The Market's Reaction To The FASB Stock-based Compensation Project

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Abstract

Stock-based compensation plans are often used by companies as a method of providing incentive compensation to top executives. In this study we investigate the market response to the announcement and subsequent withdrawal of the FASB stock-based compensation project. Our findings suggest that investors expected the reduction in uncertainty resulting from expensing stock option costs to enhance firm value and were disappointed when the FASB withdrew the project.

Introduction

The Financial Accounting Standards Board (FASB) recently considered the accounting for stock-based compensation covered by *Accounting Principles Board Opinion* (APBO) No. 25. Specifically, the FASB was concerned that APBO 25 permitted the granting of stock options to executives without requiring any reported expense in the financial statements. In 1992, the FASB added a project on stock-based compensation to its agenda which resulted in the issuance, and subsequent withdrawal, of an Exposure Draft that would have required companies to report the cost of stock options as an expense in the determination of income. Corporations were opposed to the FASB project citing difficulties in estimating the amount to expense and claiming that costs would outweigh any benefits to shareholders.¹

The purpose of this study is to investi-

gate the market response to events associated with the introduction of the FASB's project and the subsequent withdrawal of the Exposure Draft. Based on standard event study methodology, the results suggest that investors expected the required reporting of the cost of stock options to be beneficial and to outweigh the costs to firms that rely heavily on stock options in their compensation pay schemes. When the FASB dropped the project, a negative market reaction followed.

Since 1972, accounting for employee stock options has been covered by *Accounting Principles Board Opinion* (APBO) No. 25, "Accounting for Stock Issued to Employees". APBO 25 classifies stock option plans as either noncompensatory or compensatory. Noncompensatory stock option plans are designed to encourage ownership of the company's stock by its employees. Under noncompensatory plans, the company does not recognize any compensation expense. Compensatory plans, which are the fo-

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cus of this study, are plans designed to provide additional compensation to a select group of employees, generally the top executives of the company. Compensation expense is recognized as the difference between option price and market price at the measurement date, which is generally the date of the grant. Thus, if the option price is equal to the market price at the measurement date, no compensation expense is reported regardless of the length of time over which the options can be exercised. This requirement provides a method for additional compensation without an immediate recognized expense.

Stock option plans are increasingly used by companies as a method of providing executive compensation. A major benefit to the company is that executives profit only to the extent that the company's stock price increases. "If a firm's stock price reflects its future value, as theory suggests, linking management compensation to stock prices ensures that management actions are in the long-run interests of stockholders." (Hill and Snell, p. 28) Thus, in theory, these plans tend to align the interests of both the executives and the stockholders, which should counteract any potential agency problems that may arise otherwise (Demsetz, 1983; Lewellen et al, 1985).

Stock option plans can also be considered as an uncertain expense or cost to firms. A survey by the Conference Board in 1992 found that stock option plans were widely used across all industries and that the amount of stock-based compensation was significant. The same study found the size of the grants was frequently greater than the amount of regular compensation. For example, in 1992, Michael Eisner of Walt Disney realized \$197 million from the exercise of options and subsequent sale of the stock. Yet, due to the current reporting requirements of APBO 25, no compensation expense was recognized for these grants.

Recognizing the potential hidden expenses associated with APBO 25, and given the

increased use of stock option plans, the American Institute of Certified Public Accountants' (AICPA) Accounting Standards Executive Committee, the staff of the Securities and Exchange Commission, and others asked the FASB to reconsider APBO 25. On February 26, 1992, the Board added the stock-based compensation project to its agenda and subsequently issued an Exposure Draft, *Accounting for Stock-Based Compensation*, which would have superseded parts of APBO 25 and required that the value of stock options, computed using an option pricing model, be reported in the financial statements of the employer. Additionally, various disclosures were required, including such items as a description of the method and significant assumptions used to estimate the fair value of options.

Corporate America's reaction to the stock-based compensation project was unprecedented in the history of the FASB (Harlan, 1994). More than 500 letters of comment were received, far more than had been received for any previous project. The vast majority of these letters objected to the proposed requirements. Typical of these letters was one from Craig Swanson, Vice President of Finance for Protocol Systems, Inc., which stated the proposal "is a DISASTER for America." Another letter critical of the proposal was signed by 380 mostly high-tech companies. All of the Big 6 accounting firms, as well as at least one SEC commissioner, objected to the proposal. In the U.S. Senate, resolutions were passed urging the FASB to abandon the project. The chief criticism was that the difficulty of placing a value on the options, given the volatility of even those stocks with established markets, would make the reported cost at best a "guesstimate" and thus of little value to the users of financial statements. Clearly the disclosure, on the face of the financial statements, of the amounts paid to executives struck a raw nerve. Although the Board stated on a number of occasions that they would not back down from their intention to require employers to expense the cost of options, it was announced on December 14, 1994 that the Exposure Draft would be withdrawn and that the cost

of stock options would not be required to be reported as a component of earnings.²

