

# Accounting For Stock Options: A Historical Perspective

Paul J. Carruth, (E-mail: pcarruth@selu.edu), Southeastern Louisiana University

## Abstract

*In recent years stock options have become one of the most dominant and controversial forms of executive compensation. Stock options are controversial not only because of the sheer magnitude of some executive option grants, but also because of the method used to account for them. Currently, the fair value of stock options does not have to be reported as compensation expense on the income statement. Critics maintain this approach results in an inflated and misleading amount of reported net earnings. This paper addresses the role of stock options as an effective means of employee compensation and traces the historical development of the accounting treatment of stock options. In addition, the current reporting requirements for options are discussed along with recommendations for improving the manner in which stock options are accounted for.*

## 1.0 Introduction

During the last decade, stock options have gone from being a relatively negligible part of executive compensation to being the dominant portion. By the end of 2001, stock options were used by 90% of large U.S. corporations (Tyson, 2002), and they accounted for 58% of the compensation packages for chief executives in large U.S. companies (Economist, 2002). Stock options are designed to give employees the right to buy a certain number of shares of the company's stock at a specified price after a specified period of time, usually within ten years. For example, if an employee has an option to buy stock at ten dollars a share when it is trading at thirty dollars a share, the employee can purchase the stock from the company at ten and immediately sell it in the marketplace for a twenty dollar per share profit.

Stock options have become an increasingly controversial method of compensation. This is due in part because of the manner in which options are accounted for in the financial statements of companies that issue them. Under generally accepted accounting principles (GAAP), companies are not currently required to expense stock options on the income statement, even though like wages they are generally viewed as a form of compensation. Some knowledgeable financial observers believe that failure to expense stock options results in a significant distortion in reported earnings and results in the failure of financial statements to accurately represent corporate performance (Lagomarsino, 2002). This view is supported by a PricewaterhouseCoopers survey of 100 publicly traded, high-tech and emerging companies that found that the median reduction in earnings resulting from the expensing of options in the year 2000 would have been 16.5% (Whitman, 2002).

The primary role of accounting is to communicate financial information to users of the financial statements. Adequate, informative disclosure is a standard by which accounting can be judged. Important financial decisions concerning how resources are to be allocated in the capital markets are made based upon representations made in the financial statements. The purpose of this paper is to: (1) analyze the role of stock options as an effective means of compensation, (2) trace the historical development of the accounting treatment of stock options, (3) discuss the current method of accounting for stock options, and (4) suggest changes to improve the accounting for stock options.

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*Readers with comments or questions are encouraged to contact the author via email.*

## **2.0 Compensation Strategy**

A strategic compensation plan should effectively tie together the achievement of organizational goals with employee rewards. The compensation plan should be designed to motivate managers to achieve high levels of performance by basing their compensation on their performance as well as that of the company. In addition, the plan should be designed to retain talented executives as well as recruit new talent. Stock options have often been used as part of a strategy to develop employee loyalty to a company by providing them with a future equity interest based on improvements in long term measures such as earnings per share and company stock prices. In the last decade for example, cash strapped, high-tech startup companies that did not have the means to pay large cash salaries have used stock options to attract talented employees. In addition to saving these small companies millions of dollars in cash salaries, stock options served as a link between the fortunes of the employees and the success of the company, and thus served as a valuable means of recruitment and retention of valued employees.

Stock options have also been promoted as a means to solve a weakness in corporate ownership referred to as the principal-agent problem (Lee, 2002). This problem occurs when one group of people owns the company while another group manages it. The two groups do not necessarily have the same interests regarding the use of corporate resources. For example, salaried senior executives may be inclined to spend company resources on perks, such as corporate jets and yachts that stockholders do not view as good stewardship of company resources. Thus it becomes important to design executive incentive systems that align their interest with that of the shareholders. Stock options, it is argued, achieve this goal by turning managers into stockholders and therefore giving them an interest in the financial success of the company. As shareholders, managers would then have the motivation to concentrate on improving company earnings and stock prices, and of course shareholder wealth. In fact, a considerable amount of economic literature suggest that the net effect of stock options is positive in that they result in earnings growing faster due to the beneficial incentives they provide top management (Malkiel and Baumol, 2002).

