COMMENTARY

Shyam Sunder

Shyam Sunder is Richard M. Cyert Professor of management and Economics at Carnegie Mellon University.

Economic Incentives as a substitute for Detailed Accounting Requirements: The Case Of Compensation Value of Stock Options

There is an effective alternative way of inducing corporations to recognize a realistic amount of compensation expense associated with the grant of employee stock options.

Firms should be free to assign whatever value they consider appropriate to such stock options subject to one restriction: The firm must be willing to sell up to a specified number of similar options at the same date at a price equal to the stated compensation value to its own shareholders (and perhaps to the public).

Various details of such a proposal would have to be specified. The specified number of options available for sale could be set to, say, five or ten times the number granted to the employees. The plan to grant options would have to be announced ahead of time. The announced compensation value could be stated as a function of the price of the underlying equity on the date the options are granted. There will be several other details.

However, the basic idea is that firms can be induced not to understate the compensation value of equity-based options by giving them appropriate economic incentives. If they value the options at what they are really worth, this rule would have no effect, because nobody would want to buy the options at or above their economic value. If the compensation value is understated, shareholders (and the outsiders, if permitted) will rush to dilute the transfer of wealth to managers.

The proposal might be criticized on the ground that the purchase of options by non-employees may raise unwanted capital for the firm. There are two responses to such a criticism. First the firm can avoid raising any significant amount of unwanted capital by pricing the compensation value of options appropriately. Second, this method of compensating the employees is supposed to be most important to new firms that are typically short of capital. They should welcome such an opportunity to raise capital without additional effort or cost.

An economic incentives-based approach may allow us to bypass the nettlesome debate about which of the simple option pricing formulas might be acceptable for each specific employee option plan. Complexity of option schemes is bounded only by the ingenuity of the lawyers who design them. Economic modeling will never catch up with that complexity. We might be able to use economics to devise an elegant solution to the problem, independent of the complexity of the compensation schemes. Such a solution will also let the market forces discipline the disclosure of employee compensation, instead of placing the burden of monitoring the appropriate application of option pricing formulas on regulators or auditors.

In the 1940s, the U.S. Congress used economic incentives to place bounds on adoption of LIFO by publicly held firms. Judicious use of economic forces can be an effective alternative to detailed and specific accounting and disclosure regulations. Accounting for the compensation value of equity-based options presents us with another opportunity to use this principle.¹