EXPENSING ISN'T THE ONLY OPTION:

Alternatives to the FASB's stock option expensing proposal

By Benjamin A. Templin

INTRODUCTION

For the second time in just over a decade, the Financial Accounting Standards Board (FASB) proposed a new rule requiring companies to treat stock options as an expense on the Income Statement. A heated debate over the issue has raged among shareholder rights activists, accountants, economists, industry leaders and venture capitalists. Opinions have polarized into two camps. Advocates blame stock options for the Enron, Worldcom and other high profile accounting fraud scandals. They reason that the lure of lucrative gains drove greedy executives to artificially pump up the value of their company's stock. According to this camp, requiring companies to expense options will lead to much smaller grants thus removing the incentive to commit accounting fraud.

At the other end of the debate, many economists and tech industry leaders argue that options are an integral and unique characteristic of American capitalism that has led to technological innovation and world economic leadership. They agree that expensing will reduce the number of options, but only for rank and file workers and not executives. Instead of discouraging fraud, they contend the decrease in option incentives will derail

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an innovative form of wealth sharing and threaten America’s dominance as a tech leader in the global economy.

In addition to the debate over whether options produce accounting fraud, there is a more fundamental question of clarity in accounting. Will the proposed FASB rule lead to better financial information for investors? The FASB contends that the present system doesn't accurately reflect the true financial picture of a company. Since the company gives the employee a valuable equity instrument, the FASB argues that the option should be expensed at the date of grant using a sophisticated option pricing model developed by economists. By implementing the rule, the FASB seeks to bring American standards in line with those of the International Accounting Standards Board (IASB). Opponents counter that no expense should occur because no money leaves the corporate coffers when a grant is made. Moreover, they argue that FASB’s option pricing models used to value options are too unpredictable and subject to manipulation. Leading economists, even those who are against the idea of granting options to employees, agree that the option pricing models are inaccurate. The opponents of FASB contend that the results from option pricing models are likely to confuse investors rather than help them in the investment decision.

With so much money at stake and the politicians thoroughly engaged in fighting it out for their particular constituency, the real issues have increasingly become clouded in blistering rhetoric and finger pointing. Newspaper reports and columnists characterize any challenge to FASB’s new rule as being in favor of greedy CEOs and fat salaries for
The truth is that both sides have a legitimate point of view. The unfortunate result of the media hype, however, is that the specter of a handful of morally lax executives making millions off of options threatens to derail one of the most effective methods of wealth creation for rank and file workers.

In this article, I trace the history and analyze the arguments behind each side of the option debate. As a framework for the analysis, I adopt the categorization methodology used by Professor Margaret Blair in her review of corporate reform proposals spawned by the scandals that erupted in 2001. Professor Blair splits the types of reforms into two general categories – 1) Those reforms “enhancing the quality of information,” which I call Information Reforms and 2) “‘Rules-of-the-game’ reforms,” which shift power from management and directors to shareholders.

Part I reviews the FASB proposal and its history. I examine the mechanics of the current accounting rules and those of the proposed rule. I look at the political forces at work and how the Stock Option Accounting Reform Act passed by the House of Representatives modifies FASB's proposal.

Part II examines the pros and cons of the expensing issue from the perspective of an Information Reform -- i.e. does the change lead to greater clarity in financial reporting? I examine the current and proposed methodologies and underlying assumptions. I conclude that FASB's goals of reliability, consistency and comparability are not furthered by the

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3 Margaret M. Blair, Reforming Corporate Governance: What History Can Teach Us, 1 Berkeley Bus. L.J. 1, 39-40 (Spring 2004).

4 Id.
proposed expensing rule because FASB does not provide an accurate method of predicting the true cost of options to the corporation. I also find that the compromise legislation in Congress does not further the goal of financial clarity and may do more harm than good.

