

# Stock Option Accounting: The Chamber of Secrets

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Today, the most widely debated issue involving executive compensation is how to account for stock options. One school of thought maintains that options should be expensed on corporate income statements, while another believes that we should continue the long-standing practice of simply estimating an option's impact on a firm's earnings in a footnote to its financials.

Just about every compensation professional and consultant seems to have an opinion on how best to account for options, and some even appear ready to resort to magic or sleight of hand to do so.

In this article, we'll look at the possible consequences of having a P&L charge for options and challenge those who want stock options charged as an expense against earnings. A thorough consideration of all the possible ramifications of expensing options is of paramount importance if we are to avoid the types of regulatory knee-jerk reactions that have in the past encouraged the very behavior that the regulators were trying to frustrate. For instance:

\* **Golden parachute legislation.** Golden parachutes as we know them basically didn't exist until Congress enacted Section 280G of the Internal Revenue Code (Code) in 1984. This provision was intended to curb golden parachute payments by making excess payments nondeductible by payors and by subjecting recipients to an additional 20 percent excise tax on top of their other federal and state income taxes. However, as a result of the legislation, virtually every company now provides for the payment of the maximum deductible golden parachute to certain executives during corporate takeover battles.

\* **Code Section 162(m) million dollar cap.** In the early 1990s, nearly a decade after its golden parachute legislation, Congress decided that the deduction that a publicly held corporation can claim for compensation paid to a chief executive officer (CEO), or to one of the four highest-paid corporate officers, should be limited to \$1 million if the payment isn't "performance related." As a result, Congress amended Code Section 162(m) to provide for the \$1 million cap. But, like the parachute legislation, the amendment actually promoted the behavior it was designed to prevent: once the \$1 million limit was legislated, many companies immediately gave their key executives a raise to the maximum amount allowed.

In both of these cases, the intended legislated cap on compensation instead became the legislated benchmark. Therefore, the key to any proposal relating to executive pay is to determine what the proposal will motivate companies to do. When the pay schemes at Enron, Adelphia, and WorldCom are examined, we find that the firms' compensation programs actually served to motivate the type of corporate behavior that we found so appalling last year. And we don't want the final decisions regarding stock option accounting to do the same.

## Stock Options Have Value

We believe stock options have value (even though, after more than three years of a bear market and an abundance of underwater options, many option holders would most likely doubt that options had *any* value). The question is whether there should be an additional cost associated with that value.

Options are a cost to shareholders—a cost determined by diluted earnings per share (EPS). This calculation, which corporations are now required to make, measures the amount of dilution of EPS that would occur if all worthwhile options were exercised and the proceeds used to repurchase shares in the open market. The resulting dilution causes a reduction in the increase of the price of the shares. Therefore, those who say that the present method used to account for options (a P&L footnote) makes them "free" are sorely mistaken.

## The Chamber of Secrets

In J.K. Rowling's children's book *Harry Potter and the Chamber of Secrets*, someone has opened the door to a chamber at a school for wizards thereby freeing a giant snake to wreak havoc in the school. Certain death awaits anyone unfortunate enough to look the serpent in the eyes. We believe that the proposed accounting for stock options could open a similar door to a comparable chamber of secrets, possibly motivating intensely undesirable behavior and outcomes.

Let's look eye to eye at the option proposals, and then examine some possible outcomes created by what can only be described as bad magic:

**1. Repricing deluge.** A majority of public companies currently prescribe to Accounting Principles Board (APB) Opinion 25, and do not recognize an additional P&L charge for stock option expense. Instead, they provide a footnote disclosure estimating the impact of options on income and earnings per share using Financial Accounting Standard (FAS) 123. In 2000, the Financial Accounting Standards Board (FASB) added Interpretation No. 44 to APB 25, in large part to deter companies from repricing underwater stock options.

In the event companies are required to expense options and charge for their cost on financial statements, APB 25 and Interpretation No. 44 will become obsolete, and the door to underwater option repricing will subsequently fly wide open. In that event, companies will not only be allowed to reprice stock options, but will actually be motivated to do so.

