

Food For Thought

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## Should most employees receive stock options?

Dear *LogiStyle* Colleague:

Food for Thought is our way of sharing interesting concepts on corporate leadership and management with others who might find it useful. The thoughts offered are intended to be controversial and thought provoking. They always follow our motto of helping develop logical leadership.

The idea for this month's Food for Thought came out of a conversation with Dave Rolefson, Director of compensation at Google. Recognizing that employees often do not appreciate the full value of a stock option, Google created an active market for vested employee stock options. Google employees can log on to their account and observe in real time the current marketable value of their vested options, and if they so choose they can sell those option contracts. The market – consisting of employee sellers and institutional buyers – offers a value for the option that is evidently more than the difference between strike and market price, though slightly lower than the Black-Scholes value. This has enabled Google to communicate to its employees the full value of the options they hold.

That got us to thinking whether employees in most companies really understand the true value of stock options. During the high tech boom of the 80's and 90's, employee stock options began to be used by many companies as a broad-based compensation tool for most, if not all, employees. The belief was that employee stock options allowed the company to align the interests of the employees and the shareholders. Executives recognized that not all employees can easily see the link between what they do and how the stock price moves. Nevertheless, in a bullish market there was considerable appeal in using a non-cash compensation tool like stock options, particularly when it did not have any impact on the company's net income.

The party ended in 2005 with the pronouncement of FASB 123(R) requiring public companies in the US to take an accounting charge to their income statement representing the value of the employee stock options that vested during the period of the

statement. So, many companies have begun asking if broad based use of stock options is meaningful and worth the accounting charge it entails. How should a company answer that question?

We have a provocative proposal motivated by Google's approach. Imagine if an employee who was to receive an option grant was offered a choice to either accept the grant under its vesting terms or receive a cash award equivalent to the Black-Scholes value of the option grant, where the cash payment is also subject to the same vesting terms as the options. If the employee is inclined to choose the cash award, then an option award would be an ineffective use of company resources. The company might as well have received more value by offering a cash grant. Cash-strapped companies aside, one should not delude themselves into thinking that a cash grant constitutes real money and an option grant does not. The company is simply using the shareholders' money!

If this choice between a cash grant and an option grant is offered to all employees receiving stock option grants and if a predominance of those employees choose the cash grant – as believed by many to be the likely case in most companies - then the company needs to rethink its stock option policy. For example, the company might be able to satisfy its employees adequately or better by offering a cash award at a discount to the Black-Scholes value. Clearly, there is some discounted value – say, 60% of the Black-Scholes value, for the sake of a concrete conversation – where there is an even split within the employee group in their choice between a cash award and an option award. The company might be able to offer that choice and save 40% of its cost for half the employees. It could be argued that the discounted value that splits the employee group evenly represents the true value of the options. SEC permitting, the company might consider using the discounted value, in place of the Black Scholes valuation, to record their expense for the options. This is somewhat similar to the approach – al beit an open market approach – used by Zions Bancorp and Cisco that won SEC approval a couple of weeks ago.

Lastly, a company that offers this choice to its employees can use the trend data from year to year as an indicator of employee confidence in management's ability to create shareholder value. While the data in any given year is bound to be impacted by the risk profile and personal situations of individual employees, the year to year trend data is likely to factor that out. Do we dare ask the question whether a public company that offers this choice to its employees should publish the trend data to its investing public?

Lest one should mistakenly conclude that the use of restricted stock instead of options is a similar concept, we point out that providing a choice to the employees is the key component that creates an active market. We recognize that this approach, while providing comparable retention value, ignores the value of aligning the interests of the employees with those of the shareholders, a much touted feature of stock options. But,

in reality, it is questionable if lower level employees' behavior is significantly altered through stock options, beyond what simple profit sharing style compensation tools enable. Doubtless, stock options serve as an alignment tool for executives. The approach discussed here might serve as a more cost effective alternative to broad-based use of stock options.

We have received many responses to our Food for Thought mailings, asking if you can freely share and forward these thoughts. Indeed you can. All we ask is that a clear attribution to LogiStyle and our contact information are included. For the interested reader, we have archived some of our recent Food for Thought mailings at our website, and can be viewed at [LogiStyle: Food for Thought Archive](#). As always, we welcome your comments. We hope your business is doing well. If we can be of any assistance please feel free to call – even, if just to chat.

Best Regards,

Balaji