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Cornell Center for Advanced Human Resource Studies

Research Highlight

## How Do Employees Value Stock Options and What is the Cost to the Firm?

There is a relevant

policy implication

for firms which

comes directly

from this work.

Many firms are interested in not just the level of pay offered to their employees but obviously the *mix* of pay matters as well. In deciding whether to offer cash, bonus, or stock options, there are many issues for HR leaders to consider, including incentive effects, the firm strategy, and competitiveness. However, both

the cost to the firm and the value to the employee of each type of compensation are critical concerns. ILR and CAHRS faculty member Kevin Hallock, along with Craig Olson from the University of Illinois, are involved with several studies that aim to consider both

the value of stock options to employees and the cost of those options to firms.

A stock option is the right to buy a share of stock at a set price (the "strike price" or "exercise price") for some period of time, subject to vesting provisions. The common "benchmark" for considering the value of stock options is the famous "Black-Scholes" option pricing formula. This formula, developed in the early 1970s, uses six characteristics (the risk-free interest rate, the expiration date of the option,

the variance in the firm's stock returns, the firm's dividend rate, the options exercise price, and the current stock price) to value options held by diversified investors. For some time academics have felt that employees value stock options in their own firm's at a level less than the Black-Sholes value since they are not diversified

investors, as implied by the Black-Scholes model. Employees are not diversified since they are not only investing their money in their firms but they are also investing their careers. Some academic research

that has included strict assumptions about mathematical forms of employee "utility" has supported this idea.

Professors Hallock and Olson investigate the value employees place on options by observing the actual exercise behavior of a set of more than 2,000 non-executive employees at a large non-manufacturing firm in the U.S. Although the statistics involved in estimating their model is quite complicated (called "simulated maximum likelihood estimation") the basis for their research is an extremely

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simple idea. The "intrinsic value" of a vested option is the dollar amount that can be taken out immediately. If an option has a strike price of \$17 and the current stock price is \$25, the option has an intrinsic value of \$8. If on a given day with a strike price of \$17 and a stock price of \$25 an employee exercises an option then it must be the case that the utility she gains from the option is less than \$8. If not she would have kept the option, instead of cashing it in. Hallock and Olson, then, observe each employee each period (when stock prices are obviously changing) to see if the employee keeps the option or exercises it. This method is more credible than asking employees about tradeoffs since their actual behavior reveals their true beliefs about the value of the options.

The authors find that employees in the firm studied, actually value options at a level that is *higher* than the Black-Scholes level. How can this



#### HR Company Profile

## A New Leadership Model Makes Aon One

With 46,000 employees working in 500 offices in more than 120 countries, Aon Corporation is challenged to live up to its name, which means "oneness" in Gaelic. But Jeremy G. O. Farmer, Aon's Head of Global Human Resources and Senior Vice President, believes that Aon's new leadership model, along with its robust talent management program, will lead to just the kind of consistency in human resource practice that will meet that challenge.

"The new leadership model," says Farmer "is designed to embed five behaviors in all our employees. First, we are building on our earlier commitment to client focus, creating custom-tailored, innovative solutions in insurance and risk management, human capital consulting, and insurance underwriting."

Second, teamwork is critical. "During the past several years," Farmer explains, "we have acquired a number of companies. Most have employees who joined or have been assigned to work in one particular country. That regional knowledge is very important to us in managing our client relationships. But now we also need to train leaders who can work across various cultures, and embed the values Aon stands for in all facets of our business."

In its emphasis on "oneness," Aon is not looking for a one-size-fits-all service model. Innovation and creativity make up the third behavior. "We want to recruit and reward unmatched talent who are willing to take risks, advance knowledge creation, and bring new ideas to our clients," Farmer notes.

The ability to achieve business results makes up the fourth value. "Execution is paramount," remarks Farmer. Execution is informed by the fifth behavior, "integrity across everything we do."

Right now, Aon is developing tools to measure and reward these five behaviors across the full spectrum of human resource management from recruiting talent who already demonstrate these behaviors, or have the capacity to develop them, through reward systems that pay for performance and structured career development opportunities.

Talent management begins for Aon during recruitment. "We do a lot of recruiting at the college level, identifying rising seniors from the undergraduate classes and asking them to join us to work over the summer," Farmer says. He estimates that half of Aon's full-time college hires come into Aon this way.

