Stockoptions

ONE LAST GO, BEFORE THEY GO INTO EXPENSES

By Donald Nordberg

Warren Buffett is having his way, at Coca-Cola, Citigroup and a host of other companies where his Berkshire Hathaway has a large stake. The US Congress is making it uncomfortable to contemplate that the grant of stock options to executives could be anything other than a current cost of doing business. Earnings of companies - especially in Silicon Valley - will be decimated or worse, but there are few apologists willing these days to stand up and say: "Wait a bit."

I've been against expensing options, though on a couple of occasions I almost talked myself into it. My reasons are different, though, than I've heard mentioned so far.

So, one last go at options, before they go into expenses.

The case against expensing options

We've heard people say, "If options aren't a cost of employment, what are they?"

But let's ask the question: could that notion of a "cost of employment" be an anachronism, a relic of the Victorian era, when companies employed mainly unskilled labour, when people were interchangeable parts?

Despite their shortcomings, stock options still seem the best way to align executive incentives with shareholder interests. They're less than perfect, to be sure. They give managers an incentive to manipulate earnings and news announcements to meet their own timing on exercise and disposal. There are other ways to deal with those issues.

I'm not about to defend the levels of executive pay. There are a lot cheaper ways to manage a company than creating $100 million + packages for perceived "stars". The collapses of Enron, WorldCom and a host of other, previously well regarded companies have exposed horror stories of exploitation, deception designed in part to allow senior managers to gain huge financial rewards. But it we strip out the issue of the *scale* of the rewards and look at the principle, what do we see? Are stock options a current cost of business, or - like dividends and capital gains - a compensation for value placed at risk?

Starting up

Three guys band together to form a company. They have an idea, business contacts and very little money. They work hard, gain customers commitment, raise a bit of capital from a business angel and start a business. Initially they own 100 percent of the new venture at a price of zero. After raising outside funding, they still own 60 percent. If the business succeeds, they stand to make $10 million, and, according to some formula, there's a 20 percent chance they will succeed. Were those shares a cost of employment, or a representation of the intellectual capital and uncompensated time *put at risk* to build the business? Should the first year's Profit/Loss Account show a shortfall of $2 million even before they spend any money? We don't see anyone making that argument. After all, the energy, drive and the business idea of the founders aren't formally part of the new company's balance sheet. But they are still an asset - perhaps the biggest asset - of the business. That's why the founders hold a majority of the shares.

It's a year later now, and they've managed get the business up and running - a few customers, a bit of cash flow. They need some more skills, though, and some further business contacts and technical expertise to be able to build the business further. The only person they know who has them has other things to do with them. He might even set up in competition with them. But he could be persuaded to join for a portion of the equity. He'll bring his intellectual capital into the venture. He'll forego other opportunities to use his knowledge and contacts. And he'll probably work for less cash if he's given equity. But you can't just give him shares at a price of zero - the business angels have already established a price above zero, and besides, the tax regime makes that impossible. So you offer options, with a two-year vesting period, and a strike price at the level of the venture capitalist paid for his equity. Is your new "employee" economically any different from the founders?

The typical set of accounts based on conventional accounting principles doesn't reflect the capital paid into the company by the new executive, because it's not cash. The option value - reflecting the rent due to the executive for the use of that capital - shouldn't, then, be deducted as an expense.

Put it another way: the expense of the options reflects an off-balance sheet transaction between the company and the "employee". But is he really an "employee", or rather a "member of the company" with respect to the intellectual capital at risk?

Unless we add to the balance sheet the intangible assets he puts at risk for the company, it's inappropriate to deduct from the P/L the interest he receives in the form of option value.

Options in an established company

Perhaps start-up companies are different, you say. After all, there's no history, no build-up of tangible and intangible assets over generations. And the board of a public company has a fiduciary responsibility to look after the interests of all the investors who have purchased the use of those assets - those of the balance sheet (net asset value) and those off-balance sheet items (the premium of market capitalisation to net asset value) as well.

The new company

You're a director of a public company. You're about to hire an executive into a senior or middle management position. He agrees to take cash compensation that might be equal to or maybe even less than he could get elsewhere. He's experienced. He spent perhaps 20 years in business gathering knowledge - of customers, of production technologies, of how to manage people, of supply-chain dynamics - knowledge that is valuable to your company. And that knowledge is about to become an asset of your business. You intend to sweat that asset, to turn that asset over several times a year, the same way you do with plant and equipment. You want to see a higher asset-turnover level after you've employed him than you had before. And you think the assets you're about to acquire are particularly valuable because they have no fixed capacity. The leverage your company can achieve from all its intangible assets - brand value, process patents, intellectual property rights - is much higher than you can possibly get from buying hardware, software, blast furnaces, milling machines, or office tables and chairs.

