ESO Compensation: The Roles of Default Risk and Over-Confidence

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Abstract

This paper derives a pricing model for employee stock options (ESO) that expands on Ingersoll (2002) and that includes default risk and considers employee over-confidence. Results show that the more risk-averse employees are and the more stock restrictions employees have, the smaller the value of ESOs. The model also incorporates potential subjective mis-pricing on the part of over-confident employees and finds that, under normal calibrations, employees who over-estimate firm returns by more than 5% will prefer ESOs over cash compensation. The results of this study may impact relevant accounting regulations regarding the valuation of ESOs as well as compensation decisions.