefore, our control sample of nonexpensers represents firms in various stages of their life cycles and spans a wide cross-section of industries. Some nonexpensing firms included IBM, Sears, Nike, Gillette, and Merck.

Further, we argue that the overarching rationale for these results relates to the quality of corporate governance. As an aside, the composition of compensation packages may change if expensing becomes mandatory, but our present study doesn't address this issue.

STOCK MARKET EFFECTS

To identify the effects of expensing executive stock options on the expected cash flows and share value, we investigated how the stock market reacted when a firm announced it would expense its options for reporting purposes. We studied the stock market effects of 122 firms that made expensing announcements between July and December 2002. Although these results are part of an ongoing study, our findings with an expanded sample of firms are consistent with those in this article. For more details on the study, see "Sample Selection Criteria."

We analyzed the stock market returns of expensing firms by computing their returns around the dates they announced their decision to expense and netted out the general market movements. For example, if the stock market returns, after controlling for general market movements, are negative, then expensing ESOs is expected to reduce the magnitude of the firm's cash flows. This follows from the idea that, in an efficient market, the stock price reflects forecasts of expected future cash flows.

Our overall results indicated that both the average and the median share price change of expensing companies were close to zero for the three-day period around the announcement date. No real effect, actually. We certainly didn't find the negative market reaction many of the pundits expect. This result is consistent with market efficiency and suggests that investors appear to have already incorporated the footnoted information about the ESO expense into the share prices of expensing firms. This was the central argument of our previous article in *Strategic Finance*.

WHY EXPENSE ESOS?

Given that there appear to be few, if any, cash-flow effects associated with expensing, why have some firms chosen to expense while many have not? What's the rationale underlying the voluntary decision to expense? To answer these questions, we studied the decision to expense in the context of several established frameworks in corporate finance. We employed a commonly used statistical methodology called the logit analysis to analyze the firms that chose to expense relative to a control sample of nonexpensing firms. This technique allowed us to gauge the impact of several variables on the probability that a firm will begin expensing options. Three key ideas we looked at are the alignment of interests between managers and shareholders, the extent of stock option use, and how transparent a firm is.

First, we considered how the alignment of interests between managers and shareholders affects the decision to expense. If expensing serves to improve the quality of information available to help investors value shares more accurately, then expensing is more likely to occur when the interests of managers and shareholders are more closely aligned. We measured the degree of the alignment of interests between managers and shareholders by the percentage of total outstanding shares that top executives own. The idea is that the greater the share ownership, the greater the incentive to maximize firm value.

The alignment-of-interests framework also suggests that the conflicts of interests are likely to be lower for firms paying higher dividends. The reason? Companies that pay higher dividends are more likely to have to access funds through external sources to fund their ongoing investment needs, so they are expected to act in the best interests of investors to elicit the best price on the securities they issue over time. This reasoning suggests that firms paying higher dividends are more likely to expense their stock options.

Second, it's possible that the extent of stock option use in executive compensation affects the decision to expense. For example, the bulk of CEO pay derives from ESOs. Are firms more likely to expense when the use of options in executive compensation is low and their impact on reported earnings minimal? The popular press thinks they're more likely to expense. To explore this question, we examined the relation between the option ownership of executives and the decision to expense. Our sample contains firms from many industries and includes those with extensive options use (such as Iomega Corp. and Contango Oil and Gas) as well as those with minimal use.

Finally, we considered whether a company's transparency to outside investors affects the decision to expense ESOs. From the perspective of outside investors, a transparent firm is easier to understand and value. So if expensing increases transparency, is it more likely to occur in firms that are more transparent or those that are more opaque? Empirical evidence suggests that less transparent firms find it harder to raise funds from external sources and frequently sacrifice profitable investment opportunities when they have inadequate internal funds.

On the other hand, companies may be reluctant to expense their stock options if they want to obscure details of managerial compensation. In addition, given the perception that investors place undue emphasis on reported earnings, companies may have an incentive to keep reported earnings inflated by keeping the options expense in the footnotes. Bear Stearns, for example, calculated that if ESOs were expensed, the average earnings reduction would be 20% for the S&P 500 firms, according to the March 30, 2003, edition of *The New York Times*.

