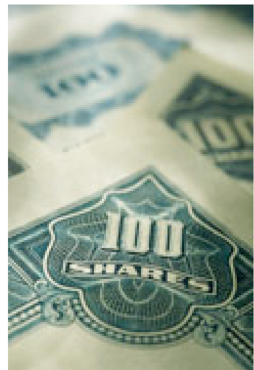
How New Accounting Rules Are Changing the Way CEOs Get Paid

Published : May 03, 2006 in Knowledge@Wharton



This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.

When a well-known compensation consulting firm predicted in early April that new accounting rules wouldn't have any impact on the use of options as compensation for corporate executives, Wharton accounting professor Mary Ellen Carter was ready to disagree. "That's just not true," she says. "Options will be cut and directors will be switching to restricted stock for executive compensation."

Carter's response is the result of her research into the role of accounting in the design of CEO equity compensation, specifically as it relates to the use of options and restricted stock. Her study coincides with a ruling, implemented this year by the Financial Accounting Standards Board (FASB), requiring all firms to expense the value of employee stock options. Specifically, Carter looks at the accounting practices of 1,500 firms from 1995 to 2001, before many large companies began expensing stock options but during the years when the FASB began pushing the reform. Carter corroborates the findings of her study by examining changes in CEO compensation within firms that voluntarily began to expense options in 2002 and 2003.

In a new paper on this topic entitled, "The Role of Accounting in the Design of CEO Equity Compensation," Carter concludes that CEO compensation will change now that companies are required to subtract the expense of stock options from their earnings, just as they are required to account for salaries and other costs. And Carter predicts that as a result, firms will switch from options to restricted stock as a preferred compensation option.

"By eliminating the financial reporting benefits of stock options, firms expensing stock options no longer have an ability to avoid recording expenses with any form of equity compensation," writes Carter, who authored the study with Luann J. Lynch, a professor at the Darden Graduate School of Business Administration, and Wharton accounting professor Irem Tuna.

"We found that companies prior to the rule changes granted more options because of favorable financial reporting. Results suggest that favorable accounting treatment for stock options led to a higher use of options and lower use of restricted stock than would have been the case absent accounting considerations. Our findings confirm the role of accounting in equity compensation design."

Leveling the Playing Field

The timing of Carter's report could hardly be better.

This past year, a revised FASB rule took effect that requires companies to expense the value of stock options given to employees. Most public companies are required to expense options for fiscal years beginning after June 15, 2005. Since most companies operate on a calendar basis, this means expensing options by March 31, 2006. Known as SFAS 123(R), the new accounting standard was developed by the FASB to create a more level playing field when it came to management incentive compensation and its impact on a company's bottom line. Before SFAS 123(R), companies that gave out stock options did not have to report the "fair value of the option" -- i.e., did not have to claim the options as an expense, which in turn would result in a reduction in net income at the end of the fiscal year. However, companies that

 All materials copyright of the Wharton School of the University of Pennsylvania.

relied on cash bonuses or restricted stock for equity compensation have always had to report or "expense" the value amount, an accounting requirement that reduced corporate net income at year's end.

The FASB first proposed changing the accounting standard in 1991. At the time, the move was strenuously opposed, particularly by many hi-tech firms and start-up businesses that relied heavily on stock options as an incentive to recruit and motivate employees to work for companies that reported little or no income. As nearly everyone knows, stock options are perks given to employees that allow them to buy company stock in the future at a set price. If the stock rises before the options are exercised, the employee can buy the stock at the lower predetermined price, and then sell it at the higher price and quickly realize the difference.

During the dot-com boom, the use of stock options skyrocketed. According to the National Center for Employee Ownership, up to 10 million employees held stock options by 2002. "Stock options were always seen as an incentive, a way of tying employee or executive action and company performance to compensation," says Carter. "In other words, 'You will get something if you get the stock price to go up.' It was a way of aligning employees' and executives' interests with those of the shareholders."

