The New York Times
nytimes.com

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November 10, 2002

When Options Rise to Top, Guess Who Pays

By GRETCHEN MORGENSON

BY proposing last week to make companies deduct the cost of stock options as they would any employee cost, the International Accounting Standards Board may finally be moving the corporate world closer to uniform treatment of this wildly popular and decidedly American form of executive pay. But the debate is not about to stop.

The board's move, which would make corporate accounting for stock options reflect reality, is already drawing fire from technology company executives and their lobbyists who favor keeping option costs out of corporate profit-and-loss statements. Proponents of the status quo argue that if options must be reported as expenses, companies will no longer dispense them.

Some say option grants are the best way to align the interests of executives with those of outside shareholders. Others, like Senator Joseph I. Lieberman, Democrat of Connecticut, contend that if companies stopped dispensing options, rank-and-file workers who receive them would be most hurt.

Now, though, a new and comprehensive academic study soundly disproves both rationales, giving shareholders more reason to reject new pay packages skewed in favor of top managers or not adequately linked to short- and long-term performance.

Joseph R. Blasi and Douglas L. Kruse, professors of human resource management at Rutgers, examined stock option grants and shareholder returns at the 1,500 largest American companies from 1992 to 2001. They found that companies dispensing significantly larger-than-average option grants to their top five executives produced decidedly lower total returns to shareholders over the period than those dispensing far fewer options.

As for the notion that options are primarily a rank-and-file perquisite — and that abandoning them would hurt lower-level employees — the study instead confirmed what many investors have suspected: in recent years, most options have gone to top executives. And that has been true at hundreds of companies, from Campbell Soup and United States Steel to the El Paso Corporation and the Rowan Companies.

Patrick S. McGurn, vice president at Institutional Shareholder Services, a shareholder advisory service in

Rockville, Md., said that the study would fuel a movement among pension fund managers and other institutional investors to start rejecting executive pay packages that pour on the options.

"I think companies are going to be shocked this season," he said.

Mr. Blasi said his study "strongly suggests that executive excess in stock options did not help total shareholder return over the entire decade.

"The problem," he added, "is not a few bad apples but the entire system of executive compensation which was created by a compromised system of corporate governance."

Carol Bowie, director of governance research services at the Investor Responsibility Research Center in Washington, says investors have rapidly become wary about stock options. "At the very least, options tended to promote a short-term focus," she said, "and at worst, they promoted fraudulent activity to manipulate earnings."

In their study, the professors looked at how widely companies had distributed options among their employees. Over the 10 years beginning in 1992, the median percentage of options going to the top five executives was 29 percent.

But companies that dispensed significantly more than the median — like R. R. Donnelley & Sons, which in 1997 handed out 94 percent of all options to its top five executives — disappointed in two respects. They produced lower overall returns to shareholders than did companies that dispensed less than the median and generally underperformed the overall market as well.

The study is part of the professors' forthcoming book, "In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them," to be published by Basic Books on Jan. 7. They researched and wrote the book with Aaron Bernstein, a senior writer at Business Week.

The professors ranked 1,500 companies according to how much of their options they awarded to their five most senior executives. The 375 that gave the most to their top executives — more than 40.8 percent of all options — performed worst, returning 22.5 percent over all to shareholders through 2001. The 375 companies that gave the fewest options to their senior executives — less than 19 percent — fared the best, giving investors a 31.3 percent return, on average.

After combing through the data, the professors said they were surprised by the number of companies that chose to hand over their entire annual stock option grant to just five top executives in any given year. According to regulatory filings from 1992 to 2001, an average of 11 companies a year gave all their options to five executives.

Companies that did so in one year during the period studied included Weatherford International, an oil

services concern; the Energen Corporation, an energy holding company; and Harvest Natural Resources, an oil driller.

"The assumption that the system is better for everybody by giving most of the pie to the top of the hierarchy is an assumption that is widely accepted by lawyers, accountants, Wall Street investment bankers and even by many academics," Mr. Blasi said. "But when you compare companies against each other, the more you increase the option grant to the top five executives above the mean, the worse your shareholder return gets."

Perhaps in reaction to investor ire about excessive executive compensation during the stock market's fall, no company gave 100 percent of its options to top executives in 2001, and only three gave more than 90 percent. And the median share granted to the top five executives fell to 18.2 percent in 2001, from a high of 28 percent in 1994.

IT is perhaps not surprising that as the stock market climbed throughout the 1990's, more and more companies were giving their top executives larger-than-average option grants. Investors did not seem to mind the transfer of wealth that these option grants represented, maybe because the investors themselves were making money on the stocks.

In 1992, for example, only 375 companies exceeded the average percentage given by companies to their top executives. But that number rose steadily during the decade, to 733 in 1999. The number has since tumbled: last year, 226 companies gave their top executives more than the average grant.

Mr. Kruse, who is also a research fellow at the National Bureau of Economic Research in Cambridge, Mass., said his study underscored the need for institutional investors to be vigilant about huge grants.

"While institutional investors are enjoying beating up on executives these days," Mr. Kruse said, "one sad implication of these results is how they actually point the finger at those same institutional investors for leaving corporate governance to the wrong people.

"Anyone who claims there hasn't been a systematic corruption of business as usual using the legal system as a front, compensation consultants as handmaidens and corporate human resources staffs as lackeys doesn't understand what's gone on."

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