Factoring-in stock options

In the wake of recent corporate scandals, support has spread rapidly for including the cost of employee stock options as an expense item in corporate income statements. David Rowe argues that while some reform is appropriate, present trends could end up doing more harm than good

It is a sad fact that many public policy initiatives grow out of a crisis. In this context, the debate usually plays out in stark terms of good versus evil. All too often, the resulting changes are made in haste, are poorly thought out and result in serious unintended consequences. I fear this familiar pattern is under way in the debate over the accounting treatment of employee stock options.

The impact of stock options

One of the enduring institutional challenges of the modern publicly held corporation is how to align the interests of paid managers and other employees with those of the broad base of stockholders. Stock options are one of the most powerful tools for accomplishing this. That said, such options have an unarguably dilutive impact relative to existing shareholders. The key issue for corporate boards is to weigh the incentive benefits of better performance against this dilution.

More to the point, as Reuven Brenner and Donald Luskin point out in a recent article in the *Wall Street Journal*[1], stock options are a form of compensation and compensation is not free. This impact has traditionally been relegated to the footnotes of financial statements, based on the argument that changing the number of outstanding shares does not alter the book value or equity. On the other hand, an important function of financial statements is to disclose relevant information to both current and prospective investors. On this basis, some explicit reflection of the cost of option grants in the financial statements appears warranted.

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First, do no harm

In recent months, a trend to treat stock options as an expense on the income statement has gained considerable momentum. Unfortunately, there has been limited discussion of alternative methods for accomplishing this. What appears to be the intended approach applied by those companies that have announced an intention to treat options as an expense is likely to offer little additional insight for investors, and could become a tool for earnings manipulation.

The announced plans will recognise an expense equal to the fair value of options when granted based on application of the Black-Scholes pricing formula. This approach has many flaws. First, the options granted are hardly ever unrestricted. They vest over time, and unvested options are surrendered when an employee moves on to another employer, retires or dies. To complicate the issue further, some option vesting schedules are contingent on meeting performance targets. In such instances, even the timing of vesting is subject to future uncertainty. Expensing the fair value of options on the assumption that they all vest would clearly overstate the true case. On the other hand, incorporation of assumptions about how many options will ultimately become vested could become a tool for earnings manipulation. Even more seriously, such an approach would not reflect increases in the value of outstanding options as share prices rise (or the reductions in their value as share prices fall).

A more plausible alternative

In fact, most of the value of employee stock options corresponds to the intrinsic value created when share prices rise after grants are made. There is a more plausible approach than treating options as expenses when granted based on 'fair value' using option pricing models with shaky volatility assumptions. This would be to focus on the intrinsic value of employee options that have vested based on the current stock price. This ignores the time value of these options, but would capture the primary source of equity overhang that can have adverse consequences for existing shareholders. It would also recognise the expense at the point where it becomes highly likely to be incurred, namely when the right to the options vests with employees, be that vesting based on tenure of service or performance targets.

Brenner and Luskin point out that "options are risky liabilities of unknown future cost… As such they should be reflected on the company's balance sheet and marked to market every quarter". They argue that this would be resisted by chief executive officers since it "reveals sharply the higher risk" involved. In fact, the idea that such treatment would lead to higher actual or perceived risk is not clear. To be sure, if changes in this liability flowed through the income statement, they would dampen earnings growth in good times when stock prices are rising. On the other hand, it would also cushion the decline in earnings in difficult times by reflecting a diminished intrinsic value of vested employee options. Risk is associated with unexpected adverse changes. Insofar as employee compensation is tied to performance, this tends to reduce the risk to existing shareholders when compared with fixed compensation of comparable magnitude.

In brief, before we rush to treat employee stock options as expenses in a massive feelgood exercise, let's have a debate about what we are trying to accomplish and the most effective means of achieving it. ■

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[1] *'Another Option on Options', Wall Street Journal, September 3, 2002*
[2] *As above*