In addition, stock option advocates argue that options provide a method of compensating managers that really does not “cost” the company because it does not have to pay out cash, as it would if salaries and bonuses were being paid. From this perspective, stock options are viewed as a redistribution of benefits between initial shareholders and the recipients of stock options. This approach to compensation does not result in the reduction of the overall amount of the earnings, but rather only affects the way the earnings are divided up. Furthermore, another often enormous benefit of using stock options as compensation is that while stock options do not have to be expensed on the income statement, current tax laws allow companies a tax deduction for the full amount of the gain the employees realize when they exercise their options (Colvin, 2002). As a result of the tax deductibility of stock options, in 2000 Microsoft saved \$2.06 billion in taxes, Cisco \$1.4 billion, and Enron converted what would have been a \$112 million tax liability into a \$278 million refund (Judis, 2002).

However, opponents of stock options have cited a number of flaws they see associated with the use of stock options. Critics of stock options have argued that these plans do not always achieve the goal of aligning the long-term interest of shareholders with that of management. In fact, some critics argue that the use of stock options actually creates incentives for top executives to manipulate earnings through inappropriate and even fraudulent accounting practices. Deceptive practices that boost reported earnings in the short-term drive up the value of the shares of stock as well as the value of executive stock options.

One of the concerns regarding stock options is the sheer magnitude of the wealth that CEOs can receive from the exercise of stock options. For example, in 2001 the CEO of The Oracle Corporation received \$706 million from the exercise of long-held stock options, even though the company’s stock was off 57% for the year ( Lavelle, Jespersen, and Arndt, 2002). As another example of perceived excesses associated with stock options, in 2000 the chairman of Enron realized \$123 million from exercising options while most ordinary stockholders lost nearly all of the value of their investments and thousands of workers lost their jobs (Hitt and Schlesinger, 2002). Critics of the current reporting method maintain that expensing the current value of the stock options on the income statement would make their cost more transparent and thus reduce some of the excesses and extravagances in executive compensation (Malkiel and Baumol, 2002).

Other critics of stock option plans question the link between compensation and performance that options are supposed to provide due to the repricing policies of some companies. For example, if stock values fall and the option price is above the current market price of the stock and is likely to remain so for some time, the options are essentially worthless. Therefore, some companies feel compelled to reprice the options at a lower exercise price or issue new options at a lower exercise price in order to retain employees (Grant and Ciccotello, 2002). This situation is particularly prevalent in high-tech startup companies that experience a great deal of volatility in their share prices. Critics argue that repricing removes the incentives that options are designed to provide, and that it in fact may even reward bad performance. Furthermore, while executives are protected from the risk associated with bad performance (i.e., dropping stock prices), existing stockholders are not.

Of even greater concern to some is the dilution of current shareholder's interest resulting from the issuance of stock options (Gray, 2002). When the options are exercised, the company issues new shares which results in the same amount of earnings being spread over more shares of stock. The resulting decline in earnings per share reflects the reduction of existing stockholder's share of the corporate earnings. Furthermore, if the stock options had not been issued at below market exercise prices, the company could have sold new shares at the current market price which would have brought in additional cash that could have been employed by the company to generate new earnings. So there is in fact a cost to the company, an opportunity cost, associated with stock options. On the other hand, if the company chooses not to have its earnings diluted when options are exercised, then it must go into the marketplace and purchase, for cash, treasury shares that can then be distributed upon the exercise of stock options. So once again, there is a real cost to the firm associated with the issue of stock options. These costs are not reflected on the earnings statement, but they do have an effect on the company's cash balance. In the past, many boards of directors viewed stock options as a free way to compensate executives, because unlike salaries and bonuses no cash was paid directly to the employees. This perspective often resulted in the over-issue of stock options, which resulted in excessive amounts of compensation to executives. Many boards of directors are now beginning to look more closely at stock option plans.

### **3.0 Historical Development Of The Accounting Treatment Of Stock Options**

The method of accounting for stock options has been very controversial for more than a decade. Under current accounting guidelines, companies must choose to either expense the fair value of the stock options against earnings on the income statement or disclose their theoretical value in footnotes to the financial statements. While the Financial Accounting Standards Board (FASB) recommends the former approach, most companies in the past have chosen only to disclose the information in footnotes. In fact, only two companies in the Standard & Poor's 500 choose to expense stock options on their financial statements in 2001 (Hitt and Schlesinger, 2002). If a company pays employees with cash, the company must record this as an expense that reduces company profits. On the other hand, by issuing stock options rather than paying cash salaries or bonuses, companies can compensate employees without ever having to reduce profits.