Part III looks at alternatives to FASB's rule. I argue that investors would be better served if FASB would adopt the Internal Revenue Service's (IRS) method of valuing options for tax purposes. The IRS values the intrinsic value of an option (the difference between the exercise price and the market price) at the date of exercise rather than use an option pricing model at the date of grant. The IRS recognizes the inherent uncertainty of option pricing models and seeks to tax the real gain that an employee receives -- i.e. the value when he/she exercises. To temper the fact that employees receive a valuable equity instrument at the date of grant, I argue that this concern can be resolved by mandating that companies only use a fully diluted in-the-money capitalization for purposes of reporting earnings per share (EPS).

Part IV turns towards the question of whether the second goal of reforming corporate fraud is furthered by the rule. Assuming that the proponents' argument is correct -- i.e. that options create an incentive to commit fraud -- I demonstrate the incentive will not be removed by the rule change since studies show that rank and file workers but not executives will have a reduction in option grants. Furthermore, I dispel the argument that options create an incentive to commit fraud and look at the overall effect on the firms and the economy from the proposed rule. After discussing the available surveys, I conclude that adverse economic consequences for both individual firms and the economy at large
will occur if the expensing rule continues.

In terms of preventing fraud, I argue that Information Reforms are ineffective in changing behavior and that effectively combating fraud requires changes in the Rules of the Game. A shifting of power away from the executives and into the hands of shareholders is necessary. One such rule would be to prevent executives from selling stock and issue preferred stock rather than options. In other words, in order to prevent short-term decision making, there should be long-term holdings by the executive of the stock.

I: FASB'S 2004 PROPOSAL: A HISTORICAL OVERVIEW

A. Background and Fundamentals of Stock Option Expensing

In March 2003, the FASB put on its project list a proposal to amend Statement No. 123, Accounting for Stock-Based Compensation, which sets forth the generally accepted accounting principles (GAAP) for how companies treat stock options and other types of equity given as compensation to employees.\(^5\) Under the proposed rule, public companies\(^6\) would be required as of December 15, 2004 to record as an expense on its income statement the "fair market value" of such stock options on the date of grant.\(^7\)

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\(^5\) While FASB Statement 123 covers any equity instrument, the primary focus of the debate over the measure has to do with stock options granted to employees. For purposes of this article, I will focus solely on how Statement 123 affects the expensing of such stock options.

\(^6\) Private companies are allowed to operate under the old rules such that they can elect to record option expense at the intrinsic value. Proposed Statement of Financial Accounting Standards: Share-Based Payment, an amendment of FASB Statement No. 123 and 95, Fin. Acctg. Series Exposure Draft, No. 1102-100, p. ix (FASB Mar. 31, 2004) [hereinafter Proposed Statement]. For purposes of this paper, I will focus on the accounting rules regarding public companies.

\(^7\) Proposed State. at xiii.
1. Fair Value v. Intrinsic Value: Theory and Practice

"Fair value" is a term of art in the accounting field that is defined as the price at which a willing buyer and seller would engage in a sale of an asset.\(^8\) The FASB "fair-value-based" method as to options measures "the compensation cost for awards of share options …at the fair value on the date of grant."\(^9\) Normally, fair value is the market price. In the absence of a market price, accountants measure fair value by using a market selling similar good as a proxy or developing an option-pricing model.\(^10\)

This isn't the first time that the FASB has tackled the issue of how to account for stock options.\(^11\) In 1993, the FASB proposed a similar rule, but the accounting board was sidelined by Congress which itself was pressured by the tech industry.\(^12\) The result of the lobbying was a compromise rule issued in 1995 that allowed for dual systems of accounting. Companies could elect either the “fair-value” method or the “intrinsic value” method of valuation under APB Opinion No. 25, *Accounting for Stock Issued to*

\(^8\) Kevin Hassett & Peter Wallison, *A Troubling Requirement*, Regulation 52 (Spring 2004).

\(^9\) *Proposed Statement*, supra at viii-ix.

