Are Options Dead? - The Future of Options

Damian Carnell, Towers Perrin
GEO Conference
Frankfurt
30 October 2002
In Praise of Options

- Employees only gain only if shareholders gain
- No P&L cost
- Simple to communicate and understand
- Risk free for employees
Companies around the world are increasing their use of long-term incentives (LTIs)


- Even companies outside the U.S., U.K. and Canada are making LTIs a key component of total pay

By 2003, most large companies around the world will have some type of LTI program

- Local companies will increasingly use LTIs to attract talent
- Global corporations will need to expand the use of LTIs into more countries
Most companies with LTI plans rely heavily on stock options

Stock options are the most widely used LTI vehicle in most countries

Other LTI programs include:
- Restricted stock
- Performance plans
- Stock appreciation rights
- Phantom stock

- Volatile markets create risks when linking employee compensation to company’s stock price
- Plan design must be flexible and simple
- Communications will vary among countries and cultural norms
Teaching employees to understand and value options

- Many U.S. employee stock option owners don’t understand how options work

<table>
<thead>
<tr>
<th>Description</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Knew little or nothing about their options</td>
<td>39%</td>
</tr>
<tr>
<td>Knew little or nothing about the tax implications of exercising options</td>
<td>52%</td>
</tr>
<tr>
<td>Didn’t know what percentage of their options was vested</td>
<td>29%</td>
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- Knowledge levels outside the U.S. are probably lower!

- Several variables affect stock plan acceptance in different countries
  - Stock ownership experience
    - U.S., U.K. and Australia — a tradition of individual stock ownership; a foundation to understand and value stock options
    - Other countries, (e.g., Germany, Japan and Brazil) — stock ownership is new, may be greeted with skepticism and resistance
  - Cultural overlay
    - Organization culture does little to diminish national culture
    - Individualism, risk acceptance, employer and employee relationship affect reaction to stock plans
So Who could Complain?

- Fund Managers
- Investors
- FASB
- IASB
- Credit Rating Agencies
- Congress
- US Taxpayers
- The Press
- Academics
- …and employees… with nasty lawyers!
Overstatement in Particular Sectors

- Reduction in operating income when employee stock-based compensation is included:
  - Communications Equipment 56%
  - Computers - Networking 53%
  - Entertainment 25%
  - Electronics - Semiconductors 24%
  - Gold/Precious Metals Mining 24%

Source: Bear Stearns
### US Tax

<table>
<thead>
<tr>
<th></th>
<th>Option Deduction</th>
<th>Tax Paid</th>
<th>% Reduction in Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dell 2001</td>
<td>$929 million</td>
<td>$958 million</td>
<td>49%</td>
</tr>
<tr>
<td>Microsoft 2001</td>
<td>$3.1 billion</td>
<td>$4.1 billion</td>
<td>43%</td>
</tr>
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Allowed nowhere else - other than by complex structures
Smell a Rat?
ENDING THE DOUBLE STANDARD FOR STOCK OPTIONS ACT

“This bill addresses a costly and dangerous double standard that allows a company to take a tax deductions for stock option compensation as a business expense while not showing it as a business expense on its financial statements.”
Voting Power

In 2001 CALPERS voted against 43% of executive share option plans for their executive dilutions....and cited 33 companies for programs with dilution levels triple the recommended ceiling.
Standard & Poor’s

Measures of Corporate Earnings
14 May 2002

“Only 2 companies in the S&P 500 include employee stock option grants as an expense in their income statements.”

“All parts of employee compensation, including stock options, should be included in core earnings.”

“Research shows that options expense could lower core earnings by as much as 10%.”
“Council of Economic Advisers, we raised strong concerns about conflicts of interest and problems in accounting standard and practices, particularly as they related to derivatives and options.”

“FASB called for a change of accounting practices.”

“The Secretary of Treasury and the Secretary of Commerce, however, violated basic principles of good governance, which call for the independence of FASB, and intervened to squash the proposed revisions. They succeeded.”

_Capital Hill Hearing, Senate Banking Housing and Urban Affairs_  
_Review of US Economic Health by_  
_Dr Joseph Stiglitz Nobel Laureate Professor of Economics, Columbia University_
"Regrettably, the current accounting for options has created some perverse effect on the quality of corporate disclosures that, arguably, is further complicating the evaluation of earnings and hence diminishing the effectiveness of published income statements in supporting good corporate governance."

"The Federal Reserve staff estimates that the substitution of unexpensed option grants for cash compensation added about 2-1/2 percentage points to reported annual growth in earnings of our larger corporations between 1995 and 2000. Many argue that this distortion to reported earnings growth contributed to a misallocation of capital investment, especially in high-tech firms."

Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System
New York University Stern School of Business, March 26, 2002
Hyper-Co

TREND LINE

EXERCISE

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A Perverse Incentive?

**Acquisition**
- Company A to buy Company B?
- 1/3 probability of success $20 rises to $30 per share
- 2/3 probability $20 becomes $10 per share
- Expected value $16.67 ➔ So REJECT
A Perverse Incentive? (cont)

- **INJECT OPTIONS**
  - 1 million at $20 per share
  - 1/3 chance of $10 million gain in one year!

- **RESULT** ➔ Go for it!!

- If you fail ➔ ISSUE MORE ➔ OR REPRICE!
A Perverse Incentive? (cont)

**Increase Debt**

“Increase in options = increase in debt? It’s a heads-I-win, tails-I-don’t lose situation, so it’s not surprising that management teams are increasingly swinging for the fences.”

_Tilson Capital, NY Money Management Firm_
_April 2002 “Fool on the Hill”_
<table>
<thead>
<tr>
<th>Year</th>
<th>Defendants</th>
</tr>
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<tbody>
<tr>
<td>2002</td>
<td>PrimeZone Media Network</td>
</tr>
<tr>
<td></td>
<td>World com/Salomon Smith Banney</td>
</tr>
<tr>
<td></td>
<td>World Access Inc/Lehman Brothers</td>
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<tr>
<td></td>
<td>Metromedia Fiber</td>
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<tr>
<td></td>
<td>Enron/UBS Painwebber</td>
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<td></td>
<td>Microsoft/Merrill Lynch</td>
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<td></td>
<td>CISCO</td>
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<td></td>
<td>SAPIENT</td>
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Class Action Lawsuits

“I believe the industry will probably pay out US $20 billion in the next five years in option cases.”

Lawrence Klayman
Klayman & Toskes
March 2002
“In Praise of Options”: Revisited

<table>
<thead>
<tr>
<th>The Theory</th>
<th>The Practice?</th>
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<tbody>
<tr>
<td>1. Employees only gain only if shareholders gain</td>
<td>Perverse Incentive?/Repricing/ excessive dilution/megagrants</td>
</tr>
<tr>
<td>2. No P&amp;L cost</td>
<td>Much criticism - soon to change?</td>
</tr>
<tr>
<td>3. Simple to communicate and understand</td>
<td>Often still misunderstood: 39% “knew little or nothing”</td>
</tr>
<tr>
<td>4. Risk free for employees</td>
<td>Then why class action law suits?</td>
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The EU Requirements

- 7 June 2002 - EU Council of Ministers approved regulation imposing IAS on EU listed companies by 1 January 2005
- Exemption to 1 January 2007 for US listed companies reporting under US GAAP
- Unlike EU Directives, EU Regulations come into force without the need for national legislation
The IASB Proposals: Timeline

- Discussion Paper comments closed 15 December 2002
- Advisory committee met in March and June
- Exposure Draft IFRS planned for Q4 2002
- IFRS on Share Based Payment planned for second half 2003
- Effective: Accounting Periods starting on and after 1 January 2004
IASB Main Proposals: Prospective

- Recognising an expense for options will be required
- The fair value of the options granted will be judged at the grant date using an option valuation model
- The non-transferability of employee options (compared to traded options) will be reflected by assessing the expected life of the option, not its total life
- The value will be further reduced to reflect the impact of performance conditions governing vesting (unless the condition is a premium price in which case the valuation model should already reflect this)
- The expense will be recognised over the period from grant to vesting
- Disclosure of the key assumptions used (e.g. the main terms of the option, the volatility, dividend yield and risk-free interest rate) will be required
IASB Main Proposals: Prospective (cont)

- Temporary tax timing differences may be accounted for through a deferred tax account but permanent differences will be recognised in the income statement.
- Shares provided by third parties (e.g. employee trusts or major shareholders) will be inside the provisions of the IFRS.
- SARs will be accounted for as a cash liability.
- Options which lapse unexercised (due to failing a performance condition or at the end of the option term) will not cause an adjustment.
- Where a cash/shares choice is involved then special provisions will apply depending on whose choice it is and how the choice has been used in the past.
IASB Main Proposals: Prospective (cont)

- The proposals apply to both new issue shares and hedged share plans. The impact of hedging will be accounted for separately.

- The proposals will apply to unlisted as well as listed companies. Guidance on how to estimate volatility will be given for newly listed companies and unlisted companies.

- The IFRS will apply to options granted after the date the Exposure Draft is issued - and to all cash settled arrangements.