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Stock options expensing: An examination of agency and institutional theory explanations

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Abstract

As the debate over appropriate compensation disclosure continues, some firms have volunteered to recognize stock option costs within their income statements. On the one hand, stock option expensing can significantly enhance the legitimacy of the organization and restore shareholders' confidence in corporate governance practices. On the other hand, expensing stock options could decrease firm earnings, leading to unfavorable comparisons to non-expensing firms. Our logit analysis of 402 S&P firms lends partial support to agency theory explanations for stock option expensing; these results depend on the costs associated with expensing. We find stronger support for the institutional theory perspective that mimetic pressures significantly increase the likelihood that firms will expense stock options, independent of the cost. Our findings have important governance implications, suggesting a more complex model of compensation disclosure in which social pressures dominate voluntary compensation disclosure decisions.

Keywords: Compensation; Corporate governance; Institutional theory; Ownership

Long-term, outcomes-based incentives like stock options have been recommended as compensation tools to create better alignment between agents and principals by encouraging employment-undiversified executives to take appropriate risks that bring value to shareholders (Eisenhardt, 1989; Jensen and Meckling, 1976). Such payments were practically invisible to owners because options were not expensed within income statements and only were apparent in footnotes in the form of diluted earnings per share. Because options were not expensed, net income and earnings per share remained high, organizations continued to give out millions of costless options during the 1990s and early 2000s, and options became a large part of executive compensation. Had firms been forced to provide a more transparent accounting of the costs of stock options, compensation decision makers might have used more restraint. With the onset of the bear market of the mid-2000s and increasingly negative public sentiment regarding executive compensation, more firms are considering voluntarily recognizing stock options costs.

But why would firms decide to recognize stock option costs voluntarily within their income statements? From an agency perspective, principals (owners) prefer stock option expensing because it can reduce information asymmetries by more accurately reflecting the firm's financial position. Owners might advocate expensing because it would force companies to give stock options only when their incentive effect is greater than the cost and when options actually pay for performance (e.g., Aboody et al., 2003). Although some managers may voluntarily expense options to signal their optimism about the firm's future (Bastian et al., 2003), in general, agents do not want to expense stock options because doing so suppresses earnings and makes the firm appear less profitable than its non-expensing rivals. Given that the costs of stock option expensing have been estimated to decrease the average company's earnings by 10%, this decision is anything but inconsequential (Leonhardt, 2002).

From an institutional theory perspective, firms might adopt stock option expensing to acquire social legitimacy among networks of other expensing firms and to match the pervasiveness of expensing within their industries (Westphal et al., 2001;

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Westphal and Zajac, 1994). Firms may adopt expensing to signal that they have sound corporate governance structures in place, which enhances their credibility in the institutional context (e.g., Westphal and Zajac, 2001). In other words, firms may expense stock options not because expensing solves information asymmetry problems but out of a desire to be on the forefront of or join other firms practicing clearer corporate disclosure.

Given this context, we raise the following research question: How do agency, institutional, and cost factors influence management's decision to reduce information asymmetry by voluntarily recognizing the cost of stock option compensation? The answer is important for both management literature and practice. From a theoretical perspective, little is understood about how agency and institutional forces may be constrained or enhanced on the basis of the costs associated with reducing information asymmetry. From a practical standpoint, our study has implications for public policy and ownership research in general. Specifically, we identify the conditions in which firms voluntarily expense options, a choice made by managers and their advisors (e.g., boards) to improve the disclosure of compensation costs.

1. Hypotheses development

1.1. Agency theory and expensing

1.1.1. The agent perspective on expensing

Historically, managers have vehemently opposed the expensing of stock options (Espahbodi et al., 2002). If agents believe that markets will read the news of a firm's stock option expensing positively, they will advocate expensing (Bastian et al., 2003). However, we argue that agents will generally oppose stock option expensing because it increases the firm's expenses and reduces its net income. Furthermore, management may oppose expensing because it makes the relationship between performance and compensation more transparent, which results in lower levels of information asymmetry. Finally, managers are more likely to oppose expensing when the costs of expensing are greater, because missing earnings estimates can result in lower stock prices and reduced bonuses.

1.1.2. The principal perspective on expensing

Institutional owners may not view the voluntary recognition of options favorably because decreased earnings are bad for owners as well as for agents (Kothari, 2001). Stock options have often been given by organizations as a way to conserve cash, but owners experience the downside of these options through the dilution of their ownership and reduced earnings per share. However, we believe institutional owners will generally advocate expensing for several reasons. First, from the shareholders' perspective, the cost of options-based compensation should not exceed the associated benefits (Gillan and Starks, 2003). Requiring stock options to be expensed would cause compensation decision makers to think twice about issuing stock options haphazardly. Second, reduced information asymmetries between owners and managers have been associated with lower costs of capital and higher stock prices (Botosan, 1997).

Consistent with this theorizing, empirical research has found that institutional ownership concentration restrains executive compensation and strengthens the connection between compensation and firm performance (Khan et al., 2005). Recently, scholars have suggested that owners have different, often conflicting preferences and effects on organizational outcomes (Hoskisson et al., 2002; Ryan and Schneider, 2002). For example, major institutional owners (including diverse groups such as pension funds, mutual funds, and insurance companies) have different incentives to monitor (Black, 1992).

1.2. Long-term institutional investors

Institutions with long-term investment horizons maintain long-term relationships with the firms in which they have invested and engage in monitoring (Johnson and Greening, 1999). Safeguarding their interests relates to options expensing, in that expensing encourages additional accountability in compensation designs while restraining the dilution of shareholder value. We believe that long-term owners (i.e., pension funds, banks, insurance companies) will advocate expensing as a way to reduce information asymmetries.

Pension funds have significant, long-term outflows to beneficiaries and, because of the duration of their investments, are interested in improving their portfolios' long-term value (Hoskisson et al., 2002; Ryan and Schneider, 2002). Pension funds cannot exit their investments by selling large blocks of stock (Pound, 1988), are more likely to hold their investments (Gilson and Kraakman, 1991), and thus are more likely to monitor management (Johnson and Greening, 1999). Moreover, pension funds have been among the most vocal participants in organizations of institutional investors (Woidtke, 2002). Consequently, improving general corporate governance through information asymmetry-reducing actions like expensing is in the interest of pension funds.

Other long-term investors like banks sell stability as much as performance and face little pressure for short-term results (Black, 1992). Bank equity investing occurs through banks' trust function, through which banks generate fee income by acting as fiduciaries (Ryan and Schneider, 2002). Bastian et al. (2003) find that banks were early expensers and therefore may be more likely to support expensing in the firms in which they invest. Compared with short-term institutional investors, banks engage in long-term debt contracts that often cover several years. Similarly, insurance companies have predictable cash outflows and typically invest for long periods (Cox et al., 2004). Moreover, they often sell long-term policies to the firms in which they invest (Ryan and Schneider, 2002). For these reasons, we expect these and other long-term owners to prefer expensing, especially because they cannot simply exit.

Hypothesis 1A. Long-term institutional ownership will be associated with more stock option expensing.