

# The Stock Plan Advisor

An Advisory Service for Stock Plan Professionals  
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VOL. 10, No. 2 • MARCH–APRIL 2002

## Why There WILL be an Expense for Options and How to Prepare Now *By Donald P. Delves*

The unraveling Enron/Andersen debacle is raising the level of scrutiny directed at the accounting profession, shining a particularly harsh light on shadowy cases involving income that may be over-reported or expenses that are understated. There is no escaping the investigative glare and the industry changes that will assuredly ensue.

Current headlines and hearings are beginning to galvanize popular opinion around the need for increased accuracy in all aspects of financial reporting, including that reflecting stock options. Since 1994, the Financial Accounting Standards Board's official position has remained the same that options should, but do not have to, be expensed. In terms of accounting changes that would cultivate public confidence, this could actually be considered the lowest hanging fruit on the vine.

An expense for stock options could have some very positive results. Options represent "free pay" and their use has exploded in the last five years. Boards and management are increasingly at odds over how much more of the shareholders' wealth should be transferred to executives and employees in the form of stock options. An expense will bring more rationality to this discussion, will add some sanity to pay levels that have gotten out of control, and will cause options to be subjected to the same cost versus benefit trade-off as any other major expense.

### RATIONALE FOR EXPENSING OPTIONS

In the first place, options represent a prevalent, sizeable and unreported major expense that the FASB has already stated should be taken (although they stopped short of requiring the expense). The accounting logic behind this stance is quite clear. While numerous arguments have been postulated against expensing options, it is doubtful any serious accounting theorists believe them.

Basic accounting principals require that, when a company gives something to someone else (usually money) in exchange for goods or services, the company has to record an expense for the value of what it has given up. So when cash or in this case, a stock option is given in exchange for services from an employee, the value of that cash or option must be recorded as an expense when the services are performed. Options given in exchange for services have historically generated a zero expense because their

value was thought to be zero at the time they were granted. However, in light of more than ten years of using Black-Scholes and other option pricing models that are widely accepted and used, we all know that options have a value much greater than zero. So, logically, there should be a significant expense that reflects the value of the options the company is giving up in exchange for services from its employees. Thus, the critical question is not whether there should be an expense, but how stock options should be valued and when the expense should be recorded.

### RESISTANCE WEAKENING

Back in 1994, the FASB attempted to require an expense for options, though their quest ultimately succumbed to intense resistance from CEO groups, all of the major accounting firms, investor organizations and Congress. Now, facing equally intense pressure from the public, the latter two strongholds are beginning to weaken: The Council of Institutional Investors recently announced unanimous support for a stock option expense a rather striking departure from the group's previous position vehemently opposing such an expense. And, in Congress, Senators Levin (Dem., Michigan), McCain (Rep., Arizona) and Fitzgerald (Rep., Arizona) have introduced a bill (similar to one introduced five years ago) providing that, in order for a company to get the tax deduction when options are exercised, it must record an accounting expense for the options. With the prevailing winds of opinion shifting, the senators presumably feel the timing and climate are now more conducive to passage of such a bill.

### PRECEDENCE

There is significant precedence for requiring the expensing of very large and difficult to measure items. Consider the massive expenses for retiree medical in the early 1990's, or for pension plans in the 1980's. In these and other cases, while there was significant resistance at first, sound accounting theory ultimately prevailed. Moreover, we also must look at the required treatment of stock options used to purchase goods and services from non-employees, e.g., law firms, recruiting firms and consultants. Since these transactions are clearly purchases, they are required to be recorded as an expense. Thus, there is substantial precedence for expensing options, and it is only a small step to extend that expense to options issued for compensation purposes.

# VIEWPOINT

## INTERNATIONAL PERSPECTIVE

The IASB (International Accounting Standards Board) has come out with its own research paper on expensing options, demonstrating that options should be expensed at the time they are granted. This research paper falls somewhat short of taking a formal position on the matter, but is a strong indication of the direction in which the IASB is headed. The chairman of the FASB has stated that he basically supports all current positions of the IASB.

More generally, the view from overseas has been negative toward a number of American accounting practices, with Europeans expressing distinct opposition to our treatment of options. The Economist even went so far as to call it "a disgrace" in a recent issue. In short, the rallying cries cannot be ignored options have obviously been utilized as payment for employee services and therefore must be expensed. The most prudent course of action is to proactively prepare for and adapt to this change before it's implemented.

## PREPARING FOR CHANGE

So assuming that expensing options is really a question of when and not if it's going to happen, the next step is to ask what this change will entail and how the industry can prepare for it.

If we're lucky, the expense will be based upon some type of valuation at the date of grant, not a variable charge based on the spread between the exercise price and the market price. So, in this case, if an option were granted at \$10, the expense would likely be about \$5. This is in contrast to a variable charge, where a \$10 option on a stock that rises to \$100 would have an expense of \$90. Given the rate at which Black-Scholes values have risen in the last few years, we can assume that, on average, the expense will be about 50% of the face value of the options at the time they are granted.

What will this "options as an expense" future look like? For starters, stock options will be:

- Evaluated on equal footing against all other long-term incentives, based purely on their own merits.
- Expected to pass the pay for performance test, where vesting may frequently be based only on performance.
- Formulated with shorter terms, to reduce their value and expense.
- Granted far less frequently as part of company-wide, all-employee plans.

As the changes take hold, we also will see companies deciding whether to grant stock options versus some type of performance cash or phantom stock units instead.

Phantom stock and performance cash plans have the benefit of a more predictable expense and more clearly defined pay for performance relationship. This is because they are based on specific financial performance measures rather than stock price. Financial performance, while not entirely predictable, is far less volatile than a company's stock price and is seen by executives as more controllable and more reflective of their personal performance.

In the future, stock options will indeed have to pay for themselves, just like any other incentive. Option plans will have to be linked to a demonstrable, measurable increase in the bottom line that is significantly in excess of the expense generated by the options.

The debate will be a healthy one, and it's long overdue. Companies and Boards will again ask why long-term incentives are granted in the first place and what they're trying to accomplish. They may ask deeper questions about why people come to work and what they're being offered beyond massive option grants. In short, they'll likely engage in the same analysis that private companies have always dealt with. As a result of this reflection, we may see a reduction in the size of executive long-term incentives, and certainly a flattening of the incredible 20%-40% annual growth in option grants seen in recent years.

To be adequately prepared, practitioners will have to be able to justify the long-term incentive expense, based on more than just competitive practice and whether there are enough shares to go around. They will have to counsel the Board regarding the pros and cons of various alternatives to options. And, they must also become experts in understanding how value is created, how the company makes money and how to measure financial performance.

It is a widely known and often repeated fact that "what gets measured gets managed." If pending changes in the industry include measuring the cost of stock options and accurately reporting that cost in financial statements, the result is likely to be far more judicious management of options smaller grants, stronger ties to performance, comparison against other incentive vehicles and more thoughtful analysis of the costs and benefits of long-term incentives.

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