\(^10\) No public market exists for employee stock options. They are non-transferable. While there is a market for publicly traded options, such options differ from employee options in such significant ways as to make it unreliable to use the public markets as a proxy for employee options. Hence, the FASB must rely on option pricing models. The most common option-pricing model used to price publicly traded options is the Black-Scholes Option Pricing Model, which is discussed below.


\(^12\) At that time, the technology industry marshaled its lobbying power so that an unprecedented bill was introduced in Congress preventing the adoption of the measure. In his authoritative history of the Securities and Exchange Commission, *The Transformation of Wall Street*, Professor Joel Seligman recounts that the political pressure was so great that SEC chairman Arthur Levitt told the FASB that the SEC would not enforce the rule if the FASB passed it. Joel Seligman, *Transformation of Wall Street*, 714-717 (Aspen 2003).
Intrinsic value measures the difference between the price that the stock is selling at on the market and the exercise price of the option. For example, if an option were issued with an exercise price of $5 and the stock was trading at $15 at the date of grant, then the intrinsic value is the difference between the stock’s market value and the cost to the employee (i.e. the exercise price), which is $10.

In practice, using the intrinsic method usually results in an expense that equals zero. Almost all employee options are granted with an exercise price that equals the fair market value of the shares on the date of grant. If the company granted options at a below market price, the company would not only have to record an expense, but there would also be tax consequences since the IRS would view the under priced option as income.

It’s not surprising that, given a choice, most companies elected to use the intrinsic value rather than the fair value method of accounting. The natural effect of recording any expense is to reduce reported earnings. Since earnings are one of the most important factors that drive stock prices on the public markets, the majority of companies used intrinsic value.

2. Intrinsic v. Fair Value: Does a Footnote Inform the Market?

If a company used the intrinsic value method under the 1995 compromise, then they

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13 Proposed Statement, supra at 13.

14 Id. at xi.

15 Id.. at ix.

16 The intrinsic value approach was chosen by most companies in spite of the fact that the FASB encouraged companies to use Statement 123 as the preferred method. Id. at 116-117.
would still have to include a fair market value calculation in the footnotes to its financial statements. This footnote probably had little impact in disclosing fair value accounting to the public since the footnotes are not included in press releases or summary accounts of earnings figures.  

17 Few investors read the detailed financials disclosure, and if they do, it's not critical to their investment decision. 18 The FASB’s position is that fair value accounting more accurately reflects an economic transaction than the intrinsic value method. 19 Since intrinsic value results in little or no expense being recorded, the FASB reasons that the employee has received an item of value from the company without a cost to the company. This flies in the face of accounting theory which requires that an expense be recorded when a valuable equity instrument is exchanged for receipt and consumption of employee services.

One of the downsides to the 1995 compromise is that it perpetuated two methods of accounting. 20 Consequently, two companies in the same industry of roughly the same size, revenue and number of option grants, but which elected different methods of accounting, would report different earnings. Although the companies are virtually identical, investors would be given different information and could not compare the two companies adequately. Granted, the company that elected the intrinsic value method would still report the fair value in its footnotes.

17 Hassett, Regulation at 52, (Spring 2004).

18 The numbers contained on the actual income statement, rather than the footnotes, carry more weight with the average investor's valuation of a company's worth. Luppino, 2003 Colum. Bus. L. Rev. at 101.

19 Proposed Statement, supra at x.

20 The FASB seeks to simplify existing accounting standards for the recognition of employee expense. Id. at 119.
In an argument that is flawed, the tech industry argues the footnotes constitute full disclosure. The market, they contend, has all of the information that it needs to make an investment decision. The FASB maintains that under FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statement of Business Enterprises reporting financial information in a footnote does not conceptually result in full disclosure. In other words, the recognition of an expense is not actually recognized if it is only contained in a footnote. The expense must also be recognized in the main financial statement.

The FASB is correct. The problem with the tech industry's argument is that only sophisticated investors read the footnotes. The common investor will likely respond to the earnings figure that is reported by the media (which is hardly ever the one reported in the footnote) and would probably never read the footnote or be aware that there were different methods applied. Consequently, a hypothetical investor might sell a stock when he should have bought or vice versa.

