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Stock-Based Compensation
and the Cost of Capital

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Accounting rules often generate opposition from corporate managers. But the opposition to a rule regarding the treatment of employee stock options has been unique in its ferocity.

A lengthy battle over the rule, which was proposed by the Financial Accounting Standards Board, ended not long ago in a victory for the managers. The issue is still very much alive, however, with backers of the proposal arguing that the current system continues to leave all but the most sophisticated investors in the dark about the true level of senior compensation -- not to mention the true state of earnings -- at many publicly held companies.

The accounting board's proposal would have required companies to estimate the present value of the options, when granted, and then account for them as a current expense.

There were dire predictions that such a change would make the awarding of options untenable at many companies, with particularly devastating consequences seen for the high-tech sector, which relies heavily on options to keep talented people on board. Even Congress and the White House joined the chorus of critics, threatening to intervene to keep the rule from going into effect.

Under the barrage of criticism, the accounting board ultimately relented, issuing a final rule in late 1995 that encourages, but does not require, the expensing of employee stock options.

While the new rule continues the tradition of allowing no expense to be recognized for the options, they are clearly of value to employees, who often take them in lieu of higher salaries or bonuses.

The accounting board's reversal permits an obvious loophole to continue as well. If a company promises employees the same future stream of cash flows as offered by a stock option, recognition of an expense is required to the extent that cash is paid out. But management can use the stock options as compensation without being accountable for them in an earnings sense. Indeed, compensation that is awarded as options in lieu of cash has the effect of inflating earnings.

Not surprisingly, the initial opposition to the proposal came from the country's largest companies, whose managers are among the principal beneficiaries of options programs. Their complaints were subsequently voiced by smaller corporations and industry associations.

The main complaint was that expensing the options would depress earnings, perhaps even pushing some smaller companies into the red. The impact on earnings would then hurt stock prices while also making it more difficult to raise outside financing, according to the doomsayers.

To see whether these fears were justified, we examined the financing habits of some 4,000 publicly traded companies. We also looked at the proxy statements and annual reports of all 348 companies that had written letters to the accounting board strongly opposing the proposed rule.

Our investigation uncovered no evidence supporting the fears about financing. For example, we found no indication that companies attempting to raise capital systematically use the options to boost accounting earnings.

We also found no evidence that stock prices reacted negatively to news of the initial proposal, even among high-tech companies that make heavy use of employee stock options.

Perhaps also not surprisingly, we found that opposition to the proposal was concentrated among companies in which top executives were rewarded with lucrative stock option grants. In fact, we found that the top executives of companies who lobbied against the proposal use options intensively for themselves, but not necessarily for employees lower down the ladder.

Our investigation suggests, therefore, that opposition to the proposal was motivated by the desire of top executives to continue to be largely unaccountable for their own compensation. (Option awards have long had to be disclosed in proxy statements, but not in conjunction with an estimate of their value.)

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Increased Cost of Capital

The key argument in opposition to the expensing of options is that it would increase the cost of raising debt and equity capital.

The argument hinges on the idea that investors form their expectations of the future performance of a company by naïvely relying on reported earnings. Therefore, a new accounting rule that reduces reported earnings is supposed to cause investors to revise their expectations downward. This, in turn, is supposed to increase the cost of borrowing and the cost of equity capital.

But this is fatuous. If investors simply took the time to understand the rules underlying the computation of earnings, then their expectations would not be influenced by mere changes in those rules.

Yet even if investors' expectations are naïvely tied to reported earnings, the case for expensing options can still be made. As long as it is agreed that granting options transfers value from the company to the employees, then expensing their cost produces a more relevant earnings number.

That is the view of Warren E. Buffett, the noted billionaire and corporate chieftain, who supported the proposal to expense options.

"I'll make [an offer] to any executive who is granted a restricted option, even though it may be out of the money," he wrote in the 1992 annual report to stockholders of his holding company, Berkshire Hathaway Inc. "On the day of issue, Berkshire will pay him or her a substantial sum for the right to any future gain he or she realizes on the option. So if you find a C.E.O. who says his newly issued options have little or no value, tell him to try us out."

Should the cost of capital in certain industries be subsidized? We won't take sides on that issue. However, allowing companies *not* to record an expense for options does not appear to be the most direct or effective way of providing this subsidy. It is also an inequitable way, since naïve investors who do not understand the true cost of stock option awards end up paying the subsidy.

To examine the validity of the cost-of-capital argument, we performed three sets of empirical tests.(1)

First, we examined whether companies requiring additional outside capital are more intensive users of stock options. In our look at the financing habits of the 4,000 publicly traded companies, we found no evidence that companies requiring additional financing used more executive stock options to boost earnings.

