Microsoft's recent decision to substitute restricted stock for stock option grants in the future and to deduct the cost of options from historic profits ends the accounting fiction that such incentives are not an expense.

More importantly, it also removes a psychological barrier to the introduction of even more effective incentive plan designs that could produce substantial value for both shareholders and employees.

Across corporate America, the distortion of income statements caused by the failure to treat options as expenses has helped create false expectations and perverse incentives. In some cases, the misuse of options encouraged senior management to take excessive risks. It also stifled innovation in the design of efficient and transparent compensation systems.

But Microsoft and others still need to deal with the legacy of problems created by previously granted options, many of which are "underwater" because the stock is still trading below the option exercise price. The existing gulf between the interests of shareholders and employees will be exacerbated by differing incentives within the workforce. For example, option-holders always favour earnings retention or share buy-backs over dividends. Many shareholders take a different view.

The existence of outstanding legacy options is also demotivating because option-holders find them difficult to value. This is particularly true of financially unsophisticated employees who receive the incentives as part of a broad-based plan.

Many value options at close to their intrinsic value - the gap between the stock price and exercise price of the option - plus something for "hope value". This often significantly understates the "fair value" of the option.

Simply put, the fair value of an option is the price at which it makes no difference to the company whether it compensates the employee in cash, stock or options.

At the time of grant, most employees do not value options at their fair value, because at that stage the incentives typically have an intrinsic value of zero. This problem only gets worse if the stock price declines, at which point the intrinsic value is negative, even though the fair value is positive. Under such circumstances, many employees consider their incentives as basically worthless, even though a third party would readily pay cash for the options, given the opportunity to do so.

The plan devised by Microsoft and JP Morgan Chase allows option-holders to benefit from precisely this opportunity by selling the options to the bank for cash. This is a serious attempt to deal with the legacy option issue, but we think it is possible to deal with this issue in more effectively for both shareholders and employees.

Assume that the company offered to exchange restricted stock for options at fair value, for example. This exchange alternative would yield several benefits compared with the cash sale plan.
Such an exchange would be tax free to the employee, whereas the cash sale would trigger an immediate tax liability.

An exchange tends to align the interests of shareholders, recipients of future restricted stock grants and current option-holders.

Option-holders would be able to calculate the value of their restricted stock at any time because the stock is publicly traded. The exchange would thus keep in place the original goals of the option grant - to retain and motivate employees - while the cash sale would eliminate them.

An exchange plan would eliminate the transaction costs that employees would incur in selling their options to a third party. The cash purchaser would inevitably offer to buy the options at a hefty discount to fair value, because of the risks involved.

An exchange alternative would also cover both in-the-money and out-of-the-money options, unlike the cash sale plan, which addresses only the latter. This represents a significant advantage because option-holders also tend to undervalue in-the-money options, further exacerbating the misalignment of employee and shareholder interests.

Last, an exchange would reduce the amount of options outstanding, perhaps radically, whereas the cash plan would not. The cash plan could also increase the economic cost to the company because the options would probably be held until expiration.

An exchange plan would be only one step in the design of more effective compensation systems. Too many ad hoc plans have been developed in recent years, leading to inconsistency and a failure to meet the long-term objectives of companies, their shareholders and their employees.

A compensation plan should be one of the most important strategic priorities for management, directors and shareholders.

Our hope is that Microsoft's bold action will unleash a wave of creativity and innovation in companies as they decide how to cultivate their most valuable resource - their people - in a new environment of fairness and transparency.

The writers are co-founders of Integrated Finance Limited. Roberto Mendoza and Peter Hancock are former executives at JP Morgan

**Indexing (document details)**

<table>
<thead>
<tr>
<th>Companies:</th>
<th>Microsoft Corp (Ticker: MSFT, NAICS: 334611, 511210, Duns: 08-146-6849)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Author(s):</td>
<td>ROBERTO MENDOZA, PETER HANCOCK AND ROBERT MERTON</td>
</tr>
<tr>
<td>Source type:</td>
<td>Periodical</td>
</tr>
<tr>
<td>ProQuest document ID:</td>
<td>382233681</td>
</tr>
<tr>
<td>Text Word Count</td>
<td>791</td>
</tr>
</tbody>
</table>

Copyright © 2010 ProQuest LLC. All rights reserved. Terms and Conditions