Farmer also points with pride to Aon's rigorous metrics-based system of talent review, including 360-degree feedback, and its tiered early career, mid-career, and leadership programs.

Each year, approximately 75 employees hired into Aon's college program participate in an intensive one-week training program in Aon's home base in Chicago, and then are deployed in locations throughout the U.S. Key talent are also given the opportunity to work outside of their home country on three- to six-month assignments. Many work for a year in the Hong Kong, London, or Chicago offices. Farmer explains, "These assignments form the pillar of our advancement strategy."

Finally, those who are identified for leadership positions are invited into Aon's intensive leadership program, run at the Kellogg School of Northwestern University in Chicago. Held twice a year with approximately 35 senior leaders, and actively involving Aon's top executives, the classes focus on strategic objectives and develop corporate cohesiveness at the highest levels.

As the head of the HR offices in London and Rotterdam as well as Chicago, Farmer believes that Aon's leadership model is key to its goal to achieve "oneness" while remaining flexible, creative, and diverse. "We have a lot of challenges ahead of us, but I believe that the deployment of our new leadership model will be the most important HR priority for the near future, and will truly allow Aon to recruit unmatched talent and deliver to our clients the best services possible."

Aon joined CAHRS in 2006, the 'HR Company Profile ...' features a Corporate HR view of new CAHRS sponsors.



#### Alcoa Grant for HR Student

## Future Research on Employee Engagement

Once again, the Alcoa Foundation is sponsoring CAHRS research through its Campus Partnership Program. Company sponsors felt that having CAHRS research fellows would give them more visibility with the MILR students, and expose them to some of the latest thinking in HR. With their need to bring in new talent, this is a priority for Alcoa. This generous grant from Alcoa

has allowed CAHRS to support one HR student position.

The CAHRS spring research topic of employee engagement is timely as Alcoa is in the process of transforming the HR function to better align its HR strategy, processes, and resources with the business needs. One of the key areas where Alcoa believes the HR function can add significant value to the business is by enabling the employee engagement process through better people systems and programs.

"This is an important research topic for all companies who believe they can impact the bottom line by creating a highly engaged workforce," says Tom Beaudoin, Manager of Compensation at Alcoa. "We believe there is a strong correlation between employee engagement and financial performance. Employees who are engaged feel a strong sense of commitment to their organization. They are proactive problem solvers, which translates into improved business results."

Employee engagement is increasingly becoming an important topic for organizations regardless of size, geographic location or industry. In addition, the body of evidence shows that employee engagement is a key driver of business performance. For Alcoa, a company with a workforce of over 120,000 employees in over forty countries, the concept of creating a highly engaged workforce is quite powerful. Alcoa is a diverse company that serves the aerospace, automotive, packaging, building and construction, commercial transportation and industrial markets. However, employee engagement is a strategy that applies to all businesses regardless of market.

One area of particular interest to Alcoa is how HR can better facilitate the employee engagement process through communication and branding to employees. Anne-Marie Kontakos, the Alcoa sponsored research assistant, will be conducting research in this area to determine the necessary steps when using "Employee Brand Engagement" to improve business results. This segment of employee

> engagement uses elements of Internal Communication, Marketing, Branding and of course HR.

There has been much buzz about getting employees to live the organization's brand from the inside out. The idea is that if employees can live and breathe the brand they will become purely committed, engaged, and create a competitive advantage for the organization. Southwest Airlines is a perfect example of an organization

that was able to successfully leverage a

strong internal brand and link it to customers. In essence, when "Employee Brand Engagement" is achieved the employees become corporate citizens; and they increase not only productivity, but also the organization's image and reputation.

But first, the organization must work to build a strong long-term internal brand that can be connected to all employees. How is this done, especially in a global and diverse company such as Alcoa? And how is this type of employee engagement measured and linked to the organization's bottom line?

Anne-Marie is currently pursuing the dual MBA/MILR degree at Cornell. This semester she is enrolled in the Johnson School's Strategic Brand Immersion which will greatly assist with the marketing and branding aspect of this research. hr

For more information on how you can get your company brand on campus, and can become involved and benefit from graduate student research grants for CAHRS, contact Dr. Pamela Stepp, Executive Director, via email: pls8@cornell.edu or Tel: 607-254-4829.