\* **Example:** A company grants stock options at \$15 per share with a Black-Scholes value of \$8. (Black-Scholes refers to an option pricing model developed by economists Fisher Black and Myron Scholes to calculate the fair value of a stock option.) One year later, the stock price falls to \$10. The options are now underwater with no perceived value to the employee. However, the company is still expensing the original \$8 Black-Scholes value and now can either (1) do nothing and continue to take the \$8 charge, or (2) reprice at the \$10 fair market value, take a lesser charge to earnings for an approximate \$5 Black-Scholes value, and reinstate perceived value on behalf of the employee.

**2. No more stock options below the executive ranks.** For the past 20 years, many human resources departments have attempted to make stock options available throughout the corporate structure to contribute to significant wealth creation for mid- to lower-level employees. Should stock options become any type of mandatory expense, these broad-based option plans would be phased out because the cost of such grants would become prohibitive.

Many companies have indicated that mandatory option expensing would reduce both the size of option grants and the number of employees eligible for the grants. Nonexecutive employees will likely be the class of workers most adversely affected by a mandate of stock option expensing, and the gap between executives and the rank-and-file employee pay will further widen—a trend stock expensing is trying to reverse.

**3. Decreased productivity in small companies.** Because most small and start-up companies have incorporated APB 25 into their compensation cultures, the use of stock options has become a key equalizer for these companies in terms of competing with larger and established companies in the market for top-level talent. While small companies and start-ups fully recognize that granting stock options can dilute the EPS of their shares, these companies have become competitive forces because of equity compensation. In the event that stock option expensing becomes mandatory, the ability of these companies to compete for talent will be severely limited. As a consequence, productivity at smaller firms will decrease and larger, cash-rich companies will receive an additional advantage.

**4. Misuse of outright grants that replace options.** Any change in the rules governing option expensing will likely be accompanied by a shift toward alternative long-term incentive vehicles and the increased use of restricted stock. Because the charge to earnings for restricted stock might be less than the charge to earnings for stock options, the use of restricted stock may lead to the erroneous expectation, by those executives who previously received option grants, that the number of restricted shares they'll receive will equal the number of shares awarded under pre-expensing option grants. (The (general rule, however, is that one restricted share equals three stock option shares.)

**5. Black-Scholes could lead to option abuse.** The Black-Scholes option pricing model, as well as many other models presently in use, cannot accurately predict the value of stock options due in large part to their long vesting terms and nontransferability. In addition, Black-Scholes doesn't distinguish a lower-priced stock with good appreciation potential from a less aggressive growth stock in a more mature company. Despite these shortcomings, however, executives have sought the use of the Black-Scholes model for grant purposes during bear markets because of the potential windfalls due to the model's inability to accurately assess an option's market value.

## Final Thoughts

There is no quick answer to the question of how best to account for stock options. At this stage, we simply must ensure that any proposed system thoroughly addresses the "how" and "when" of the system's implementation, and "for whom" the benefits of the system inure. For example:

\* **How?** If the amount of dilution in a stock's EPS, caused by option exercise, is an insufficient measure of the option's cost, we will have to abandon the use of the Black-Scholes model to value options in favor of a measurement technique that specifically addresses the use of options for compensation.

\* **When?** Corporate America has become accustomed to existing option accounting practices, which have been in place for more than 30 years. It would therefore be shortsighted to believe that a new scheme, which would take effect immediately, could be put in place with no transition period. For any new accounting practice, we must create a transition timetable that is conducive to continued corporate productivity.

\* **For whom?** A new or revised system of option accounting must not reverse 20 years of concerted effort to make options more widely available to rank-and-file employees; options should not again become a means of rewarding or compensating top executives only. Perhaps incentives can be devised, either through accounting and/or tax law changes, to induce companies to continue the use of options for the benefit of all, or for a broad range of workers.

Option accounting is not an easily soluble issue—waving a wand at it will not make it go away—and it surely evokes strong emotions on the part of both those who believe options should be expensed and those who think the existing footnote system is sufficient. And while there are no giant snakes staring us in the eyes, the final decisions regarding option accounting will have a significant impact on the ability of the United States to continue its leadership role in the world economy.

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