Initially after 1995, the two methods of accounting -- intrinsic value and fair value -- didn’t create much of a problem in comparing financial data. For the most part, companies elected the intrinsic value method since it led to a higher reported earnings figure. If given a choice between promoting a higher or lower EPS, any company’s PR

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21 Economist Kevin Hassett thinks that the expensing information is appropriately contained in the footnote since the valuation methodology of Black-Scholes is widely considered to be flawed. Therefore, he reasons that the information is appropriate to footnote status. Those investors who want to see how the firm might have reported the expense can do so but the rest of the investors will have a truer picture of the corporation without a flawed predictive mechanism. Kevin A. Hassett, Testimony Submitted to United States House of Representatives Committee on Financial Services, http://financialservices.house.gov/media/pdf/042104kh.pdf (Last updated April 21, 2004) [hereinafter Hassett, Testimony].

22 Proposed Statement, supra at 125.

machine will naturally trumpet the higher figure. Setting aside for a moment the matter of whether intrinsic value is a reliable figure, if nearly every company was using the same method, then every investor would have the same yardstick and comparability would not suffer. Everything else being equal, one could presumably make valid comparisons if everyone used the same accounting method.

3. Bear Markets and Disgruntled Shareholders

The compromise settled on in 1995 might still be with us today if it had not been for the corporate scandals that erupted in the public markets after the stock market bubble exploded in early 2000. From its height to its lowest point, the S&P 500 Index dropped from over 1500 to below 800 in the next two and half years -- losing 48% of its value.24 There are many speculations on what caused the bubble and the subsequent bust but public scrutiny began to focus on corporate misconduct starting with the Enron bankruptcy.

Roshan Sonthalia notes that six of the eight largest bankruptcies in history occurred in the twelve-month period following Enron’s collapse in December 2001. Of those six, he notes, four of the companies involved executives who used questionable accounting practices to pump up the share price.25 The executives often cashed in by exercising their options and then pocketing their gains by selling the stock. The option grants were often

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24 On the week closing March 20, 2000, the S&P 500 stood at 1527. The worst week recorded thereafter was on September 23, 2002 when the S&P hit a low of 800.

generous – having been granted by a friendly board of directors.\textsuperscript{26}

There was also increasing dissatisfaction with executive compensation. The disparity between a company's lowest paid worker and the CEO had grown substantially in the previous two decades. "The average chief executive officer's pay has increased from 42 times in 1982 to 411 times that of the average production worker in 2001."\textsuperscript{27} A large portion of the executive's compensation was reflected in options. Former Reagan economic advisor William Niskanen thinks the rise in the use of options for executive compensation was strongly influenced by the 1993 tax law, Internal Revenue Code Section 162(m)(1), that limited deductions for compensation to executives that was over $1 million.\textsuperscript{28} Whereas, certain types of options qualify as deductions.\textsuperscript{29}

As the financial scandals came to light in 2001, a significant number of companies began to elect to expense options thus leading to difficulties in comparing data. With more companies electing to choose fair value instead of intrinsic value, it became more difficult for investors to make meaningful comparisons of financial statements.\textsuperscript{30} Clearly, there's an uneven playing field if companies are using different standards of accounting.

\begin{footnotes}
\footnote{26 Several commentators, including Federal Reserve Board Chairman Alan Greenspan and former SEC chief Arthur Levitt have blamed options for the stock market boom and bust between 1995 and 2000. Both contend that the possibility of a rich reward from options drove CEOs to manipulate share prices so that earnings were reported higher than the real figure. Seligman, Transformation of Wall Street at 717.}
\footnote{28 Email from William Niskanen, Chairman, Cato Inst., to Benjamin A. Templin, Prof., Thomas Jefferson Sch. of Law, FASB Options Article, (July 12, 2004) (copy on file with Prof. Templin).}
\footnote{29 Options granted under a non-statutory, performance based option plan that is approved by shareholders are eligible for deductions. I.R.C. Section 162.}
\end{footnotes}
Comparison of financial data, which is a critical factor in the investment decision, becomes extremely difficult.

