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Options Should Be Reflected in The Bottom Line

By Zvi Bodie, Robert S. Kaplan and Robert C. Merton. **Wall Street Journal**. (Eastern edition). New York, N.Y.: Aug 1, 2002. pg. A.12

Abstract (Summary)

First, some argue that grants of stock options do not involve cash outlays, and therefore no expense should be recorded. This reasoning violates the basic accrual principle of accounting. Not every cash outflow is recorded as an expense in the period in which it occurs, nor does every expense recognized in a period involve a cash outflow. For example, when a company compensates employees by making outright grants of stock or promising future pension benefits, no cash outflows occur. Yet the company would record, as compensation expense, the value of the stock granted or the present value of the pension benefit promised. Stock-option grants should receive comparable treatment.

A second error is to argue that the expensing of stock options would be double counting because the diluting effect of granting the options is recognized by an increase in the number of shares in the denominator of a fully-diluted earnings per share calculation. But by extension this argument would apply to shares of stock granted to employees as well as to stock options. If accepted, companies could issue stock in lieu of salary to employees, ignore the value of the stock issued, and just record the increase in the number of shares outstanding. This erroneous argument would also enable a company to issue stock options to, say, a supplier of materials or energy, and not record the materials or energy consumed as an expense because the effect would show up in the higher number of shares in an earnings-per-share calculation. Curious reasoning.

Full Text

(917 words)

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There are some issues on which accounting and finance professors disagree, but the expensing of employee stock options is not one of them. Despite the pronouncements of a few renegades in our disciplines, we believe there is near unanimity of opinion among scholars in the fields of accounting and finance that the value of employee stock options should be expensed on a firm's income statement at the time they are granted.

The reasons are clear. Stock options have a market price, so when a company grants options to employees, the company has given up something that has considerable value. This value is the amount the company would have received had these same options been underwritten and sold for cash in a competitive options market. Indeed, Coca-Cola recently led the way when it announced plans to expense employee stock options using competitive bids from investment banks to compute the cost of its options.

Even when a company's options are not traded directly in a market, their approximate price can be inferred from the prices of other securities that are traded in markets. Analysts use mathematical models and formulas to estimate the prices of all types of options. In this respect, options are no different from any other class of financial assets such as stocks, bonds, mortgages, and widely-traded derivative securities.

Sometimes analysts' models provide only a rough estimate of the "true" market value of a nontraded asset. Nevertheless these estimates are used every day to settle transactions involving the payment of billions of dollars, such as in a merger or acquisition.

When a company issues securities whose value can be reasonably determined, accounting principles require that this value be recorded in the company's financial statements. Yet many executives, venture capitalists, politicians, journalists, and even some professional economists have voiced their opposition to proposals that

companies reflect the cost of employee stock options on their income statements. We think their arguments make one or more errors in reasoning.

First, some argue that grants of stock options do not involve cash outlays, and therefore no expense should be recorded. This reasoning violates the basic accrual principle of accounting. Not every cash outflow is recorded as an expense in the period in which it occurs, nor does every expense recognized in a period involve a cash outflow. For example, when a company compensates employees by making outright grants of stock or promising future pension benefits, no cash outflows occur. Yet the company would record, as compensation expense, the value of the stock granted or the present value of the pension benefit promised. Stock-option grants should receive comparable treatment.

A second error is to argue that the expensing of stock options would be double counting because the diluting effect of granting the options is recognized by an increase in the number of shares in the denominator of a fully-diluted earnings per share calculation. But by extension this argument would apply to shares of stock granted to employees as well as to stock options. If accepted, companies could issue stock in lieu of salary to employees, ignore the value of the stock issued, and just record the increase in the number of shares outstanding. This erroneous argument would also enable a company to issue stock options to, say, a supplier of materials or energy, and not record the materials or energy consumed as an expense because the effect would show up in the higher number of shares in an earnings-per-share calculation. Curious reasoning.

Third, some argue that employee stock options are worth less than publicly traded options because employees do not gain full ownership of the shares for several years (called the vesting period) and the company may place restrictions on employees' selling their options. But a firm's financial report reflects the perspective of the firm and its shareholders, not the entities with which it contracts. This principle is so fundamental that it is usually taught on the first day of an introductory accounting course. Therefore, the value of the stock option to the company is its cost -- the cash forgone by granting the options to an employee rather than selling them to external investors -- not its value to the person who receives it.

Finally, some opponents of expensing employee stock options make two arguments that actually conflict with each other. First, they claim that it is enough to disclose the information in the footnotes to corporate financial statements as is done now. And second, they claim that to require that options be expensed would hurt companies, particularly high-tech firms that rely heavily on options as a form of compensation. But if deducting the expenses of options that are already disclosed in footnotes would drive a company's stock price down, then we have proof that the disclosure alone was inadequate to capture the underlying economic reality.

The accounting for employee stock options on a firm's income statement should be decided according to economic and accounting principles, not by dubious rationalizations. If the following true-or-false question appeared on an accounting exam, the answer is quite clear: Employee stock options should be expensed on a firm's income statement. True.

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(See related letters: "Letters to the Editor: Stock Options: To Expense or Not to Expense" -- WSJ Aug. 12, 2002)

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