Anne-Marie Kontakos and Tom Beaudoin

#### **SAVE THE DATE**

### CAHRS Spring International Sponsor Meeting

## Employee Engagement: What Do We Really Know? What Do We Need To Know To Take Action?

May 22-23, 2007 • Paris Marriott Hotel Champs-Elysees - Paris, France

Employee engagement is high on the agenda for many CAHRS sponsors whether they are based in Europe, Asia or the U.S. Many companies are presently defining what is employee engagement and are conducting surveys to measure the commitment of their employees to consistently act in the best interest of the organization. The CAHRS Paris conference will present rigorous faculty and sponsor company research to explore the real issues of employee engagement. In addition there will be presentations and roundtable discussions to share best practices. We will all work together to learn about the integration of concepts of employee engagement into corporate strategy, how HR offers products and services to support the business delivery of the strategy, how employee engagement impacts business performance, and how it drives the outcomes of HR measurement and analysis.

#### **WORKING AGENDA**

#### Town Hall Debate: Employee Engagement is Hogwash!

Defending the Resolution: Chris Collins, Associate Professor, Cornell CAHRS and Peter Attfield, VP, Organisation Effectiveness, Unilever

Opposing: Ewout Durieux, Head of Shell People Survey Office, Shell International and Gordon Lyle, VP of Partner Resources, EMEA, Starbucks

## Building Profit Through Building People: The SYSCO Employee Engagement Story

Patrick Wright, Professor and Director, Cornell CAHRS

#### **Emotional Commitment and Employee Engagement**

Colleen Rumbal, VP, Head of Human Resources, EMEA, American Express

#### Panel Discussion: Branding and Line of Sight

Invited Loreal, Diageo and Novartis

#### Panel Discussion: Fairness in Engagement

Facilitator: Quinetta Roberson, Associate Professor, Cornell CAHRS

John Hausknecht, Assistant Professor, Cornell CAHRS Melissa Thomas-Hunt, Professor, Cornell University Simon King, Executive Director, Business Partnering, AstraZeneca

#### Panel Discussion: Employee Engagement and The Bottom Line

Facilitator: Kevin Hallock, Associate Professor, Cornell CAHRS Akil Walton, Manager Organizational Research Analysis, Eaton Steve Peterson, VP, Global Talent & HR Functional Excellence, Eaton

Ian McGinty, Head of Change, Communications & Employee Engagement Globally, Johnson & Johnson

#### Panel Discussion: How Does HR Make Employee Engagement Work

Facilitator: Chris Collins, Associate Professor, Cornell CAHRS Alison Demille, VP, Gap Inc.

Karen Vella, Director of People and Organizational Effectiveness, Gap Inc.

Tim Stevens, VP of HR, France, Northwest Africa, DRH IBM

#### Panel Discussion: Employee Engagement and Change

Facilitator: Brad Bell, Assistant Professor, Cornell CAHRS Isabelle Korfan-Loy, Regional HR Director ISMO, AstraZeneca Muriel Schulz, Director of Human Resources, Groupe NORISKO

Roundtable Discussions: Sharing Company Experiences about "What Went Right" and "What Went Wrong - Where Do We Go From Here?"

#### **REGISTRATION INFORMATION**

To register for the meeting please fill out our online registration form located on our website: http://www.ilr.cornell.edu/cahrs/springregform.html

#### HOTEL INFORMATION

We have set up a block of rooms at the

Marriott Paris Champs-Elysees for you to make reservations.

PLEASE NOTE you will need to download A REGISTRATION FORM to reserve a room at the hotel.

For additional information on the Marriott Paris Champs-Elysees, please visit http://marriott.com/property/abouthotel/default/pardt

#### Inquiries, please contact:

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#### SAVE THE DATE

### CAHRS Executive Briefing Profiling American Express

## April 4, 2007 American Express 200 Vesey Street • Board Dining Room, 50th Floor New York City

The next CAHRS Executive Briefing will be held on April 4, 2007, and will be hosted by American Express Company at their offices in downtown Manhattan.

The event will kick off with a dinner on the evening of April 3, and the session on April 4 will open with introductory remarks by Kevin Cox, Executive Vice President of Human Resources, followed by a keynote address by Ken Chenault, Chairman and Chief Executive Officer. The day will include presentations, panel discussions, and breakout sessions on key areas of HR focus where American Express has pioneered innovative thinking and best practices. Senior HR leaders from American Express will lead the sessions, which promise to be both informative and interactive. We look forward to sharing this dynamic event with you in April.

