Business

FOOTNOTE REPORTING DISTORTS IMPACT OF STOCK OPTIONS

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THE FOLLOWING IS AN ADAPTATION OF AN ARTICLE THAT APPEARS IN THE MARCH ISSUE OF HARVARD BUSINESS REVIEW, "FOR THE LAST TIME: STOCK OPTIONS ARE AN EXPENSE," PREPARED EXCLUSIVELY FOR THE BOSTON GLOBE.
The controversy over stock-option accounting has gone on far too long. For the second time in nearly two decades, the Financial Accounting Standards Board, the industry's leading standards-setting body, is reviewing the issue. When FASB last made a ruling, in 1995 and after more than a decade of debate, it bowed to pressure from businesspeople and politicians and issued a compromise that recommended, but didn't require, expensing stock options. Today, with a few exceptions, most companies list their stock options in their footnotes, where they have no impact on the income statement.

FASB shouldn't make the same mistake twice. Relegating stock options to footnotes not only violates basic accounting principles, but distorts corporate reports. Consider this: Had AOL Time Warner in 2001 reported employee stock-option expenses, it would have shown an operating loss of about $1.7 billion rather than the $700 million in operating income it actually reported.

Despite what we feel is an overwhelming financial and accounting case for expensing options, there continues to be intense and vocal opposition to the idea, particularly from the high-tech community. But the four most common arguments against expensing do not stand up.

Fallacy 1: Stock options aren't a real cost. It is a basic principle of accounting that financial statements should record economically significant transactions. Issuing stock options is just such a significant transaction and footnote reporting is not a substitute for recognition on the income statement. Even if no cash changes hands, issuing stock options to employees incurs a sacrifice of cash, an opportunity cost that needs to be accounted for. If a company were to grant stock, rather than options, to employees, everyone would agree that the company's cost for this transaction would be the cash it otherwise would have received if it had sold the shares at the current market price to investors. It is exactly the same with stock options. When a company grants options to employees, it forgoes the opportunity to receive cash from underwriters who could take these same options and sell them in a competitive options market to investors.

Fallacy 2: The cost of employee stock options can't be estimated. Some argue that existing option-pricing models can't capture the value of employee stock options, which are private, nontradable contracts between the company and the employee with restrictions such as two-to four-year vesting requirements. But option-pricing practice during the past 30 years has evolved to permit all the features of employee stock options to be incorporated into a pricing model. A few investment banks will even quote prices for executives looking to hedge or sell their stock options prior to vesting, if their company's option plan allows it. Also, since option-pricing models are based on the characteristics of the underlying stock, good pricing estimates can be obtained even if the options themselves are not traded or tradable.

Fallacy 3: Stock-option costs are already adequately disclosed. Some critics argue that expensing options would amount to "double counting" in earnings-per-share: first as a potential dilution of the earnings, by increasing the shares outstanding, and second as a charge against reported earnings. This argument is incorrect on two grounds. First, fully diluted EPS numbers ignore the costs of options that are nearly in the money or could become in the money if the stock price were to increase significantly in the near term. Second, it is easy to demonstrate that the proper calculation of EPS must include the cost of options granted in the numerator, as well as the increase in number of shares in the denominator. The present rule, with disclosure relegated to a footnote, leaves many important and widely followed profit measures, such as operating income and return on investment, to be distorted by the omission of options costs.

Fallacy 4: Expensing stock options will hurt young businesses. Many critics of expensing argue it will make life more difficult for the businesses that rely heavily on options to reward their entrepreneurial talent. We recognize the vitality and wealth that entrepreneurial ventures, particularly those in the high-tech sector, bring to the economy, and in principle we have no objection to measures that encourage and assist new ventures.

But we have to question the effectiveness of the current rule, which essentially makes the benefits from a deliberate accounting distortion proportional to companies' use of one particular form of employee compensation. After all, some forms of incentive compensation, such as restricted stock, performance cash awards, and indexed or performance options, arguably do a better job of aligning executive and shareholder interests than conventional stock options do. Yet current accounting standards require that these, and virtually all other compensation alternatives, be expensed. Are companies that choose those alternatives any less deserving of an accounting subsidy than Microsoft, which, having granted 300 million options in 2001 alone, is by far the largest issuer of stock options?

A less distorting approach for delivering an accounting subsidy to entrepreneurial ventures would simply be to allow them to defer a percentage of their total employee compensation for some number of years. That way, companies could get the supposed accounting benefits from not having to report a portion of their compensation costs no matter what form that compensation might take.

Options are a powerful incentive tool. But failing to record a transaction that creates such dramatic effects is economically indefensible and encourages companies to favor options over alternative compensation methods. It is not the proper role of accounting standards to distort compensation by subsidizing one form of incentive compensation relative to all others. FASB should make the right decision and require companies to record stock-option grants as an expense.

OPINION Zvi Bodie is a professor of finance at Boston University's School of Management. Robert S. Kaplan is the Marvin Bower Professor of Leadership Development at Harvard Business School. Robert C. Merton is the John and Natty McArthur University Professor at Harvard Business School.

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