

The Implications Of Expensing Stock Options On Corporate Governance

Vinita Ramaswamy, University of St. Thomas, Houston
C. Joe Ueng, (E-mail: ueng@stthom.edu), University of St. Thomas, Houston

ABSTRACT

This paper examines the roots of the abuse of stock options, finding it centered on a principal/agent problem that arises when employee stock options are not required to be expensed in the income statement. The failure of corporate governance, including the proper oversight of executive compensation, and the failure of FASB to require expensing stock options, leads to a management-centric organization whose motives diverge from the interests of shareholders.

INTRODUCTION

Employee stock options, or ESOs, were initially introduced as a means of compensating valued and innovative employees, giving them ownership in the company's performance by linking their work effort, stock prices, and their compensation levels. Used wisely, employee stock options were considered to be a crucial ingredient that gave management ownership interests, and thus prevented them from focusing on short-term results. They could then spend on R&D, repairs, maintenance, capital replacement and other issues that cut into short-term profits, but increased long term profitability. Stock options were also a way to reward employee contributions without cutting into the scarce capital and cash resources required for company investment and growth. Early accounting rules did not require stock options to be expensed on the income statement; however they were deductible for tax purposes. This gave a double boost to bottom line net income, and companies saw their earnings and stock prices grow.

As stock options became very popular in the 1990's, especially as the stock market grew by leaps and bounds, boards of directors and their compensation subcommittees should have been increasingly on the lookout for abuses. Yet too many companies in this country had no cogent internal processes to evaluate CEO performance. They had effectively outsourced the evaluation of CEO performance and compensation to the market, and often to consultants. As an example, from 1990 to 2001, the share of equity-based compensation in total CEO compensation grew from 8 percent to 66 percent. Almost all of that was due to ESO programs that made relatively poor use of market information and were poorly designed. Faced with a galloping bull market and consultants who regularly overstated compensation packages, CEO compensation ratcheted up to high and very often distorted values. The *Wall Street Journal* reported that while average CEO compensation was about \$ 2 million, their stock options were 15 to 90 times their base pay.

The dotcom bust in the mid nineties first focused investor attention on stock options. Then came a series of accounting scandals that seemed to grow and multiply. As stock markets crashed and investors lost confidence in reported earnings numbers, analysts and researchers discovered that employee stock options gave rise to numerous abuses. Managers continued to focus on increasing stock prices, rather than on increasing the true economic value of companies; stock prices could be artificially inflated by granting compensation in the form of stock options—compensation whose value need not be deducted from revenues when calculating net income. Boards awarded huge stock options to their chief officers, in spite of poor or apathetic performance. In cases of poor performance, boards added insult to injury by repricing the stock options. Instead of reigning in ESO abuses, corporate boards gave CEOs free reign, and the abuses multiplied. This failure of corporate governance cause many stakeholders to suffer unnecessarily.

This paper examines the roots of the abuse of stock options, finding it centered on a principal/agent problem that arises when employee stock options are not required to be expensed in the income statement. The failure of corporate governance, including the proper oversight of executive compensation, and the failure of FASB to require the expensing of stock options, leads to a management-centric organization whose motives diverge from the interests of shareholders.

CORPORATE GOVERNANCE: AN OVERVIEW

To understand the linkages between the abuse of employee stock options, the failure to expense these options, and the failures of corporate governance, we must first familiarize ourselves with each of these issues. A specific definition of corporate governance to difficult to state, as it covers a number of economic phenomena. According to the OECD, “corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities amongst different participants in the organization. This includes the Board of Directors, managers, shareholders and stakeholders, which spells out the rules and procedures for making decisions in corporate affairs.

Matheson (2002) however, defines the concept thus: “Corporate governance is a field in economics that investigates how to secure/motivate efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation.” Thus corporate governance not only includes the rules governing the relationships between all the stakeholders of a company (shareholders, directors and managers) as defined by the corporate charter and its bylaws, it also includes the agency problem of motivating managers to work in the best interests of the shareholders. Such motivation came from stock options.

