Mandatory Expensing of Stock Options: A Bad Idea Whose Time Has Not Come

*By Daniel Fisher**

I. Introduction

The corporate scandals of the last few years have dramatically altered the landscape of corporate governance. These scandals resulted in a rush by regulators and legislators alike to alter the existing regulatory framework, which was thought to have led to billions of dollars in investor losses. The scandals and the market losses they caused have been addressed by reform measures such as the Sarbanes-Oxley Act, enhanced New York Stock Exchange, NASD, and American Stock Exchange corporate governance standards, New York Attorney General Eliot Spitzer's use of an obscure 1921 statute, the Martin Act, to launch a crusade against Wall Street, and SEC Chairman William Donaldson's recently announced proxy rule changes.[1] These actions have been in response to demand, of varying degrees of intensity, from the public and the investment community. However, like many previous sets of reforms, the test of whether the recent corporate governance measures will actually result in less corporate wrongdoing, or will merely force those wishing to engage in corporate wrongdoing to be more creative, will come over time.

Recent corporate governance reforms, whether by legislation or litigation, have arguably been burdensome, but not excessively harmful to public companies that must comply with them. However, the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) are nearing a decision that would be truly deleterious to public companies, especially small and medium-sized ones, and the benefits of which would not come close to outweighing the burdens: to force companies to account for employee stock options as an expense on their income statements.

Even a brief examination of the role that employee stock options play in the economy, and the manner in which they are currently accounted for in corporate financial statements, shows their importance. This article examines the potential FASB action, embodied in proposed modifications to Financial Accounting Standard 123 (FAS 123), as well as alternatives that would increase the transparency and usability of financial statements without the harmful effects of mandatory expensing. To force the expensing of employee stock options would be a significant overreach that would not have the effect intended, but would instead result in blowback that would be harmful to the economy, especially some of its most vulnerable parts.

II. The Role of Employee Stock Options

Like stock ownership itself, employee stock options have grown in popularity over the past decade, and are now granted not only to senior executives but to hourly workers and middle managers as well. Advocates of employee stock options claim that they serve a valuable purpose by aligning the interests of a company's employees with those of its shareholders and promoting a sense of ownership, which leads to better corporate performance, and by allowing smaller companies to offer competitive compensation packages that attract talented employees.

Employee stock options are particularly important among start-up companies in technology and related fields. Large, established companies, with more predictable cash flows, have little difficulty utilizing cash compensation to attract employees. However, emerging or other growth businesses often need to save their cash resources for crucial stages of their own internal development. As a result, such companies must include stock options as a substantial component in order to offer competitive total compensation packages. Thus, the ability to grant options relatively painlessly is important to the competitiveness of these crucial parts of the economy.

Companies that decided to issue fewer employee stock options would likely place a high priority on ensuring that their executive compensation packages remain attractive, and would allocate those options remaining to their high-ranking executives. Thus, lower-paid workers and those with fewer stock options, and for whom stock options are a key part of what could be an otherwise modest compensation package, could well be most affected. This result runs contrary to the intent and spirit of the recent corporate governance reforms, which has been to limit the possibility of malfeasance by a handful of high-ranking executives, and to put strict limits and controls in place to prevent such individual abuses. Instead, any decline in the popularity of options would penalize workers farther down the corporate ladder, workers who have been the victims, rather than the villains, of the corporate scandals of the past several years.

The data on the broad range of stock option grantees speaks for itself. According to the National Center for Employee Ownership (NCEO), as of 2002 there were over 4,000 broad-based stock option plans covering between 8 and 10 million participants.[2] As an indicia of the broad nature of the stock option plans, in making its calculations the NCEO only counted as "broad-based" those plans that granted stock options to more than half of a company's full-time employees.[3]

III. The Current Paradigm

Prior to FAS 123, Accounting Principles Board Opinion 25 (APB 25) governed the accounting of stock options. APB 25 stated that the compensation expense of options charged against earnings at the time of grant was the difference between the company's current stock price and the option strike price at the time of grant. Since the option strike

price is virtually never below the company's current trading price, this essentially results in no charge against the income statement. However, companies must nonetheless provide some pro-forma information about the effect of employee stock options on their financial statements.

Currently, the number and value of employee stock options are typically disclosed in footnotes to the income statement and balance sheet presentation of a company's annual report on Form 10-K. Companies have varying ways of displaying these data. However, the core metric that allows investors to understand the impact of employee stock options on the company's financials statements is called "diluted earnings per share" (Diluted EPS). Diluted EPS is built off the company's normal earnings per share, which is generally calculated by dividing net income by the number of outstanding shares. Diluted EPS takes into account the potential impact on earnings of employee stock options by increasing the number of the company's outstanding shares—the denominator in the EPS equation—by the number of employee stock options that are "in the money".[4] This metric is appropriate because it takes into account the maximum realistic exercise of options, and is easily readable and distinguishable from normal EPS.