In the early 1990s the FASB, which is the authoritative body responsible for promulgating generally accepted accounting principles, became very concerned about the method of not expensing stock options on the income statement. The primary concerns were that, in the view of the FASB, a) the value of issued stock options is compensation, b) compensation is in fact a cost that should be recognized on the income statement, and c) an accounting standard that requires nonrecognition of cost results in financial statements that are neither representationally faithful nor credible (Derieux, 1994). As the result of these concerns, the FASB issued an exposure draft on June 30, 1993 entitled "Accounting for Stock-Based Compensation." The recommendations were that the value of stock options issued to employees should be recognized in the financial statements as compensation expense and that disclosures related to these options be enhanced. In other words, the FASB was proposing that a new accounting standard be adopted that would require companies to expense the fair value of stock options on their income statement, thus reducing the amount of net earnings reported by companies that issued stock options as part of their compensation package.

The exposure draft was met with a firestorm of protest from the business community. Some critics of the exposure draft argued that stock options are not compensation expense because they do not cost the company

anything. In their view, the company simply issues pieces of paper that allow employees to buy stock at a set price. If the stock price goes up, the employee benefits because they can buy at the lower exercise price. Hence no outlay cost to the company and thus no expense to the company.

Other critics of the exposure draft contended that it was difficult if not impossible to appropriately price the options at the time of issue. These opponents of expensing options argued that it is extremely complex to calculate their value at the time they are issued with accuracy. This difficulty is due in part to many variables that are associated with options such as: they do not vest immediately, they are dependent upon continued employment, they often are not exercised for five or six years out, and they sometimes are not exercised at all if the stock prices fall. The difficulty of estimating the variables associated with stock options can result in a wide range of estimates of the fair value of options at the time of issue.

Perhaps the argument most used by critics of the exposure draft was that expensing stock options would have disastrous effects on American business, and in particular the high-tech industry. The economic consequences argument revolved around the concern that the lower reported net earnings resulting from expensing stock options would increase the borrowing cost of start-up companies and put them at a competitive disadvantage in obtaining needed venture capital. Also, required expensing of options might force some high-tech, start-up companies to stop using options to attract the type of talented people needed to make their companies successful. And since these types of innovative, high-tech companies were viewed as a driving force in the “new economy”, those opposing accounting reforms argued that the United States economy would be harmed if stock options were required to be treated as a reduction of company earnings.

As the result of an intense lobbying effort by the business community, the United States Congress got involved. In the Senate, a bill was introduced that would have mandated that the Securities and Exchange Commission (SEC) require that no compensation expense be reported on the income statements for stock option plans. Against this backdrop, the FASB looked for political support to back their exposure draft but found few willing to support their proposal for expensing stock options. Out of concern of Congressional involvement in setting accounting standards on the basis of economic or political agendas, and out of concern that the divisiveness of the debate over accounting for stock options could threaten the future of accounting standard-setting in the private sector, the FASB backed away from their exposure draft which if adopted would have mandated the expensing of stock options.

#### **4.0 Current Method Of Accounting For Stock Options**

In 1995, the FASB issued *Statement of Financial Accounting Standards (SFAS) No. 123* “Accounting for Stock-Based Compensation” which recommends but does not require that compensation cost for the fair value of stock-based options plans be recognized on the income statement as an expense (SFAS No.123, 1995). The position of the FASB is that accounting for the cost of compensating employees should be based on the fair value of what is paid. Therefore, the compensation cost resulting from employee stock options should be based on the fair value of the stock options granted. While this value is difficult to determine with complete accuracy, the FASB recommends that acceptable option pricing models such as the Black & Scholes Model be used to value options at the date of grant and to expense this amount on the income statement. This accounting approach is referred to as the “fair value method.” The pricing model developed by economists Fischer Black and Myron Scholes is designed to project the long-term value of stock options. Mr. Scholes was awarded a Noble Prize in economics for his work on the model (Hitt and Schlesinger, 2002). This sophisticated mathematical model takes into account such factors as the volatility of the underlying stock, the expected dividends during the life of the options, and the expected life of the options.