STOCK OPTIONS: AN INTRODUCTION

Employee stock options grant employees the right to purchase (or *exercise*) company stock at a specified price (known alternatively as the *grant*, *strike*, or *exercise* price) during a specified period of time (known as the *exercise* period). It is common for the exercise price to be set equal to the market price of the company stock at the time the options are granted, and it is also common for the exercise period to begin 4 or 5 years after the options are granted and persist for ten years, but these parameters can vary from firm to firm, subject to legal restrictions. As the company stock appreciates above the strike price during the exercise period, ESOs increase in value, since employees have the option to purchase shares below their market value; on the other hand, if the stock price remains below the strike price then the ESOs are *under water*, or worthless.

Two types of stock options are most common in the United States—*incentive* stock options (ISOs) and *nonqualified* stock options (NSOs). By law, the exercise price of ISOs must be equal to or greater than the market price of the company stock at the time the options are granted. ISOs enjoy more favorable tax treatment for most employees than their wage income; taxes are deferred until any exercised stock is sold, and the capital gain is taxed at a lower rate than most employees’ ordinary income tax rates. To gain these tax benefits, employees must adhere to restrictions; an employee cannot sell exercised stock until at least one year after the exercise date and two years after the grant date, and only \$100,000 of ISOs may be exercised annually per employee.

NSOs have fewer restrictions and fewer tax advantages to employees compared to ISOs. The exercise price may legally be set below market value, and (unlike ISOs) the employee may legally transfer NSOs to children or to charity. A personal tax liability is created as soon as NSOs are exercised, on the *bargain element*—the capital gain derived from the spread between the exercise price and the market price of the exercised stock, and this liability is taxed at ordinary income tax rates. The company is allowed a tax deduction for the bargain element (equivalent to the deduction it would receive had it paid an equivalent amount of ordinary wages to the employee).

A BRIEF HISTORY OF EMPLOYEE STOCK OPTIONS IN THE UNITED STATES

The Firestone Tire and Rubber Company is generally acknowledged as the first American company of significance to grant its employees stock options; beginning in 1916, Firestone employees were awarded the option to acquire shares of company stock at below-market prices. More recently, interest in awarding stock options as a form of employee compensation was probably sparked by the experiences of the eight founders of Fairchild Semiconductor Corporation. In 1957 their financier, Fairchild Camera and Instrument, agreed to fund the new company only if it was granted the option to buy the ownership equity of the founders at a later date if the new company prospered. Several years later the eight owners' equity was purchased, and each owner realized a capital gain of approximately \$1.5 million (measured in 2004 dollars). Some of these eight entrepreneurs then founded their own technology companies (including Intel, Teledyne, Union Carbide, and Advanced Micro Devices) in the 1960s and 1970s; realizing the power of stock compensation to lure young talent in lieu of high salaries, these and other cash-strapped startup technology companies offered stock options as compensation.

Outside of the technology industries, in the 1960s and 1970s stock options were employed primarily as tax shelters for high-level executives' incomes. During this period the highest tax bracket for ordinary income peaked at 91%, but for most of this period income derived from the exercise of stock options was taxed at lower capital gains rates (as low as 25%). Then in 1978, cash-poor Toys-R-Us, newly emerged from bankruptcy and lacking funds to provide competitive salaries to upper-level managers, set aside an unheard of 15% of its outstanding shares for stock options for executives. Within four years the hugely successful company saw its stock price increase more than 2000%, resulting in multi-million dollar gains to several employees, including a \$120 million (in 2004 dollars) gain accruing to CEO Charles Lazarus.

The Toys-R-Us experience encouraged more widespread use of stock options for employee compensation in the 1980s, and this use was fueled by the Reagan-era bull market and tax cuts. In the 1990s, reductions in capital gains taxes, the Clinton-era bull market, and an October 1995 FASB ruling further accelerated the use of stock options for employee compensation. By the turn of the 21st century, ESOs were commonplace even among middle managers, and the success and widespread use of ESOs, fueled by spectacular increases in stock prices, had peaked.

