Stanford eCorner

Changes in Stock Options

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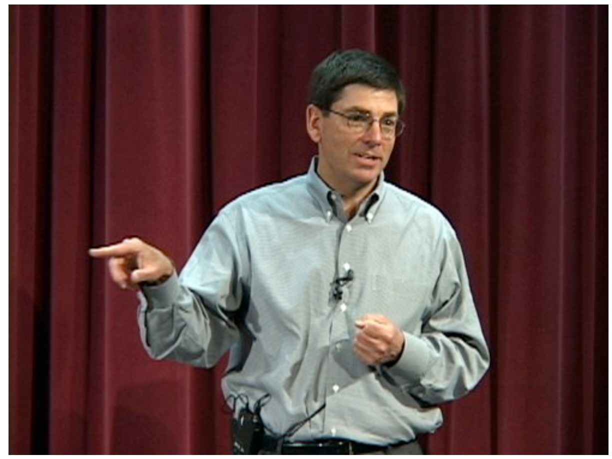
Video URL: http://ecorner.stanford.edu/videos/891/Changes-in-Stock-Options

The way in which stock options are valued is going to change. Though many companies have generous stock options, they also pay generous salaries because Silicon Valley is an expensive place to live and engineers need cash. Therefore, there is not a big differential between the salary with stock options and the salary without stock options. The size of stock options is likely to decrease, which means a reduced ownership of the company by employees and therefore a lowered incentive for creativity and innovation.



Transcript

Stock option accounting is definitely going to change. There will definitely be expensing of stock options. This is a very, very highly charged thing. There are bills introduced in Congress recently to try to limit it but it's clear that Congress and FASB and the SEC wants stock options to be expensed. The idea is it's some kind of phantom way to pay your workforce in a way that doesn't appear on the income statement. The truth is even though companies have very generous stock option programs, they also have free generous salary programs and so it used to be that a startup team would work for stock and not cash. That's true for a little bit of time but as you know, it's not cheap to live in Silicon Valley so the engineers need cash too. So the differential between the salary you pay without stock options and the salary you pay with stock options isn't that great. The big debate right now is how you value stock options. There's no really good science to this.

It's the Black Scholes model coauthored by a Stanford professor which was designed for trading options on the commodity exchange doesn't really work for long-term employee options. Many people think a great deal and values stock options and therefore it causes a bigger charge to earnings than should be, could be fair. So the big wrestle right now is how do you compute the value of a stock option? That's the thing that's up in the air right now. Between now and the end of the year, FASB is going to try to figure that out and we'll have a method January 1st I'm sure and all the companies would be forced to follow it. What's the impact? The impact I fear will be significant. Most companies are saying if forced to expense stock options, we will cut back on the number of stock options we grant to the rank and file, not to the senior executives. They'll still do that which is probably a third to half of the options anyway but will stop giving options to the rank and file. We'll just pay more cash. There are all kinds of other mechanisms; restricted stock, restricted stock units and some other things that would still create equity incentives but maybe not yield as big an accounting charge, but I think the result will be less stocks for employees. And then venture capitalists and entrepreneurs in this area feel less creativity, less of the ownership mentality and less successful for startup companies, less competitive advantage for the Silicon Valley type startup.

We'll see. I'm more optimistic than those critics. I think that we'll go back to something that the SEC tried to eliminate which is pro forma accounting. I think what will happen is stock analysts will say okay, what would it be without the stock charge? Because right now, there's a footnote disclosure of what the charge would be so now it will be up in the income statement. Everybody say okay, well, what if you back that out and everybody will calculate their own cash earnings or pro forma earnings? Maybe it will have no effect. I certainly hope that's true but what I'm hearing in boardrooms is expensing options will mean fewer options granted.