IV. The FASB "One Size Fits All" Solution

FAS 123 encourages companies to account for the expense of stock options as a charge against earnings on their income statements, and to use the date of the grant of the option as the basis to calculate the expense. In the alternative, FAS 123 permits companies to continue to adhere to APB 25, but requires those that do so to provide further disclosure about pro-forma net income and earnings per share as if the company recorded the employee stock options as an expense at their grant date. If the FASB drops the optional APB 25 provision, as it is considering, and the SEC recognizes the modified FAS 123 as GAAP (and therefore mandatory in financial statements provided on Form 10-K), reporting companies will have no choice but to expense their stock options in the manner provided for by FAS 123.

There are a number of serious flaws with the mechanics of mandatory expensing, even if the policy considerations in favor of stock options are ignored. Perhaps the most difficult aspect of expensing options in adherence with FAS 123 is the problem of valuing the option at the grant date. Currently, options are generally valued according to the Black-Scholes model, which is a multi-factor model that takes into account current stock price, option exercise price and duration, expected stock volatility and dividends, and a theoretical risk-free interest rate, and was initially developed to value tradable short-term options. However, Black-Scholes is generally thought to overstate the value of employee stock options, since it does not take into account that fact that, unlike the tradable short-term options for which the model was developed, employee stock options are not tradable, have vesting period of varying lengths and are subject to blackout periods.[5] Although several alternative models to Black-Scholes have been developed, these are as yet untested, and may well contain similar or additional flaws to those of the Black-Scholes model.

Another potential problem that could stem from mandatory expensing is the double-counting of the impact of options on a company's bottom line and equity holders. As described above, Diluted EPS, which consists of net income divided by shares (including "in the money" options) is a crucial metric in analyzing financial statements and best represents the impact of extant stock options on current shareholders. If options were required to be expensed, the EPS equation numerator (net income) would be reduced, since the expense of options would be offset against net income. However, Diluted EPS already takes options into account by increasing the denominator (to reflect the "in the money" options). Thus, the expensing of options would have a double impact on the Diluted EPS numbers of a company. This combination would cut diluted EPS sharply at many companies, including some that are the cornerstones of the U.S. economy, and could serve to confuse investors far more than it would help. For example, if Microsoft had been required to expense options in 2002, its Diluted EPS would have gone from $1.41 per share to $0.98 per share, a 30% drop.[6]

V. Alternatives to Mandatory Expensing

Many companies, mindful of the controversy surrounding the accounting treatment of employee stock options and seeking to improve transparency and accountability in light of the current corporate governance environment, have recently begun to expand their presentations of the impact of employee stock options in their financial statements in order to give an even fuller picture of their financial effect. For example, in its notes to its financial statements, Microsoft presents pro-forma income statements that reflect compliance with the FAS 123 expensing requirements. Other companies utilize similar presentations in their Form 10-Ks.

As the sector perhaps most seriously affected by the possibility of mandatory expensing, the technology industry has been at the forefront of opposition to the FASB's proposed modifications to FAS 123. TechNet and the American Electronic Association (AeA), which represent the interests of high-tech executives and companies, respectively, have proposed guidelines for greater stock option impact disclosure that would not have the deleterious effects of mandatory expensing. The TechNet/AeA proposal recommends that on a quarterly basis, in their 10-Q filings, companies report detailed information about employee stock option exposure in a manner accessible by investors. The TechNet/AeA proposal calls for increased disclosure of:[7]

- employee and executive option grants;
- year-to-date option activity, as well as option activity in the prior fiscal year;
- "in the money" and "out of the money" option informa-

tion as of the reporting date (i.e., options that have an exercise price below a company's current share price, as well as options with an exercise price above the company's current share price); and
- the portion of options that go to executives versus the portion provided to the rest of the company's employees.

The TechNet/AeA proposal would also separately provide more information about options granted to and held by a company's senior executives, including:

- new options granted during the quarter;
- options exercised during the quarter and the value of those options;
- the total number of options held by executives; and
- the dollar value of options that are "in the money".

The TechNet/AeA proposal is intended to give shareholders a "one-stop shopping" approach to employee stock option information and to avoid the conflicting presentations sometimes found in annual reports, while providing a proactive solution to calls for increased transparency and avoiding mandatory expensing.

Currently, companies may also make the choice to treat options as an expense or to stop issuing them altogether, either because they seek to maximize their transparency to the financial markets or because stock options no longer fit their compensation structure. This allows companies the flexibility to comply with FAS 123, but does not impose on all public companies compensation structures that, in reality, are highly dependent on individual circumstances. For example, Microsoft recently announced that it would no longer issue stock options, but would instead issue restricted stock with a five-year vesting period to employees. The financial press treated this announcement as an admission by Microsoft that it was no longer a growth stock, and that employee stock options with high strike prices were not the incentive that they had been previously, rather than any normative statement about the need for pure accounting standards. Other companies, such as Fannie Mae, have announced that they will continue to issue stock options, but will voluntarily adhere to FAS 123 and record the cost of options as an expense against earnings at the time of the grant. Market capitalism would presume that these companies have weighed the danger to employee morale and competitive compensation versus transparency and other corporate governance factors, and determined that expensing is worth the cost. If they have not made such a determination, their rush to judgment should be reflected in their financial performance.