Because of the considerable opposition to the FASB’s proposal to require the use of the “fair value method”, the final version of *SFAS No. 123* allows companies to choose to use the alternative “intrinsic value method.” This approach measures compensation cost as the excess of the market price of the stock over the exercise price of the stock options on the date the options are granted. However, since stock options are generally used to provide incentives for executives to grow the value of the company, the exercise price is almost always set at a price equal to or greater than the market price of the stock on the date the options are granted. Thus, the “intrinsic value

method” almost always results in no cost being assigned to stock options and therefore no compensation expense recognized on the income statement. However, if a company uses the “intrinsic value method”, the standard requires it to disclose in a footnote pro-forma net income and earnings per share data showing what net income would have been if the “fair value method” had been used. In other words, the company would have to disclose in a footnote what net income would have been if the fair value of employee stock options had been expensed on the income statement (Grant and Ciccotello, 2002).

Given the benefits of not expensing the fair value of employee stock options against earnings, most companies in the past have chosen to use the “intrinsic value method.” However, if companies were required to recognize stock options as an expense, the impact on reported earnings would be quite significant. For example, Bear Sterns & Company estimate that net profits of Standard & Poor’s 500 stock index companies would have been 9% lower than reported if the estimated cost of stock options had been expensed against earnings in 2000 (Gleckman, 2002).

## **5.0 Recommendations**

Because of the unjustified size of some executive stock option plans, and due to the inflated earnings that result from the failure of most companies to expense stock options, reform in the area of stock options is needed. This reform must focus on both the use of stock options as a means of executive compensation and the manner in which options are reported on the financial statements.


Reform in the area of compensation requires the use of strict performance-based option plans. No longer should executive insiders reap enormous gains while at the same time shareholders are losing their retirement savings. Furthermore, mediocre performance should not be rewarded, as can happen with standard stock options during bull markets when almost all stock prices rise. The old plans must be replaced with ones that reward management only when the company outperforms the market. Companies should be expected to clearly disclose whether the executive stock option plans require better than average performance in order for executives to benefit from the exercise of options. Without such requirements, executives may reap huge rewards for mediocre or even below average performance. For example, if a stock option is issued with an exercise price equal to the market price on the date of issue, say \$100, a mere 5% annual increase in the stock price compounded over five years could result in an enormous profit for the options holder. This would occur because the option holder could purchase company stock at the exercise price of \$100 when five years later the market price is \$127. This benefit would accrue to the company executive even if the average annual return on all stocks was greater than the 5% earned by the company. Existing shareholders would be better served if the exercise price of the options rose every year by a percentage equal to at least the average increase for all stocks. This approach would assure that executives are rewarded only for better than average performance. Adjusting the exercise price upward would help achieve one of the primary goals of executive stock options, that of aligning the interest of corporate executives with that of the shareholders.

Needed reform in accounting for stock options has become apparent in recent years. Various studies have shown the extent to which the current treatment of not expensing stock options has resulted in companies reporting inflated profits. For example, the Federal Reserve has calculated that if stock options had been charged against earnings in the years from 1995 to 2000, Fortune 500 companies would have seen their annual profit margins reduced from 12 percent to 9.4 percent (Judis, 2002). Another study suggest that the value of unexpensed stock options amounted to nearly 20% of the profits of large American firms in the year 2000 (Economist, 2002).

A survey by the Association for Investment Management and Research (AIMR) found that more than 80% of portfolio managers and financial analysts worldwide believe that employee stock options are in fact compensation and should be expensed on the income statement (Hayward, 2002). Currently, the information on stock options can be found in the footnotes to the financial statements, but investors must search for this information and then factor it into their valuation of the company. While some analyst don’t necessarily believe they would get more information, they do believe the markets would be better served if the fair value of options were expensed on the earnings statement because the financial statements would be more transparent, would provide a more accurate picture of the company’s financial position, and would give investors more confidence in the financial information being

presented. Some investors believe that the current form of disclosure is a deliberate attempt to conceal information about stock options, and this brings into doubt other presentations made by the company.

## 6.0 Conclusion

Reform is never easy. It is particularly difficult when a large number of influential individuals have a vested interest in things remaining the same. However, recent corporate scandals have refocused attention on accounting practices in general and accounting for stock options in particular. Reported net income and earnings per share represent some of the most important information companies provide to investors. The proliferation of stock options as a form of executive compensation and the failure to expense this compensation cost has systematically inflated corporate earnings, distorted financial statements, misled investors, and encouraged a diversion of capital resources away from their most productive and efficient use. The adoption and use of accounting standards must be done in a manner that best serves the public good. Better accounting standards provide transparency that leads to greater investor confidence in the capital markets, which leads to better allocation of the nation's resources. The accounting profession must be unyielding in its efforts to improve accounting standards by improving the method of accounting for stock options. 

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