But from the beginning, companies balked at putting a numerical value on options and expensing them, arguing that doing so would result in a negative impact on their stock price. After intense lobbying, the FASB backed off the proposal in the early 1990s, but issued a compromise, known then as SFAS 123: Companies had to disclose the use of stock options and their fair value in the footnotes of their financial reports or proxy statements.

Nearly 10 years later -- in the wake of the volatile post-Enron era, when improper and unethical accounting practices were widely exposed in one corporate scandal after another -- the FASB returned to the concept of expensing stock options. At the time, corporate institutions like Global Crossing and WorldCom, in addition to Enron, had became synonymous with corporate greed, and anyone who followed their downfalls quickly understood how company executives who held substantial stock options were motivated to artificially inflate stock prices for their own financial gain.

In an effort to distance themselves from companies that routinely "cooked the books," many corporations wanted to showcase their ethical financial practices. So they began to voluntarily expense options in their proxy statements, a step above and beyond the footnote citation already required by the FASB. In 2002, General Electric, Bank One Corp., Coca-Cola, The Washington Post Co., Procter & Gamble and General Motors announced that they would expense options, along with Amazon.com and Computer Associates. Some companies -- like Papa John's International, USA Interactive and Microsoft -- announced that they were doing away with options altogether.

The push for corporate accountability and more transparent financial accounting practices received an undisputed boost with the Sarbanes-Oxley Act of 2002, which required that executives and auditors evaluate internal financial controls and be accountable for financial statements. In turn, the FASB responded in early 2004 by presenting the revised draft of its accounting standard related to options expensing, or SFAS 123(R). This time, there was little protest, primarily because companies had already responded to the suggested changes and were resigned to the practice of expensing options.

As *BusinessWeek* reported on April 1, 2004: "Like an approaching hurricane that generates more advance warnings than damaging winds, FASB's proposed rule probably won't cause a lot of additional change. Some 500 publicly traded companies have already started expensing options, or said they will. Many have begun shifting toward other non-option-based pay schemes that are likely to deliver more motivational bang for their compensation bucks. And investors, who can already look up option costs in the footnotes of companies' quarterly financial reports, seem to have grown accustomed to factoring the values of options into what stocks are worth."

 All materials copyright of the Wharton School of the University of Pennsylvania.

What, then, was the impact of accounting practices in the compensation choices for CEOs? Noting that "prior literature is inconclusive," Carter set out to determine if favorable accounting for stock options had motivated the use of options, deterred the use of restricted stock, and led to higher overall executive compensation. Carter and her fellow researchers focused on the use of options in CEO compensation before the new accounting standards went into effect -- through either voluntary or required measures. They studied 6,242 executive compensation packages from 1995 to 2001, using information from ExecuComp, a database of executive compensation information that covers the S&P 1500.

Carter's study found that the "method of accounting for options *has* affected decisions regarding their use." Among the findings:

Between 1995 and 2001, approximately 80% of the ExecuComp firms were granting options to CEOs, while only approximately 20% of these firms were granting restricted stock to their CEOs.

- The use of stock options increased steadily throughout the sample period. Specifically, the percent of sample firms granting options to CEOs increased from 76.5% in 1995 to 82.3% in 2001.
- Firms in the sample used very little restricted stock compared with options. However, the use of restricted stock to compensate CEOs increased steadily throughout the study period, from 18% of firms in 1995 to 21.6% in 2001.

Notes Carter: "We find that firms that are more concerned about the earnings they report used more stock options in their equity compensation due to the favorable accounting treatment for options, and that once firms start expensing stock options, they shift into restricted stock. Our analysis provides insight into what changes are likely to occur in CEO equity compensation now that the FASB has made stock option expensing mandatory: While we may not see an overall decrease in CEO compensation, we anticipate a decline in stock option use and an increase in the use of restricted stock."

