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Letters

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COMMENTS

LETTERS

CRITICISMS

Still unrealistic?

In the article, "Financial Aspects of Stock Options," by Linda H. Kistler (M/S March-April, '67, p. 23) several points seem to warrant comment. The additional consideration of stock flotation costs simply suggests that the opportunity cost to the company on stock options is less than formulated under the original model.

This modification seems trivial in light of the gross shortcomings still inherent in this model. The single most noticeable omissions are the concepts of the time value of money and discounted cash flows. Should not the stock option alternative of executive salary augmentation be considered in a time horizon exceeding one year? Furthermore, the period for holding options to qualify for capital gains treatment is mentioned yet not introduced into the model.

Finally, the basic formulation of the model appears inconsistent as stated in the illustration. That is, if "a company wants to give X dollars of additional compensation to a number of its executives but also wants to minimize the overall costs, considering the corporation and the employee as a team," changes in the mix of costs assumed by each party affect the net return to the executives. I suggest that the proposed change leaves the model in a state that is no more realistic than its predecessor.

Roger M. Emanuel
Concord, California

An improvement

Mr. Emanuel comments correctly that consideration of flotation cost suggests that the opportunity cost to the company of stock options is less than formulated under the original model. However, contrary to his conclusion that the revision is trivial, I believe the introduction of flotation costs and recognition of the need to estimate market values are significant because this alters the compensation indifference point and thus substantially changes data which management may utilize in deciding whether to offer executives options or increased salary.

The illustration included in the article compared the simple model with a model incorporating flotation costs and market values, and it found that the indifference point was substantially lower using the revised model. Instead of $100,000, the compensation indifference point was $52,000 or $64,000 depending upon the estimated market value of the company's stock when the option is exercised.

Although the illustration was inserted only to indicate how the model might be used, it appears that a substantial decrease in the indifference point is likely when flotation costs are considered. This decrease justifies offering stock options at lower salary levels than many writers have mentioned in the past. Management should recognize that the simple formulation of salary versus option decision is not adequate and, indeed, may be seriously misleading.

The example assumed a one-year holding period because this is a common requirement of option plans now in effect. It should be remembered that the opportunity cost of options involves only the period between the date of grant and the exercise of an option. Under the 1964 Revenue Act this period may not exceed five years, and this is the relevant period for management's purposes.

Mr. Emanuel has erroneously referred to the three-year holding period for options and implies the model should include this factor. There is no holding period for options to qualify for capital gains. Rather, there is a three-year holding period for stock purchased under exercise of stock options. After an option is exercised and

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stock is purchased, such stock must be held three years prior to disposal in order to qualify for capital gains treatment.

Aside from considerations of the time value of money concept discussed later, introduction of the three-year holding period for stock into the model is totally irrelevant and would render the model worthless. I want to emphasize that the relevant period for management's purposes is the holding period for options, which often is one year and which may not exceed five years.

Most mathematical models in business and economics are simplifications of reality; basically they are an attempt to isolate a few factors and to analyze interrelationships among the variables under examination. The revised model I have introduced obviously is a simplification of the complex option versus salary decision problem, but I believe it represents an improvement over the simple model. It is an attempt to concentrate upon several essential features of the two forms of compensation, salary and stock options. However, a reader should realize the model is only one tool among many which management would utilize in making stock option decisions.

Numerous factors were ignored in order to focus upon the indifference point as one criterion management can employ in its selection of executives to whom options may be offered. Mr. Emanuel mentions the time value of money and discounted cash flows. Possibly the more important omissions should have been stated in the article. However, the purpose of the revised model was to recognize the influence of flotation costs on the simple model. I agree that inclusion of the time value of money, discounted cash flows, and several other factors would be desirable, but then the formula might have become so unwieldy that its value and utility for management would have been decreased.

Finally, Mr. Emanuel has stated that changes in the mix of costs assumed by each party affect the net return to the executives. This is not correct because one of the basic conditions of the model is that the net return to the executives remains the same under either the salary or option alternative (see page 25 of the March-April issue).

In conclusion, I would like to point out an error in the printing of the article. The final formula for the original model was incorrectly printed (on page 25) as follows:

$$T_p + 1 - (1 - T_g)\ (1 - T_c)$$

It should read as follows:

$$T_p = 1 - (1 - T_g)\ (1 - T_c).$$

Linda H. Kistler
Lowell Technological Institute
Lowell, Massachusetts

First IMPACT

As former executive vice president of the Computer Dynamics Corporation (now part of Bunker Ramo Corporation), I developed and used a proprietary planning and control technique called IMPACT for government and industry clients in 1962.

This system incorporated many of the features of the one described in the article on page 34 of the July-August, 1967, issue ("Systems Approach to Integrating Cost and Technical Data" by Howard M. Carlisle). The Computer Dynamics IMPACT system was recognized by IBM as preceding theirs and the Air Force IMPACT system as well as portions of the concepts being copyrighted.

Since MANAGEMENT SERVICES is copyrighted and uses the term "IMPACT," there should perhaps be some recognition given to the original IMPACT, which also has been published.

B. J. HANSEN
Vice President
John I. Thompson & Company
Washington, D.C.

More information?

I was surprised to receive [a copy of] the letter from Mr. B. J. Hansen of John I. Thompson & Company regarding his prior development of a similar technique utilizing the title of IMPACT. I was never aware of such a system. I would like very much to have access to information [about his technique] since I am in the process of writing a book . . . regarding planning and control techniques of this nature.

I would like to apologize for not [referring to Mr. Hansen's system], but, as you can see, I was entirely unaware of it.

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