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148

The Ugly Option

By Susan Lee

An arcane accounting question—whether employee stock options should be expensed—has a lot of people lathered up and chewing the rug. But nobody is asking the larger question of whether the enterprise itself is worthy. Well, the past decade's experience with stock options has given economists a lot of information to work with and, when these studies are taken as a whole, the picture is not pretty.

Awarding stock options to employees, particularly top managers, was supposed to remedy a pesky flaw in corporate ownership—the principal-agent problem. Simply put, one group of people (principals or shareholders) owns the corporation while another group of people (agents or managers) runs it. Although the interests of the two groups are broadly in harmony, there is some divergence. Shareholders, for example, might not think that a fleet of jets and a corporate art collection represents good management practices, while senior executives do. In fact, managers have an incentive to consume such perks because they reap almost all the benefits while bearing only a fraction of the costs.

Enter stock options. Making managers into shareholders, and thus giving them a stake in the financial success of the firm, was designed to align their interests with owners. Most importantly, by giving managers the incentive to maximize shareholder wealth, options were supposed to result in higher earnings; managers, it was thought, would focus more on the bottom line.

Sounds like a slam-dunk, eh? Unfortunately, there is no empirical evidence that options have enhanced earnings.

Various studies have produced only mixed and uncertain results. The clearest conclusion was that higher option grants during the year are associated, although weakly, with higher stock prices at year's end. However, researchers found no relationship between options granted last year and the stock price at the end of the following year. (Unpleasantly, the association of increased options with increased share prices may owe more to corporate anticipation of rising stock prices than is the driver of them.)

However, even if there is no evidence that options generate better performance, there is plenty of evidence that they have changed executive behavior in less productive ways.

For starters, take the practice of repricing options when the stock price falls below the grant price. Rather than taking their lumps, managers have shown a preference for "repricing" options, issuing new options to supplement out-of-the-money ones or, the newest ploy, canceling options and replacing them with lower-priced ones. Repricing is undoubtedly great for managers—bad performance is rewarded. However, it's not clear that repricing is good for shareholders. It removes any incentive effect that options may have. Moreover, repricing means that shareholders retain the risk from bad performance while employees don't.

Options have also changed corporate payout policies. Firms that grant a lot of options are less likely to use cash to pay dividends and more likely to repurchase stock or retain more earnings. Again, it's a matter of incentives. Paying dividends reduce stock prices and the value of outstanding options. And so do options if they increase dilution. Since investors pay intense attention to earnings-per-share, managers are chary of dilutive transactions. Thus, firms that issue options have an incentive to buy back shares to counter that dilution. Moreover, stock repurchases, which can boost EPS and exert upward pressure on stock prices, can also increase the value of options—what a happy coincidence!

The hooker is that while stock repurchases are good for option-holding employees, it's not clear that they are entirely in the interest of shareholders. Repurchases cost money. They decrease liquidity and constitute an opportunity cost—firms lose the alternative uses of money, like making new investments.

Then there's the fact that the current accounting for stock options encourages extravagant practices. Options, unlike other forms of compensation, are not considered an expense; that is, they are not charged to earnings. This little loophole, according to Kevin Murphy, an economist at the University of Southern California, promotes the perception that the cost of options is zero. Of course, the real cost is not even close to zero. Beyond the dilutive impact, there is an opportunity cost involved in selling shares to employees at less than the market price.

But if managers mistakenly perceive that there are no real costs to options, they have an incentive to over-issue them—particularly by granting options to lower-level employees who have no direct impact on earnings. Thus, says Mr. Murphy, if options were expensed, and the economic cost recognized, fewer would be granted. In fact, something similar happened a decade ago when companies were suddenly required to show the liabilities of health care costs for retirees. When the costs of those promises had to be recognized, companies started to take them seriously and brought them under control.

Consider, too, the evidence that options create incentives for truly malign behavior. For example, managers can manipulate the timing of announcements, like earnings estimates, to increase the worth of their options.

Several studies found that managers make option grants just before the release of good news and the subsequent increase in stock prices. In other words, managers give themselves options that quickly become in-the-money when stock prices rise in response to good news. Conversely, managers grant themselves options after the release of bad news and the subsequent fall in stock prices which, in turn, results in a lower exercise price for their options. Managers who delay good news and accelerate bad news are really self-dealing. Not quite a behavior that benefits shareholders.

Options may yet prove to be the answer to the agency problem. But the current practice of granting (and accounting for) options may have changed management incentives in ways that cannot, even remotely, be seen as aligning their interest with shareholders. This is a polite way of observing that options have certainly focused managers on the bottom line—only it's their bottom line, not the shareholders'.

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