#### Registration Information

To register for the meeting please fill out our online registration form located on our website: http://www.ilr.cornell.edu/cahrs/Amex07RegistrationForm.html

#### Inquiries, please contact:

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### How Do Employees Value Stock Options

Continued from Page One

be? Isn't it the case, that since employees are not diversified in their firms that they should value options less than the Black-Scholes level? No. The reason highlights a misunderstanding of options. Conventional options are never exercised before they expire. If a holder of a conventional (non-employee) option wants some money from the option, her best alternative is to sell the option since she will always get more from selling it to someone else (since there is still upside potential) than exercising it. On the other hand, employees cannot sell their options and if they seek cash from an option, their only alternative is to exercise it. So, from a theoretical point of view, employees could value options at a level below or above the Black-Scholes value. Of course, this study is only one firm and another reason for the findings could be that this firm is simply unusual.

There is a relevant policy implication for firms which comes directly from this work. Given new Financial Accounting Standards Board rules changes now requiring the "expensing" of employee stock options, some firms have been pulling back from offering options. When the firms replace these options with some other form of compensation, if the firms have underestimated the value employees place on the options, they may face turnover problems.

In follow-up work, Professors Hallock and Olson are considering the important issue of the cost of the options to the firm. It turns out that the technical methods they have developed for evaluating the value of options to the employees can be then used to come up with a credible and consistent way to put an appropriate cost on the options for the firm's balance sheet. This, however, is the subject of another paper.

For more information regarding this research please contact Kevin Hallock via email: kfh7@cornell.edu, or Tel: 607-255-3193. This article references research from the CAHRS Working Paper #06-13, which can be found on our web site: www.ilr.cornell.edu/cahrs/paper.html .

## CAHRS HR Leadership Podcast Series

How can busy HR professionals get access to leading HR thinkers in today's fast paced and costconscious environment? While standard week long face-to-face executive education programs are ideal, they are expensive both in terms of time and money, thus limiting how many people a firm can afford to develop in this way. Teleconferences and webcasts are nice, but they require participants to be close to a phone or computer at a certain time, and they usually cost money. To help CAHRS sponsor firms provide broad-based development to their HR professionals at zero cost, the new CAHRS HR Leadership Podcast Series will offer 45-60 minute interviews with accomplished senior HR executives who can share their wisdom and experience in a medium unconstrained by time or geography.

During 2007 CAHRS will offer interviews with the leading Chief Executive Officers (CEO's), Chief Human Resource Officers (CHRO's), and academics.

This series will examine the role of the CHRO particularly focusing on the current challenges they face and best practices they use in building HR organizations that can add value. They will share their perspectives on how the HR profession has evolved, where it is today, and how it will change in the future.

These interviews will be downloadable in MP3 format for professionals to listen to at their own convenience. All CAHRS Podcasts will be available for FREE to HR professionals within CAHRS Sponsor Companies.

#### Inquiries, please contact:

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Professor and Director, CAHRS
Phone: 607-255-3429; Fax: 607-255-4953
Email: pmw6@cornell.edu

## PODCAST INTERVIEWS 2007

DAVE PACE
EVP Partner Resources, Starbucks

JIM DONALD CEO, Starbucks

WILLIAM CONATY SVP HR, General Electric

J. RANDALL MACDONALD SVP HR, IBM Corporation

EVA SAGE-GAVIN EVP HR, Gap, Inc.

L. KEVIN COX SVP HR, American Express

HUGH MITCHELL Director HR, Royal Dutch Shell

> ELEASE WRIGHT SVP HR, Aetna

JOHN MURABITO SVP HR, Cigna

KEN CARRIG SVP HR and CAO, Sysco Corp.

