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

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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.