For the most part, the increase in the number of companies expensing options was not a decision based on the higher principles of reliability, consistency and comparability. Rather, the decision to expense was merely a matter of publicity. In the wake of the accounting scandals, many firms wanted to signal to the market that they were “honest” and generate positive publicity as a result.31 If the companies were perceived as honest, then shareholders would buy into the corporation and stock prices would rise. These favorable benefits from the decision to expense reached its peak in the summer of 2002.32

This disparity in accounting practice grew to the point that by February 2004, companies that represented 41% of the market capitalization of S&P 500 index had elected fair value accounting instead of intrinsic value.33 Clearly, one standard was needed if investors were meant to make easy comparisons of financial data.34

B: The FASB acts and Congress responds: The Stock Option Accounting Reform Act

30 Proposed Statement, supra at 118-119.

31 The decision to expense for firms was positively associated with an increase in the number of stories about the firms appearing in the Wall Street Journal and there exists data that supports the notion that there was a positive valuation benefit with the decision to expense. Chandra Seethamraju & Tzachi Zach, Expensing Stock Options: The role of publicity, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=461760 (Last updated October 2003).

32 Id.

33 Proposed Statement, supra at 177.

34 One of the guiding principles of the FASB can be found in FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information, which states that the useful of a company’s financial data is greatly enhanced when it can be compared with the same information from other companies. Comparisons are not useful if two standards are perpetuated. (Id. at xii.)
As a result of these scandals, Congress, the media, shareholder rights activists, the SEC, stock exchanges and the accounting profession began to call for new rules to control corporate misdeeds. The principle legislation was the Sarbanes-Oxley Act.\textsuperscript{35}

One change not addressed by the Sarbanes-Oxley Act but within the purview of the FASB was to reexamine the financial reporting rules surrounding option grants.\textsuperscript{36} Shareholder rights activists felt that they could curb excessive grants by requiring companies to record an expense when a grant is made. The reasoning is that if a company’s earnings drop as a result of the grant, then the share price will be affected and therefore boards of directors will be less likely to grant excessive options.

Since companies still had the choice of either intrinsic value or fair value accounting, shareholders took two routes to implementing the measure. First, they lobbied the FASB to revisit the issue.\textsuperscript{37} Second, shareholders initiated shareholder proposals to compel companies to expense options.\textsuperscript{38} The proposal efforts were largely successful as evidenced by the growing number of companies that began to elect the fair-value based method over the intrinsic value method.\textsuperscript{39}

The FASB also cites feedback from investor groups, which requested that the FASB


\textsuperscript{36} Proposed Statement, supra at 117.

\textsuperscript{37} Id.. at 117.

\textsuperscript{38} Spector, Developments and Trends in Compensation, supra.

\textsuperscript{39} As of March 2003 when the FASB restarted the project to expense options, 179 public companies had elected fair-based value. The number rose to 276 by May 2003 and 483 companies by February 2004. Proposed Statement, supra at 177.
eliminate the dual reporting structure of the 1995 Statement 123.\textsuperscript{40} A 2001 survey of stock analysts and fund managers by the Association for Investment Management and Research fund show that 83\% supported the expensing the stock options.\textsuperscript{41} Over 90\% of the respondents to a survey by stockbroker Merrill Lynch of 30 institutional investors supported a compensation expense for employee options.\textsuperscript{42} In the Merrill survey, over 70\% said that an analysis of employee options is a significant factor in their valuation of a company’s shares.\textsuperscript{43}