C. WILLIAM POLLARD former Chairman and CEO, ServiceMaster

LEE DYER
Professor of HR Studies, Cornell University



## In The News



Quinetta Roberson

Quinetta Roberson Highlighted in Diverse Magazine – In the January issue of Diverse magazine, Sixth Annual Emerging Scholars Edition, a publication devoted to issues in higher education, Dr. Quinetta Roberson's achievements showed her talents. The article asserts, "Dr. Roberson wanted to have an MBA before she turned 21, and to become a tenured professor by the age of 35. She did both." Dr. Roberson is an Associate Professor of HR Studies here in the ILR School. "I've always been an over-achiever," she says, and "once she realized that she was passionate about research and writing, all she had to do was figure out how to be in school for the rest of her life." Roberson returned to academia knowing what she wanted to do, and as a research professor at Cornell who wanted tenure, Roberson knew she'd not only have to get published, but published in top-tier journals. She did it, and in 2005 she became the first Black professor to receive tenure at ILR. It wasn't easy; she had to juggle at least 15 studies at a time, having them at different stages working

with co-authors. When advising tenure-track professors, she also stresses the importance of maintaining balance between teaching and service. Roberson also chooses to mentor minority and female students, and encourages both groups to be persistent, but also to take time out for their sanity. "What is most impressive about Quinetta is that, despite her extraordinary achievements, she is known for 'keeping it real'," continues the article. She enjoys whitewater rafting and skydiving among the things she loves to do. Now that she's tenured, Roberson says she has more flexibility in terms of her research. Her primary area of expertise remains organizational justice – the study of how fairly people are treated in the work place – but she's added diversity as a secondary specialization. Dr. Roberson has a PhD. in Organizational Behavior from the University of Maryland; an MBA in Finance and Strategic Planning, University of Pittsburgh; and a BS in Finance and Accounting, University of Delaware.



Ana Virginia Gomes

Ana Virginia Gomes Visiting Fellow from Santos, Brazil – Ana Virginia is Professor of International Labor Law in the Master in Law Program at the Santos Catholic University, in Santos, Brazil. She is also Professor of Trade Union Law and International Labor Law in the Law School at the Mackenzie University, in São Paulo, Brazil. She earned a Ph.D. in Labor Law at the University of São Paulo. Her research focuses on the labor dimension of economic integration and related processes. More specifically, she is interested in the bilateral Free Trade Agreements between the U.S. and Latin American countries including regional groups such as the Mercosur. Ana is working on a research project on trade agreements and labor law. Challenges posed by the process of international economic liberalization for labor regulation have significant consequences for the national and international order. The debates about lower labor standards in nation states is directly related to doubts about the effectiveness of the traditional system of international

protection of labor, built during the XX century, especially in the form of the International Labor Organization (ILO). Arguments about the lack of enforcement of the ILO conventions, the existence of social dumping and the race to the bottom, especially, between developing countries, place the relations between labor and international trade as one of the most important subjects for the present and for the future of labor law. Despite the failure in creating a multilateral international system in which labour and trade would not be isolated, it makes sense to question, especially with the expansion of international trade, if this relation exists and, if so, how it operates. Her research project attempts to examine and to develop a critical analysis of economic treaties with a labor dimension within the Americas. The central objective of the project is to analyze the Bilateral Free Trade Agreements of the U.S. with the countries of Latin America and the labor norms of the Mercosur. Ana is currently visiting the ILR School through June 2007.



Arild Johnsen

Arild Johnsen Visiting Fellow from Trondheim, Norway – Arild Johnsen is a researcher at SINTEF Health Care Research in Trondheim, Norway. His field of research is organizational theory, specializing in change processes in the health care sector. Johnsen is currently working on his Ph.D. which looks at work related sick-leave among nurses and cleaning staff at three different Norwegian university hospitals. His research explores interventive organizational change processes based on a participative intervention strategy in order to reduce work related sick leave. Key themes are: empowerment and local theory. His dissertation deals with the following four issues: Researcher involvement in actual work situations in order to enhance learning processes; Dealing with embodied experiences of pain, in order to enable these experiences to be integrated into the change process; Using dialogue arenas as reflective vortexes in change processes; and understanding ethical standards in relation to empowerment. Arild is visiting ILR through June 2007.

## CAHRS EVENTS CALENDAR

2006 - 2007

CAHRS Advisory Board Mtg
CAHRS Executive Briefing
CAHRS Spring Sponsor Meeting
Executive Compensation Working Group
ILR Orientation and CAHRS Executive Roundtables
CAHRS Fall Sponsor Meeting November 14 - 15, 2007 Ithaca, NY
For more information, contact Jo Hagin at 607/255-9358 or email: jap7@cornell.edu, or visit our website at: www.ilr.cornell.edu/cahrs/Calendar.html
ILR Executive Education & Events
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