In the year 2000 the NASDAQ index climbed above 5000; over the next two years it lost more than 80 percent of its value. Many ESOs granted during this period expired worthless or remain under water in 2004. Also during this time a number of high profile corporate scandals emerged, including the bankruptcies of Enron and MCI/Worldcom, and scandal over executive compensation at Tyco International. Shareholders, regulators, and politicians increasingly questioned the large grants of ESOs to corporate executives, and some blamed the accounting treatment of ESOs for exacerbating corporate malfeasance. Indeed, at a May 2003 press conference, Senator Carl Levin stated that "Stock options are the 800 pound gorilla that has yet to be caged by corporate reform. Corporate scandals have shown how current U.S. accounting rules are fueling stock option abuses linked to deceptive accounting, excessive executive pay, and nonpayment of taxes by profitable corporations." The link between stock option compensation and income manipulation was becoming increasingly obvious during these years. As revenues flatlined and expenses soared, managers resorted to artificial means to meet earnings targets, and to earn their options.

EARNINGS MANAGEMENT AND STOCK OPTIONS

Of late, the term "earnings management" has been appearing with distressing regularity within the financial community. Also known by other names such as "creative" or "aggressive accounting", or "income smoothing", these activities have a singular ultimate objective - creating an imprecise picture of a firm's financial performance. Arthur Levitt, the past chairman of the SEC called it a "game among market participants." The rewards of this game can be many and varied. These include: increased share prices, improved debt rating and reduced interest costs, higher bonuses for company executives, lower political scrutiny resulting in less regulatory action, and less taxes. With so much at stake, it is no wonder that more and more companies are willing to enter this risky, and many times, unethical game.

There is an accumulation of recent evidence supporting the contention that stock options encourage earnings management, as CEOs and other upper level managers focus on maximizing the firm's short term share price (and the values of their own options) rather than the firm's intrinsic value. This evidence includes Bergstresser and Philippon (2003), Gao and Shrieves Cheng and Warfield (2003), Kedia (2003), and Peng and Roell (2004). Often this short-term manipulation results in later earnings restatements (as shown by Kedia) that evaporate shareholder value after the managers' options have been exercised. In extreme cases, accounting gimmicks and outright fraud lead to the eventual bankruptcy of the firm (as in the Enron debacle).

How Are Earnings Managed?

This so called "game" with accounting numbers is played by actively altering reported financial results in the income statement or the statement of cash flows, or altering even the numbers of financial position reported in the balance sheet. The objective of this misstatement is, as stated earlier, to achieve some desired amount or a desired trend in the financial statements. A company can achieve this end through accounting policy choice, accounting policy application or outright fraudulent financial reporting.

One way the financial numbers game is played is through a company's selection of accounting policies it employs in the preparation of its financial statements or in the manner in which these accounting policies are applied. "Given managers can choose accounting policies from a set (GAAP), it is natural to expect that they will choose policies so as to maximize their own utility and/or market value of the firm." The selection and application of Generally Accepted Accounting Principles (GAAP) is flexible, leaving much room for judgment in certain areas. As a result, through their choice and application of accounting policies, companies in similar circumstances may report dissimilar results.

Where does accounting flexibility exist? Various methods of accounting are provided for inventory costing, software revenue recognition, estimates of uncollectibles, depreciation, and perhaps most importantly, in the methodology of reporting the cost of employee stock options. Using this flexibility, management has the means and the opportunity to play the financial numbers game. Using this flexibility, companies can "manage" their earnings by:

- Changing depreciation methods
- Changing the useful lives for depreciation
- Changing estimates for the salvage value for depreciation
- Estimating allowances for uncollectibles and warranties
- Estimating the percentage of completion for long-term contracts.
- Varying the portion of employee compensation awarded as ESOs

Consider a firm whose earnings numbers for an accounting period are running below analysts' estimates. To avoid announcing "disappointing" earnings, the firm can distribute a larger percentage of employee compensation in the form of ESOs (as opposed to ordinary wages) in the accounting period. If the firm does not expense ESOs, then the value of the ESOs is not subtracted from revenues when calculating earnings (whereas ordinary wages are subtracted). Hence earnings are given an artificial boost, analysts are satisfied, and the firm's stock price is not adversely affected by a disappointing earnings announcement. This use of stock options to manage earnings is a perversion of ESOs' legitimate role in encouraging employee effort. It is a result of self-interested, short-sighted management, of lazy and inefficient corporate governance, and of lax accounting rules.