Testing the Hypotheses

To corroborate these findings in her report, Carter also studied 206 firms from the same ExecuComp database that began to expense stock options in 2002 or 2003. Carter's goal was to determine "whether firms that expense stock options alter CEO equity compensation packages in response to the decision to expense options." Based on these firms' experiences, "we examine changes in the structure of CEO pay packages concurrent with and after the decision to expense options," Carter says. "Using this sample, we are able to test our hypotheses without having to rely on a proxy for firms' financial reporting concerns. Our findings confirm the role of accounting in equity compensation design. We find that firms expensing options decrease compensation from options and increase compensation from restricted stock, even after controlling for standard economic determinants of compensation and general economic trends."

For instance, Carter found that before expensing options, 88.7% of the firms in this sub-group were granting options as part of a CEO's compensation; during the year the firm first expensed options, the number of firms granting options dropped 18.6%, down to 68.9%; the year after expensing for the first time, the number of firms granting options dropped further to 64.3% for a total decrease of 23.7%. In contrast, the number of firms granting restricted stock to CEOs grew from 42.8% in the year before expensing options to 55% the year after expensing, an increase of 12.2%.

During an interview, Carter pointed to proxy statements from the following two corporations to illustrate how companies shifted from options to restricted stock for CEO compensation:

From Liberty Property Trust, proxy statement filed on 3/26/2004: *In making long-term incentive compensation awards with respect to 2003, the Compensation Committee, as it did with respect to 2002,*

All materials copyright of the Wharton School of the University of Pennsylvania.

placed greater emphasis on restricted shares and less emphasis on options as compared to past awards of long-term incentive compensation.... In part, this change is a reflection of the Trust's determination to begin in 2003 to record options as an expense at the time of issuance. Additionally, greater reliance on restricted shares reduces the potential dilutive impact from option grants. This change is intended to provide appropriate long-term incentive to Named Executive Officers that is competitive and consistent with the interests of shareholders.

From FBL Financial Group, proxy statement filed on 3/31/2004: *For 2004 we have included grants of performance-based restricted stock to the executive group. This change is partially in response to our expensing of stock option costs, and partially to create more performance based incentives for this key group. We traditionally grant stock options to executives and other key employees each January 15. For the 2004 grant, we have determined a target level of incentive awards to this group, then divided it by value, 50% in stock options and 50% in performance-based restricted stock.*

And what, if anything, happened to the amount of executive pay packages? Carter found "no evidence of a decrease in total compensation" to CEOs once companies expensed options. The fact that executive pay did not decrease led Carter to one of two conclusions: Either the favorable accounting treatment for stock options did not lead to higher levels of executive compensation "or firms find it difficult to downsize the large executive pay packages that resulted from the favorable accounting treatment for stock options," Carter writes.

In summary, Carter concluded, the fact that "firms are granting fewer options and more restricted stock suggests that these firms are shifting towards restricted stock [in order to] provide longer-term performance incentives, and that there will likely be changes in CEO compensation now that SFAS 123(R) is effective. Though firms may have appeared to favor options, under a regime of mandatory expensing, the role of options in executive compensation may be restricted."

Like an asterisk at the bottom of a key paragraph, Carter and many others who studied the ramifications of options expensing admit that the drop in granting stock options is something of an "unintended consequence" of the new FASB requirement. Why? Because the financial markets have proven to be relatively efficient; the accounting change to options expensing has actually not resulted in a significant drop in corporate stock prices, a byproduct once feared by companies opposed to the change. In 2004, a study by compensation consultant Towers Perrin of 335 companies that voluntarily began to expense options found no impact on their stock prices; another study by Bear, Stearns & Co in 2004 predicted that the options expensing change would reduce reported earnings of S&P 500 companies by less than 3%, according to *BusinessWeek*.

"There really shouldn't be a problem," Carter says. "The value of the options was in the footnotes. Anyone who is a hard-core market efficiency person would say that any information that is public is already included in the stock valuation. So expensing options shouldn't be making any difference at all. But it is. Companies are cutting back on options because they believe that there is an impact to expensing, but there really shouldn't be."

This is a single/personal use copy of Knowledge@Wharton. For multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International: reprints@parsintl.com P. (212) 221-9595 x407.