The FASB has, at various times and through various means, acknowledged the external pressures that are exerted on them. For example, it has considered the economic consequences of proposed standards defined as the potential impact on businesses, government, unions, investors, and creditors, by commissioning studies of economic consequences (Zeff, 1978). An example of the impact of lobbying by businesses on the FASB's actions is provided by Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions". SFAS 87 itself ". . . makes quite clearly that major compromises were made in arriving at a standard that was acceptable to the corporate constituency . . ." The FASB's stock-based compensation project, therefore, provides a test for the value of additional disclosures as determined by the market.

The objective of this study is to determine how the market perceived the FASB's stock-based compensation project would impact on firm value. Several arguments relative to the need for determining and reporting the value of stock options are studied. The first is that the FASB project could result in a net cost to firms that rely on stock options as a form of compensation, an argument opponents to the FASB proposal advanced. If this line of reasoning is correct, one would expect that companies using stock options would experience negative abnormal returns around event dates when new information regarding positive progress on the FASB's proposal is made known. A second argument is that the market is aware of the use of stock options and can reliably determine the cost of the options. Thus, one would expect no abnormal returns under this viewpoint, since the reporting of this information would not provide new information to the market. The third argument is that the FASB proposal provides additional information in the form of a reduction of uncertainty of future cash flows that are a function of stock options and their cost. When ex-

ecutive stock options are exercised, firms must either supply the stock from treasury shares, purchase the shares in the market or issue new shares. In all cases actual costs are incurred by the firm. The reduced uncertainty of these costs that the FASB proposal could provide might be viewed positively by the market and thus would result in positive abnormal returns.

Statistical Methodology

Market response to the decision to add this project to the Board's agenda and the withdrawal of the Exposure Draft provides information on investors' expectations regarding the FASB's stock option project. The first event date, February 26, 1992, is when the stock-based compensation project was added to the Board's agenda. Since this signaled renewed interest in reporting the cost of stock options, this is clearly an important date. The second event date, December 14, 1994, is when the withdrawal of the Exposure Draft signaled a major change in the Board's position regarding the expensing of stock options.³

Firms appearing in the *Wall Street Journal 1995 Executive Pay Survey* are used in this study. These firms are used since they are closely monitored and thus would be likely to show any market impact due to the FASB project. Additionally, they are widely diversified across industries. For each of the firms listed in the survey, information regarding the use of stock options for the five highest compensated executives in each company was collected using Lexis/Nexis. A ratio of compensation from stock options to compensation from cash was computed for each firm. Based on this information, the sample was divided into two subsamples, one with lower than average reliance on stock options as a percentage of total compensation and one with above average reliance on stock options.⁴

Daily returns are taken from the University of Chicago Center for Research in Security Prices (CRSP) Daily Data File. In addition,

Figure 1
Sample Firms

Source	Number of Firms
<i>Wall Street Journal Executive Pay Survey</i>	191
Lexis/Nexis Search - missing firms	(48)
CRSP - missing firms	(12)
Total sample size	131
Firms with above average reliance on stock options for compensation	73
Firms with below average reliance on stock options for compensation	58

thinly traded stocks are dropped based on the criterion that the stock had to be traded in over 50 percent of the estimation period. This reduces problems with non-synchronous trading.⁵ The final number of firms in the sample is 131, of which 73 have an above average reliance on stock options as a method of compensation and 58 have a below average reliance on stock options as a method of compensation. Figure 1 provides details of the sample size.

Event study methodology, as described by Brown and Warner (1985), is used to measure abnormal returns around the two event dates of February 26, 1992 and December 14, 1994.⁶ An event study describes a technique of empirical accounting and financial research that enables an observer to assess the impact of a particular event on a firm's stock price. Analyzing the impact of any announcement on a firm's stock price is a difficult task. On any particular day stock prices respond to a wide range of economic news. Isolating the part of a stock price movement that is attributable to a specific type of announcement is not a trivial exercise. An event study is a marriage of efficient market theory with the market model. The objective is to measure the unexpected return that results from an event. This is the difference between the ac-

tual stock return and the return that might have been expected given the performance of the market on a particular day.