PERVERSION OF EMPLOYEE STOCK OPTIONS: A PRINCIPAL/AGENT PROBLEM

Given the distorted earnings information derived from income statements that fail to expense ESOs and the perverse incentives driven by such omissions, it is reasonable to ask why many high-level company managers, absent an explicit FASB directive, have decided to continue to supply the shareholders—the owners of the company—with income statements that fail to expense options. According to Warren Buffett (2002b), this decision is an example of what academics call a *principal/agent* problem, and the problem persists due to a failure of responsible corporate governance. It is impractical for the principal owners—the shareholders—to oversee the operations of the

corporation—so they rely upon a board of directors to fill this task. It is the job of the board to hire upper level managers to competently and efficiently manage the firm, and it is the board's responsibility to oversee the actions of management and audit performance—to ensure that the interests of shareholders are protected. Yet both of these agents—the board and the managers—have their own agendas that diverge from those of the shareholders. Board members are often more closely aligned with management than owners, and there is often an incestuous relationship between the two. It is in the self-interest of managers to inflate their compensation if they can hide the true cost of such compensation from shareholders; ESOs enable managers to mask the dilutive effect of their options-based compensation on shareholder value, and to mask poor performance during an accounting period by excessive issuance of ESOs (rather than ordinary wages) during the period or by using other accounting gimmicks to manage earnings. An effective board of directors, truly representative of shareholder interests, should thwart such self-interested actions by managers, but recent evidence suggests that many boards shirked their fiduciary responsibilities and merely rubber stamp the actions and policies of management. The stock market declines and scandals of the early 2000s have awakened powerful shareholders such as CalPERS, and reform of corporate governance is proceeding in many instances, including government-mandated compliance with the Sarbanes-Oxley Act.

BUT SHOULD STOCK OPTIONS BE EXPENSED?

There is a general (though not universal) consensus among academics in business disciplines that ESOs should indeed be expensed, and the logic behind this consensus is straightforward. In principle, to calculate the true economic income of a company, all relevant costs of doing business in a time period should be deducted from revenues. This includes all labor costs, including wages and other employee perquisites, including ESOs. Unlike wages, ESOs do not result in a cash expense during the accounting period. Nevertheless, there is an opportunity cost to granting ESOs; stock options have value, and a company is surrendering this value to employees at the time that the options are granted. This argument is forcefully made by Bodie, Kaplan and Merton (2003), supported by Warren Buffet (2002a), and succinctly stated by Federal Reserve Chairman Greenspan:

To assume that option grants are not an expense is to assume that the real resources that contributed to the creation of the value of the output were free. Surely the existing shareholders who granted options to employees do not consider the potential dilution of their share in the market capitalization of their corporation as having no cost to them. The particular instrument that is used to transfer value in return for labor services is irrelevant. Its value is not. Abstracting from tax considerations, one must assume that the value is the same for the employer irrespective of the nature of the instrument that conveys it--which could be cash or its value equivalent in the form of stock, free rent, a college annuity for one's children, or an option grant.

To omit the value of ESOs—to omit a cost of doing business—results in an overstatement of income (or earnings) in an accounting period, and overstates the financial health of the firm to shareholders. Such omission means that ESOs can be granted in huge amounts—a huge giveaway by shareholders to employees—without any negative impact on reported earnings. Indeed, estimates by Bear Stearns analyst Pat McConnell indicate that the 2003 reported earnings of the S&P 500 companies would decline by 8% if they were restated to expense options.

There is another perverse incentive caused by excessive reliance upon stock options—an incentive to increase the value of the options by artificially inflating earnings, through accounting gimmicks, legal or illegal, as was apparent upon investigation of the Enron collapse. Hence an excessive reliance on ESOs is self-reinforcing: awarding labor compensation through ESOs instead of salaries results in inflated earnings; the inflated earnings results in an inflated stock price; the inflated stock price increases the value of ESO compensation.

