Minnesota Public Radio: Marketplace

Wednesday, July 24, 2002

Commentary: An alternative to expensing stock options

DAVID BROWN, anchor: You know, sometimes in order to understand a complicated issue, it helps to hear the argument; and not just an opinion, but a real back-and-forth. I mean, if Click and Clack can disagree about that pinging sound under your hood, surely a couple of Yale professors could disagree over expensing stock options. So let's think of this next bit as 'Add and Pad: The Numbers Guys.' Barry Nalebuff is a business strategy professor at the Management School.

Professor BARRY NALEBUFF (Management School): The bottom line is that options are a form of compensation and sometimes the dominant form, so not counting them means we really don't know how much executives are being paid or firms are really earning. That's terrible for investors because they don't really know how much a company is worth.

Professor IAN AYRES (Yale Law School): Now hold on. Wait a second.

BROWN: That is Yale Law School Professor Ian Ayres.

Prof. AYRES: So long as you disclose how many options are out there, even if it's just in the footnotes, smart investors and analysts can figure out what the likely cost is going to be down the road. Besides, how and when are you supposed to count them anyway? There'd be one expense when the options are issued and then a second cost when and if the options are exercised. Now that just wouldn't be right. And if you force firms to expense them today, that would hurt earnings and kick the stock market right when it's already down, just what we don't need.

And what's the problem anyway? Neither WorldCom nor Enron imploded because they failed to expense options.

Prof. NALEBUFF: Wait a minute. The very fact that you say stocks would fall if we were to count options is proof that investors today don't get the real costs. So you're admitting investors are clueless about a company's worth. Now at the peak of the Internet boom, the cost of Microsoft's options would have been more than its entire history of earnings. Look, options lead to excessive and outrageous CEO compensation packages and give managers incentives to take excessive risks. Execs make boatloads of money just by going up with the S&P. But options also reward volatility.

OK, so options issued over the last two years are worthless, but it's critical to start expensing them now because options issued at today's depressed prices will be a gold mine later, when and if stocks come back to par.

Prof. AYRES: Whoa. Taking risks is a good thing. Options reward executives for thinking big. They're also a great tool for preserving the remaining shreds of employee loyalty. And boards could always grant executives options that couldn't be exercised for some years, if we want to ensure the gains are real.

Prof. NALEBUFF: Ian, that I agree with, but expensing isn't enough. Damn it, they should have to go and buy those options. I don't want to stop firms from using stock options. I just want them to stop issuing the options. Why not make the firm go out and buy these options in the market? Goldman Sachs and Bear Stearns can compete to sell them. These investment banks buy and sell options all the time. That way, the firm really does incur an expense at the time the options are issued. And if and when they're exercised, it's Goldman or Bear that's on the hook.

Prof. AYRES: Ehh, this is just another ill-conceived ploy to get rid of options altogether. Now you're saying companies not only have to expense the options on their books, they actually have to pony up real dollars today? Just where are these dollars going to come from, Barry?

Prof. NALEBUFF: Ah, see that? So, finally, you agree with me. These options do have a real cost. I say don't trust analysts to figure out the hidden costs. Trust the market to get the stock and option prices right. It's fine to support stock options for secretaries, but not at the cost of bamboozling investors.

Prof. AYRES: In New Haven, this is Ian Ayres.

Prof. NALEBUFF: And this is Barry Nalebuff for MARKETPLACE.

BROWN: 'Add and Pad, The Numbers Guys' are Yale Professors

Barry Nalebuff from the School of Management and Ian Ayres of the Law School.