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1. Introduction

We investigate whether current mid-level and future entry-level managers subjectively value stock options and restricted stock consistent with economic theory. We also investigate whether managers' subjective valuations are sensitive to changes in key characteristics of these equity instruments. We believe our investigation is important for three reasons. First, in recent years firms have granted the vast majority of options to employees who are not senior-level executives (Jensen, Murphy, and Wruck 2005).[1] Indirect anecdotal evidence suggests that these employees are less likely than senior-level executives to understand how stock options work.[2] Second, a fundamental premise underlying the traditional economics-based literature on stock options is that employees understand how to value them. If this premise does not hold, the efficacy of stock options as an incentive mechanism, and the findings from the literature relying on this premise, are called into question. Third, in 2005 the Financial Accounting Standards Board (FASB) began requiring firms to recognize the fair value of stock options on the income statement. Since that time, many firms have considered cutting broad-based stock option plans or switching from broad-based option plans to restricted stock plans (Deloitte 2005). If employees perceive the relative value of stock options and restricted stock differently than firms do, switching from stock options to restricted stock could create ill will, increase employee turnover, and dilute the incentive effects of issuing equity compensation.

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