Finally, the failure to expense ESOs gives executives a tempting method to manage earnings—artificially changing the path of earnings, misstating the true performance of the firm in an accounting period, and perverting the legitimate function of ESOs as incentives to employees.

ARGUMENTS AGAINST EXPENSING OPTIONS (AND THEIR COUNTERARGUMENTS)

Despite the generally favorable opinion among academics regarding expensing options, there is considerable opposition by CEOs, politicians, and others. Many arguments are offered against expensing of options; the major arguments are listed below, along with counterarguments.

Stock options are not a real cost. Warren Buffett has famously stated that he will gladly trade insurance services or other Berkshire Hathaway products in exchange for a CEO's stock options. Value can be subtracted from the organization without a cash outflow—a commonly understood concept in economics and managerial accounting. Such is the case with depreciation of fixed assets, for example, or with the granting of ESOs.

The value of ESOs cannot be estimated when they are granted. It is difficult to place a precise dollar value on ESOs because vesting and ownership restrictions of ESOs cause their values to diverge from readily recognizable values of marketable traded options. Nevertheless, reasonable estimation methodologies have been developed, including the modified Black-Scholes method, the (Whaley) Quadratic Approximation method, and the Bulow-Shoven method. Such imprecise valuation estimates have been commonplace in financial accounting for many years.

Stock options costs are already disclosed in financial statements. These disclosures have been opaque, hidden in footnotes, misleading, and have generally required further analysis and computation to ascertain the true affect of ESOs on earnings. This lack of transparency puts the individual investor at a disadvantage to the professional trading houses, and leads to a lack of fundamental fairness and hence confidence in the American financial system.

Expensing stock options will inhibit cash-poor startup businesses and stifle the engine of U.S. economic growth. Expensing ESOs results in no real change in any fundamental business process except for accounting methodology. The engine of U.S. economic growth is not based upon deluding stockholders as to the accurate value of their holdings; it is based upon the efficient allocation of capital, and such efficiency requires the full and accurate disclosure of the returns to capital.

The labor of the current time period produces not only earnings in the current time period but also assets (some intangible) that persist into the future. These asset values, if real, should also be factored into the earnings calculation. As the saying goes, "Two wrongs don't make a right."

ACCOUNTING RULES FOR STOCK OPTIONS

Initially, stock options were not a part of the income statement as long as the strike price was greater than the market price on the grant date. But the FASB took the view that stock options need to be expensed as per the conceptual framework guidelines of comparability, decision usefulness, relevance and asset definition. As early as 1991, when the first signs of stock option abuse began to appear, the FASB proposed a new accounting standard that would mandate the inclusion of such options as compensation expense on the income statement. The FASB also suggested that the "fair value" of the options be measured using the Black-Scholes option pricing model. This ruling was the center of a long drawn out controversy. The enormity of the recent accounting scandals involving Enron, WorldCom and numerous others has only increased the intensity of the debate. Many company officials remain adamantly against expensing options – citing the need to attract top quality employees and the need to conserve cash. Analysts and investor representatives insist that options must be expensed – "permitting companies to compensate employees with millions of dollars worth of stock options and not make this compensation crystal clear to every shareholder who reads the annual report flies in the face of fair disclosure and investor protection."

But the growing accounting scandals and the need for strong corporate governance gave impetus to the FASB's proposal to control the misuse of stock options through accounting rules. Options are now considered a part of American business and a valuable form of compensation, in spite of the negativity attached to it. Until the mid-nineties, however, options rarely showed up on the income statement. The Financial Accounting Standards Board initially argued that options belonged on the income statement, citing reasons from the Conceptual Framework –

matching, relevance, reliability, and materiality. In 1995, the FASB issued Statement of Financial Accounting Standard No. 123 regarding stock options and gave companies and their accountants a choice on dealing with option expenses. Companies could use the “intrinsic value method” that they had been using so far (and that avoided options expense on the income statement) or they could use the new “fair value method.” The fair value method used the Black-Scholes Option Pricing Model (or similar models) to place a value on the options granted and to expense them over the term of service. In either case, the company had to disclose the impact of such options on their income statement, and to include the dilutive effects of the options on the EPS calculations.