The response from the opposition to the latest FASB attempt took shape in Congress in much the same way that it did in 1994. Tech industry lobbyists persuaded friendly House representatives and Senators to introduce the Stock Option Accounting Reform Act -- H.R. 3574 in the House and S. 1890 in the Senate – in November 2003. In the House of Representatives, the bill was primarily sponsored, not surprisingly, by Congressional representatives from California, home to many of the tech companies which would be adversely affected by the FASB proposal.\textsuperscript{44} The bills enjoyed an unusual show of bipartisan support during a contentious presidential election year.\textsuperscript{45}

Corporate executives fought hard to get legislation blocking the FASB since their

\begin{flushleft}
\textsuperscript{40} Id. at 125-126.
\textsuperscript{41} Id. at 126.
\textsuperscript{42} Id.
\textsuperscript{43} Id.
\textsuperscript{44} Of the eight initial sponsors in the House of Representatives, five were from California including: Dreier (R), Eschoo (D), Honda (D), Lofgren (D), and Tauscher (D). H.R. 3574 as introduced, 108th Congress (Nov 21, 2003) (available at http://financialservices.house.gov/media/pdf/108hr3574ai.pdf).
\textsuperscript{45} As of May 12, 2004, there were 52 Democrats and 59 Republicans sponsoring the House bill and 6 Democrats and 12 Republicans sponsoring the Senate bill. S. 1890, 108th Congress (November 19, 2003).
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compensation packages -- and those of their employees -- were at risk. If corporations have to register an expense whenever an option is granted, then their reported earnings could be reduced dramatically. If earnings go down, then it’s likely that the share price would follow. With the drop of the share price, the executives own options may turn worthless.

However, self-interest isn’t the only reason executives opposed the FASB. Options are a lucrative means of employing and retaining talented employees without spending any money, especially for cash strapped technology companies. Cash became increasingly scarce after the downturn in the markets in 2000. Moreover, opponents contend that the economy and America’s technology leadership could be affected if the measure is put into place.

However, the strength of the lobbyists in 2003 and 2004 was much less than it was a decade before given the recent corporate scandals. Whereas the original legislation preempted option expensing, the opponents to the FASB didn't have enough public support to accomplish that goal. However, politicians introduced compromise legislation that required expensing of options for only a company’s top five executives and not for the rank and file workers. Moreover, there were many exemptions from even that limited expensing requirement and manipulations of option pricing models that would drive the expense downwards. Among the exemptions would be businesses with revenues and a market capitalization of less than $25 million and any company that had gone public (i.e.

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46 One provision of H.R. 3574 requires when a company uses an option-pricing model, that the variable normally called "volatility" (see below) be set to zero. The theory is that volatility is a very subjective number that cannot be accurately determined, but the net effect of this requirement is to substantially reduce the value of the option. H.R. 3574, 108th Congress (July 20, 2004).
had its initial IPO) within the past three years.

One of the main thrusts of the Stock Option Accounting Reform Act ("Reform Act"), however, was to require an economic impact study by the Departments of Commerce and Labor before the SEC could require companies to implement any changes that the FASB makes to the stock option expensing rules. The study would focus on the impact the FASB rule would have on 

(1) the use of broad-based stock option plans in expanding employee corporate ownership to workers at a wide range of income levels with particular focus on non-executive workers; (2) the role of such plans in the recruitment and retention of skilled workers; (3) the role of such plans in stimulating research and innovation; (4) the effect of such plans in stimulating the economic growth of the United States; and (5) the role of such plans in strengthening the international competitiveness of United States' businesses.'\(^\text{47}\) The FASB had taken the position that economic impact was not relevant to its rule-making role.\(^\text{48}\)

On July 20, 2004 the U.S. House of Representatives passed the legislation restricting the FASB by 312-211 -- a 21% margin of victory.\(^\text{49}\) Whether the Senate passes similar legislation will be a much more difficult win according to news reports.\(^\text{50}\) One attempt to block the measure came from Sen. Peter G. Fitzgerald who said in a letter sent to ranking members of the Senate and in a press release on July 28, 2004 that he would "use every

\(^{47}\) Id. at § 3.