Second, we examined the stock price reactions of companies using options when they made announcements relating to the expensing proposal. We looked for a reduction in the stock price around these announcements on the basis that sophisticated investors would bid the price down because naïve investors would no longer be fooled by artificially inflated earnings. But we found no evidence of such price moves. Despite the claims of management that companies would be decimated by the new proposal, the stock market simply did not react.

Third, we examined the characteristics of the companies that lobbied against the proposal to determine whether they needed additional financing. What we found was that the 348 companies that expressed criticism to the accounting board were among the most cash rich in the country.

Overall, we therefore found no direct evidence to support the cost-of-capital argument.

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Accountability for Top Executive Compensation

In the early 1990's, when the proposal to expense options was introduced, the country was in a recession and the compensation of top executives was under scrutiny from the media and politicians. The amount of that compensation was frequently criticized in the press for being "excessive" and "not linked to performance."

The proposal to expense stock options provided a methodology for valuing and reporting the grants that were being made to top executives.

"FASB's proposal, if it becomes final, would place a reasonable check on executive pay packages which contain options -- a check which up until now has been missing," Senator Carl Levin, Democrat of Michigan, was quoted as saying in the Chicago Tribune in 1993.

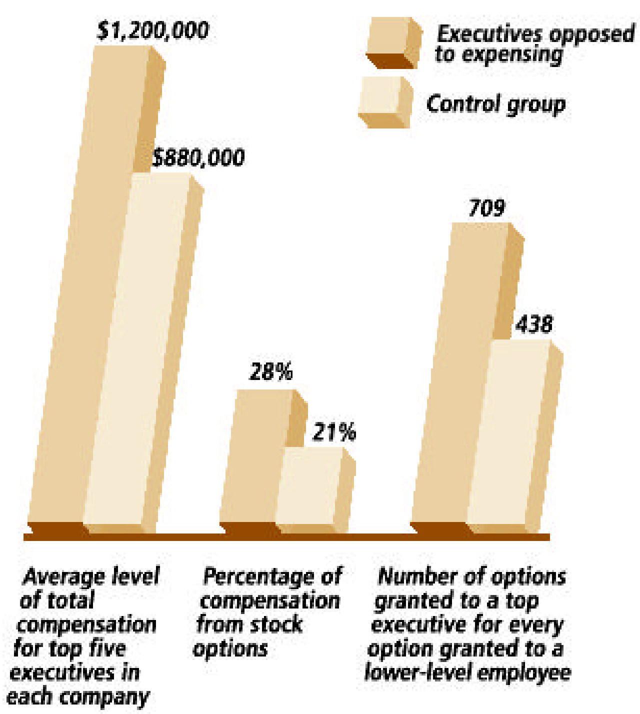
The computation and recognition of an expense associated with stock options would provide further ammunition for lobbying against excessive executive compensation, supporters of the proposal said. Moreover, the computation and recognition of a cost for this form of compensation could provide a basis for imposing taxes and other wealth transfers on top executives.

We researched this alternative view of the accounting board's proposal by examining the characteristics of the 348 companies that lobbied against it. For the purpose of comparison, we also collected data on a sample of control companies, matched by industry and size, that did not submit comment letters opposing the proposal.

Through a detailed analysis of financial and proxy statements, we compared the two groups of companies in terms of their policies on top executive compensation. The results, summarized in the accompanying exhibit, demonstrate that executives who opposed the proposal have higher total compensation and receive a greater proportion of that compensation in the form of option grants.

Exhibit I

Compensation for Executives Opposing Expensing of Stock Options Compared with a Control Group



Source: Journal of Accounting Research

Even more striking is the fact that the top executives of companies opposing the proposal use option compensation most aggressively for themselves as compared with other employees in their firms. The average number of options received by a top executive for every one option received by a lower-level employee was 709 in the opposition sample and 438 in the control sample.

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Broader Implications

While corporate America appears to have won its battle to block the changes in accounting for employee stock options, the effectiveness of the regulatory process has been undermined in the process.

In theory, accounting information exists to provide investors with relevant data concerning the financial condition of a business enterprise. This includes providing an earnings number that has had compensation costs deducted from it. In practice, though, corporate America represents a major force in the accounting regulatory process.

If corporate management successfully used its lobbying muscle to protect its own interests, rather than to provide stockholders with relevant information, then the regulatory process is simply not performing its intended purpose.

FOOTNOTE

1 For more details on the tests discussed here, see "Economic Consequences of Accounting for Stock-Based Compensation," a forthcoming article in the Journal of Accounting Research, Spring 1997, Volume 35, written by the same authors.