Abnormal stock returns are generated by first computing daily returns for each security j using the index model

$$R_{jt} = \alpha_j + \beta_j R_{mt} + \varepsilon_{jt} \quad (1)$$

where

t = from -120 to -3 for each event date,

R_{jt} = return for security j on day t ,

R_{mt} = return on the CRSP equally weighted index,

α_j , β_j = parameters of the market model, and

ε_{jt} = unsystematic part of security j 's return on day t .

The index model in this form is called the Market model and holds that stock returns are determined by a market factor and a firm-specific factor. Estimates of the market model parameters are derived using security j 's observed daily return on day t and the CRSP equally weighted market index m on day t . The

Table 2
Second Event Date
Exposure Draft Withdrawn

Panel A						
Firms with Below Average Reliance on Stock Options						
Period	Standardized Average Residuals (SAAR)	Positive/Negative		t-stat	Standardized Cumulative Average Residual (SCAAR)	t-stat
-2	0.332	39	19	2.523*	0.332	2.523*
-1	-0.090	24	34	-0.688	0.242	1.301
0	-0.023	30	28	-0.172	0.219	0.963

Panel B						
Firms with Above Average Reliance on Stock Options						
Period	Standardized Average Residuals (SAAR)	Positive/Negative		t-stat	Standardized Cumulative Average Residual (SCAAR)	t-stat
-2	-0.563	25	48	-4.809*	-0.563	-4.809*
-1	-0.510	17	56	-4.360*	-1.073	-6.483*
0	0.068	36	37	0.579	-1.005	-4.959*

* Significant at the .05 level

mechanism for correctly conveying information into the firm's disclosure statements, thereby discouraging manipulation and time inconsistency. This ensures that firms have a commitment to timely disclosure and that the process of transforming firms' information into disclosure messages is well understood.

Conclusions

In this research, the impact of the FASB's stock-based compensation project on the value of common equity of firms using stock options in their executive compensation plans is studied. The results suggest that investors expected the FASB stock option proposal to reduce the uncertainty of the firm's future cash flows. Reduced uncertainty can lead to lower discount rates and, therefore, higher firm value. Based

on the findings of this research, the FASB stock option proposal was not perceived by investors to have the dire effects that many large corporate opponents to the proposal had suggested. In other words, the decision to withdraw the Exposure Draft due to external corporate pressures may not have been in the best interest of common stockholders. It should be noted that the companies in the sample were large companies closely watched by Wall Street. A study based on a sample of smaller, less closely monitored companies may yield different results.

Implications For Future Research

While previous research has examined the market effects of issued FASB Statements, the proposed stock-based compensation project provided a unique opportunity to examine the

market effects of a proposed statement that was withdrawn. Given the resolve shown by the FASB to issue this statement, in spite of strong opposition, the decision to back down caught many by surprise. The market effects found in this study could result from the withdraw of the proposed statement itself, or perhaps relate to a perceived change of direction by the FASB which could effect future accounting standards. Studies of previous statemnets that were later withdrawn or exposure drafts that did not become final statements, could shed light on these issues.

Endnotes

1. The FASB recently resolved the controversy whether to require companies to expense the value of stock options granted to their top executives by requiring footnote disclosure in the financial statements.
2. The stock-based compensation contract is an agreement between the firm and the executive for the firm to provide a specified number of shares to the executive after a specified time period at a specified price. If the firm supplies the shares from treasury stock, it forgoes the opportunity to sell the shares in the market at a higher price. The same is true for issuing new shares. If the shares are purchased in the market, then the firm is "buying high" and "selling low" to the executive. In all cases, the markets may view internal estimates of these costs as reducing uncertainty.
3. Four additional event dates between February 26, 1992 and December 14, 1994 were also studied, but not reported. They are: March 4, 1992 - The first public meeting of the FASB on the project; April 7, 1993 - The Board instructs the FASB to prepare and Exposure Draft; June 9, 1993 - The Board approves the Exposure Draft; and June 30, 1993 - The Exposure Draft release date. None of these dates resulted in statistically significant cumulative abnormal returns over the entire three day event window studied. The results are

available from the authors upon request.

4. The experimental design of grouping is founded in the concept of local control, which is often statistical design proper. Local control is intended to reduce experimental errors and make the analysis more powerful. Local control is often obtained by means of stratification of the experimental units as done in this research.
5. Since this sample of firms is taken from the NYSE and the firms are some of the country's largest followed by COMPUS-TAT, problems with non-synchronous trading are minimal.
6. Karafiath (1994) analyzes the "event-clustering" scenario using Monte Carlo procedures. He finds that OLS is well-specified in finite samples and that, for sufficiently large cross-sections, there is no advantage to several other more complex estimators.

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