Unsurprisingly, the issue of expensing options has become political. Members of Congress who represent areas with high concentrations of start-ups and high-tech companies have been outspoken in their opposition to expensing, and have attempted to force the FASB to reverse itself. Two such members, Republican Congressman David Dreier (chairman of the House Rules Committee and a member of the Republican leadership) and Democratic Congresswoman Anna Eshoo, both of California, have introduced HR 1372, the Broad Based Stock Option Plan Transparency Act.[8] HR 1372 would compel the SEC to increase disclosure requirements for employee stock option information in ways generally designed to increase the average investor's ability to understand the data. However, the Dreier-Eshoo bill would also impose a three-year moratorium on the ability of the SEC to require companies to expense options. HR 1372 has received a hearing in the Capital Markets Subcommittee of the House Financial Services Committee. However, a similar bill in the Senate, sponsored by Senator Barbara Boxer (D-CA) and Senator John Ensign (R-NV) has been temporarily blocked by Senate Finance Committee chairman Richard Shelby (R-AL), who opposes what he claims is political intervention in FASB affairs.[9] Other politicians, such as Senator John McCain (R-AZ) and Senator Carl Levin (D-MI), who have generally been proponents of broad corporate governance reforms, have taken the lead in attempting to force companies to expense options.[10]

VI. Conclusion

Compensation policies appropriate for Microsoft or Fannie Mae are not necessarily appropriate for smaller high-tech or growth businesses, and the potential damage of mandatory expensing of options seems far higher than the marginal transparency benefits supplied by FAS 123. Moreover, there are substantial functional problems with the calculations required to implement FAS 123. If FAS 123 was to become mandatory, public companies would be forced to take hundreds of millions and in some cases billions of dollars of charges against their income statements based on a theoretical formula not designed for its current use, and producing valuations of dubious reliability.

Mandatory adoption of FAS 123 would also have a damaging effect on the ability of American companies to hire and retain skilled workers at all levels. It would reduce companies' earnings based on an uncertain metric—the very opposite of the goal of increased transparency. Furthermore, coming on the heels of Sarbanes-Oxley, the stock exchange and NASD corporate governance reforms, and the endless investigations of corporate scandals, mandatory expensing of stock options has the feel of a late-stage progressive reform whose full effects may not be fully understood, and whose true impact might not be known, until it is too late. In 1911, California Governor Hiram Johnson pushed through a well-intended measure, Constitutional Amendment No. 22. Constitutional Amendment No. 22 was passed by the California legislature and ratified by the public at the tail end of a number of other progressive political reforms and sought to ensure that state government was accountable to the people it serves—certainly a laudable goal. Constitutional Amendment No. 22 is perhaps better known as the California recall

measure, and we are seeing today the uncertainty it is bringing—an effect almost certainly not intended by its drafters. Will mandatory expensing of options have a similar effect? Will FAS 123, instead of resulting in one special election in one state as California Constitutional Amendment No. 22 has, result in significant damage to the American economy? Only by postponing mandatory expensing, studying the issue more fully, and developing a more accurate valuation model can we even begin to answer these questions.

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Footnotes

[1] The Martin Act, which has traditionally been seldom used, is among the most powerful state securities law in the nation. Jerry Markon and Charles Gasparino, *For Corporate-Crime Fighters, 1921 Martin Act Isn't Too Old*, Wall Street Journal, October 2, 2002.
[2] National Center for Employee Ownership, A Statistical Profile of Employee Ownership (April 2002).
[3] *Id*.
[4] In the money options are options for which the exercise price is below the current market price of the underlying stock.
[5] Letter from Biotechnology Industry Organization to FASB (January 31, 2003), *available at* <http://www.bio.org/tax/letters/20030131.asp>; *see also* Letter from TechNet to FASB (February 1, 2003), *available at*http://www.technet.org/issues/option_comment_letter_02_03.html>.
[6] Microsoft Corporation 2002 Form 10-K.
[7] The TechNet/AEA proposal, which is restated here, is available at <http://www.technet.org/issues/stock_options_disclosure.html>.
[8] *See* <http://dreier.house.gov/pdf/stockoptions_summary.pdf>.
[9] Craig Schneider, *Congress, FASB in Stock Option Flap*, CFO.com, June 2, 2003, *available at* <http://www.cfo.com/article/1,5309,9644,00.html>.
[10] *Dreier, Eshoo Go on "Offensive" in Debate Over Options Accounting, Introduce Measure*, BNA Pension and Benefits Reporter, March 25, 2003. Senators McCain and Levin have introduced several bills seeking to both pressure FASB to issue mandatory expensing standards, and to pressure companies into voluntarily expensing options.