Following the FASB's direction, S&P announced that they will now report earnings for companies by subtracting the footnote options expensing from income. The IASB has approved staff recommendations to establish options accounting standards; European Union countries will adopt the IASB standards in 2002. Major companies such as Coca-Cola, Amazon, GE, GM, the Washington Post Company, Level 3, Citigroup and Bank One are now expensing options voluntarily. These companies could be at the vanguard of a shift in the U.S. Alan Greenspan, Federal Reserve Board chairman, predicted in congressional testimony that the Financial Accounting Standards Board, which sets accounting rules in the U.S., would vote in favor of the switch. In a surprise move, Congress jumped into the act by passing the Accounting Standards Reform Act in July 2004, trying to block the FASB's proposal to make expensing mandatory.

But in December 2004, the FASB issued Statement of Financial Accounting Standard 123 R, which mandated the expensing of stock options at their fair value. The rationale for the new rule was representational faithfulness, comparability, simplicity and compatibility with International Accounting Standards. “Recognition of that compensation cost helps users of financial statements to better understand the economic transactions affecting an entity and to make better resource allocation decisions. Such information specifically will help users of financial statements understand the effect that share based compensation transactions have on an entity's financial condition and results of operations.” (FASB, 2004)

Starting from June 2005 (December 2005 for smaller companies), companies now have to show stock option compensation as an expense on their income statement. Companies would use a modified prospective application method, where compensation cost is recognized on or after the required effective date for the portion of outstanding awards for which the requisite service has not yet been rendered, based on the grant date fair value of those awards calculated under SFAS 123. Prior years presented may be adjusted on a basis consistent with the pro forma disclosures previously made.

The FASB had finally won a fifteen year battle, but stock options are only the tip of the iceberg in principal/agency conundrum, where the well known issue of moral hazard leads to significant problems in corporate governance and shareholder trust.

MAKING DIRECTORS ACCOUNTABLE TO SHAREHOLDERS

Recent corporate governance reforms such as Sarbanes-Oxley have focused on accounting transparency and the independence of board directors from upper level firm managers. Yet little has been said about another fundamental problem: *the representative of the shareholder—the board of directors—is not sufficiently accountable to the shareholder!* In theory, shareholders can vote to purge a disfavored director at the annual corporate meeting; in practice such occurrences are extremely rare. In practice, management controls committees that nominate directors, and management has an incentive to maintain a passive board. As suggested by Bebchuk (2003), measures are needed to invigorate the sclerotic process of nomination and election of directors. These measures can include the following:

- Permit large shareholders to directly nominate candidates, rather than having all candidates come out of the management-controlled nominating committee.
- Require corporations to fund the campaigns of outside candidates, to give them funding parity with incumbents, whose campaigns are funded by the corporation.

- Eliminate the “staggering” of board elections. Most corporations elect only a third of board directors annually, meaning that dissatisfied shareholders need two years—two annual meetings—to expel enough incumbents to gain a majority of new directors. This encourages incumbency

In addition, more agenda-setting power must be given to large shareholders (and large groups of smaller shareholders). The agenda of annual meetings and the ability to modify the firm’s corporate governance rules need to be extended beyond the board of directors and to the shareholders. These measures should ameliorate the principal/agent problem that has allowed managers to control corporations to their own desires, sometimes with disastrous consequences for shareholders.

CONCLUSION

Given the direction that FASB rules are headed, and given the relatively favorable reception given to the stock prices of companies that have decided to expense employee stock options, it is perplexing why so many firms, with considerable political support, continue to resist expensing of options. Perhaps some CEOs would rather fathom earnings from accounting sleight-of-hand rather than true economic performance, or perhaps they feel that their shareholders are not intelligent enough to know that a change in an accounting rule is not a change in the true economic nature of the firm. Transparency, on the other hand, is the friend of the stakeholder and the enemy of the illusionist, and it should be the guiding force behind intelligent corporate governance. Expensing of employee stock options, enforced by FASB rules and an accountable, independent board of directors, will portend a more honest, effective corporation, a more efficient allocation of capital, and a more efficient corporate America.

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