We measured the degree of transparency by firm size because evidence suggests that larger firms have a wider analyst following, which makes them more transparent. In addition, the adverse impact of the lack of transparency on a firm's investment is likely to be higher when the need for funds is greater, such as when a firm has ample profitable investment opportunities and when current cash flow is low. In such a case, do firms make an attempt to increase transparency by deciding to expense? We explored this related question by including variables that measure investment opportunities and current cash flow. Specifically, we measured investment opportunities by the market-to-book ratio of assets, R&D expenditures, and current cash flow by the ratio of operating income before depreciation-to-book value of assets. A higher market-to-book ratio of assets indicates greater investment opportunities. Table 1 shows the variables we used in the study and their anticipated effect on the decision to expense.

Table 1: **Study Summary - Key Variables**

ATTRIBUTE	VARIABLE MEASURE	ANTICIPATED EFFECT
Alignment of Interests	Share Ownership	Positive
	Dividend Yield	Positive
Option Usage	Executive Option Ownership	?
Transparency	Firm Size	?
	Investment Opportunities	?
	R&D Expenditures	?
	Cash Flow	?

All these attributes contribute fundamentally to the firm's quality of corporate governance. For instance, a greater alignment of interests indicates that managers are more likely to give highest priority to actions that maximize shareholder value. Similarly, outside investors find it easier to value more transparent firms, such as those with clear financial statements and understandable communication. Thus, a firm characterized by closely aligned views of management and investors coupled with understandable, credible communication with the market is widely viewed as one engaging in high-quality corporate governance.

THE RESULTS

We performed our statistical analysis on the combined sample of our expensing firms and a large sample of non-expensing firms to determine which key variables are important. Our overall results suggest that the expensing of ESOs is more likely to occur in firms that are more transparent and with more closely aligned interests between managers and investors.

Let's look at Table 2 for specifics. Our results suggest that the larger a company's size, the greater the extent of share ownership by executives, and the higher the dividend yield, the more likely it will expense options. A company is less likely to expense when its growth potential is greater as measured by its market-to-book value and R&D intensity. The decision to expense doesn't appear to be related to the extent of option use in executive compensation. Thus, the potential negative impact on earnings caused by the expensing of options doesn't appear to play a role in the decision to expense.

Table 2: Summary of Results

ATTRIBUTE	VARIABLE MEASURE	ANTICIPATED EFFECT
Alignment of Interests	Share Ownership	Positive
	Dividend Yield	Positive
Option Usage	Executive Option Ownership	No Effect
Transparency	Firm Size	Positive
	Investment Opportunities	Negative
	R&D Expenditures	Negative
	Cash Flow	No Effect

THE CONNECTION BETWEEN GOOD CORPORATE GOVERNANCE AND EXPENSING

As we mentioned earlier, greater transparency and more closely aligned interests between managers and investors are likely to be associated with good corporate governance. Thus, our results are also consistent with the notion that expensing is more likely to occur in firms that engage in good governance.

A recent issue of *Fortune* helps build our case. *Fortune* considered eight attributes associated with good corporate governance in its March 8, 2004, issue that featured its annual ranking of America's most admired companies. The key attributes included innovation, financial soundness, employee talent, quality of management, use of corporate assets, long-term investment, social responsibility, and quality of products and services.

We found many of America's most admired companies chose to expense. Among the top 10 companies on *Fortune's* list, we find those such as Wal-Mart, GE, and Microsoft, all of whom have chosen to expense. In addition, *Fortune* ranks the top three firms in each key attribute, and about half expense their ESOs. Further, *Fortune* ranks the top 10 firms in each industry based on these eight attributes, and, again, about half of our overall sample of expensing firms belongs to the top 10 list across the industries. In light of the fact that fewer than 10% of major U.S. firms have decided to expense ESOs, this is striking evidence that companies practicing good corporate governance are more likely to expense ESOs.

NOT JUST A PR PLOY

These results indicate that expensing executive stock options is influenced more strongly by how closely aligned the interests of management and shareholders are than by the negative impact on earnings caused by options expensing. The results further suggest that the more transparent the firm's financial status, the greater the probability it will voluntarily expense its stock option grants. It's widely accepted that greater transparency and greater alignment of interests go hand-in-hand with good corporate governance. Thus, our results imply that expensing of stock options is more likely in firms that practice good governance.

Still, some suggest that companies expense ESOs as a public relations ploy to show they listen and respond to shareholders. GE and Coca-Cola were among the first to do so. Our evidence indicates, however, that companies engaging in these so-called public relations initiatives also tend to be the ones already practicing superior corporate governance.

And based on our results, if the controversial new rule does go into effect, we believe there again will be much ado over nothing! ■

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