Let's say now that you're the candidate. You have 20 years of experience and both specialist and general knowledge. You *could* set up your own company, investing that knowledge as well as cash from a business angel, venture capital firm or friends and relatives, and probably own 40-80% of the new venture. You'd own it outright, without any strings attached. And with a book value of zero. If the idea works, you stand to get seriously wealthy. If it doesn't, well, you've earned a salary - greater or lesser depending on how much equity you were willing to sacrifice to get the initial cash, that is, how much risk you seek to offload. But there's a listed company that has been wooing you to join. They have resources - much greater resources than you and your capital providers can bring to bear. Moreover, they offer the security of a large balance sheet and cash flow statement that reduces your risk.

Two questions, then:

What type of package would lure this executive to put his on ideas on hold, perhaps forever, since someone else will - no doubt - exploit the opportunity he sees before he can get back to it?

What is the nature of the economic value of this transaction?

Only with those answers can we judge how to account for the costs.

You're the director, now. You offer him a salary and an annual bonus that is probably more than his providers of capital would agree to allow him to withdraw from the business. You could pay a cash price up front - a joining bonus - to compensate him for his knowledge. But you don't want to take that risk, you want him to take it. So you offer him stock options. You put strings on them. The options won't vest for two or maybe three years. And if the share price doesn't go up, they will be worthless. The book value isn't zero. It's the strike price times the number of shares in the grant. You make him a risk-taker in *your* enterprise.

You are paying for labour and buying an asset at the same time. The price of labour is the salary, the bonus is a reward for success of that labour. But the asset is paid for in equity.

If you acquired *his company* to gain the company's assets (that is, at this point, his knowledge), you might pay him cash and account for the expense as goodwill, the premium over book value of the assets. Or you could issue stock. In either case, you would add his company's assets to yours and then amortise the goodwill over time. But for some obscure reason, the intellectual capital you acquire by employing him is treated differently in accounting terms that it would be if you bought his business.

Options for current staff

One of the great tools for motivating and retaining staff since the mid-1970s has been employee stock options or stock purchase plans. They give staff a sense of belonging, a share in the reward, and a share in the risk. And for you, the director, they help align the effort of staff with those of the shareholders.

But unlike the case of the new recruit, you might want to argue that the "asset value" of the knowledge and experience of the workforce are already assets of the company. Chances are that your staff's employment contracts assert that any intellectual property created during employment belongs to the company. There's certainly a provision to prevent staff leaving employment from taking commercial secrets with them. There's probably even an explicit prohibition on sales people from taking or using customer lists in their future employment.

In practice, however, such stipulations are almost impossible to enforce. Indeed, in some countries labour law explicitly prohibits contractual constraints that would prevent a worker from exercising his trade. That makes it impossible, for example, to stop sales people from calling on previous accounts. The salesman might not be able to download to the memory of his home PC all the purchases from his old employer and take those to a competitor. But the law doesn't require him to undergo electroshock therapy to rid his personal memory of buyer behaviour.

In an economic sense, therefore, ordinary employment involves two elements of compensation: payment for current labour and the opportunity to develop experience and thus create a personal asset and goes with the employee forever. In a fast-changing technological environment, some of those assets will depreciate quickly. But whatever labour contracts say, savvy, know-how, gut-instinct and all the other managerial skills cannot by law be left on the doorstep when the employee goes home at night, or leaves the company for good. They are assets of the employee.

The knowledge society

It's not surprising that employee stock options gained credence at the time when we began to understand just how much our economy had changed in the years since the Victorian era, which gave rise to our concepts of capitalism.

Joint-stock corporations came into existence in the mid-1800s because entrepreneurs needed cash to purchase the technologies and employ the labour needed to exploit the idea. Labour was largely unskilled. Machines represented the assets. Businesses that didn't need technology but did need skilled labour - law firms, stockbrokers, accountancy practices - remained as partnerships and compensated their most valuable employees with equity.

But increasingly over the last 150 years - and especially in the services sector and the technology industries - the real assets of the business aren't in the machines, they're in the people who make and use them, the people who find and develop the customer relationships. Shareholders must pay them for two things: their time and their experience. Time is clearly a current cost. Experience is capital.

So, from an economic point of view, salaries and bonuses are clearly expenses in the current accounting period. But stock options - designed to pay for assets represented by experience - ought to be considered as the price of a capital acquisition financed with equity. **And unless those assets are brought into the balance sheet, it makes no economic sense to deduct the cost of using them from the P/L. You might as well deduct the cost of future capital gains for shareholders.**

By all means, let us force companies to report earnings per share on a fully diluted basis. But expensing options - even if we could find a robust formula to do it - distorts the financial picture of the corporation, it does not clarify it.

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