\(^{49}\) H.R. 3574, 108th Congress.

procedural tool available to oppose any legislative vehicle that seeks to block a FASB rule." Presumably the Illinois Republican means that he would start a filibuster if the measure ever came to a vote in the Senate.

C. FASB: Independent Agency or Political Pawn?

The FASB response to the House and Senate bills was one of outrage. The governing board of the FASB called the bills an attempt to undermine the very authority of the independent standards board. In a press release, the agency stated, "We believe that once Congress starts setting accounting standards through its political process, the integrity of U.S. accounting standard setting and the credibility of U.S. financial reporting will be dangerously compromised." There is concern that if Congress trumps the FASB then the independent accounting board could be subject to even more political pressure and standards will be skewed to special interests.

Paul Volcker, former Federal Reserve Board chairman and current chairman of the foundation that oversees the IASB, said, "If the U.S. Congress or political authorities in

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other countries seek to override the decisions of the competent professional standard
setters...accounting standards will inevitably lose consistency, coherence, and
credibility.”

However, opponents to the FASB measure state that it’s part of Congress’
job to oversee the FASB. If Congress doesn’t do it then who will?

Former NASDAQ Vice-Chairman Alfred R. Berkeley, III warned that the accounting
profession itself is subject to lobbying and self-interest. “Like all human endeavors,
accounting has its own internal politics and fads. A current fad is to run more and more
transactions through the income statement, and to put on the balance sheet more and
more human judgments, particularly about future values…. [T]he accounting profession
is in the throes of its own battle for intellectual control, and the more arcane the
accounting concept, the more accountants have employment.”

The drama is still playing out, and the forces against the FASB are gaining
momentum. There were calls to have the FASB delay implementation of the measure to
consider some of the alternative calculation methods. Notably, at a June 24, 2004
Roundtable Meeting organized by the FASB to solicit comments, University of
California, Berkeley professor Mark Rubinstein, one of the creators of the expensing
formula that the FASB relies on to price options, told the FASB that there is a better way
to price options. Rubinstein’s method would probably throw off the timetable if it is

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54 Craig Schneider, Who Rules Accounting? Congress muscles in on FASB -- again,
Schneider, Who Rules Accounting?].

55 Ltr. from Alfred R. Berkeley, III, Vice Chairman, NASDAQ, to FASB, Letter of Comment on Proposed
001/14268.pdf).

56 See below for more information on Rubinstein’s proposal.
adopted by the FASB.\textsuperscript{57}

Moreover, pressure was mounting from corporations. Companies were already struggling to meet recently mandated changes in corporate governance stemming from the Sarbanes-Oxley Act. Imposing the accounting change at this time would put undue burden on companies, they argued.\textsuperscript{58} The FASB was also inundated with numerous pleas from employee groups. By far, the majority of over 6000 unsolicited comment letters as of June 30, 2004 to the FASB’s March 2004 Draft Exposure Statement were from employees lobbying the FASB not to go forward with the proposal.\textsuperscript{59} The two constituencies – investors and employees – are obviously at odds in the debate.

However, this isn’t a question of who had more lobbying power. The issue that is at stake is good accounting practices. While reasonable people can disagree on whether or not to expense options, one premise is self-evident. Having two standards does no one any good. Moreover, burying the information in a footnote results in only sophisticated purchasers of stock having the information and does not support the underlying goal of comparability of financial data. There should be only one figure for reported earnings and not two. A decision needs to be made as to whether to use fair value or intrinsic value – not one or the other.

\textsuperscript{57} Donna Block, \textit{Professor unveils expensing model}, TheDeal.com, \url{http://biz.yahoo.com/deal/040629/professorunveilsexpensingmodel_2.html}, (Last updated June 29, 2004) [hereinafter Block, \textit{Professor Unveils}].

\textsuperscript{58} Stephen Taub, \textit{FASB Might Delay Options Expensing}, CFO.com, \url{http://www.cfo.com/printarticle/0,5317,14455|T,00.html?=options} (Last updated July 1, 2004).

\textsuperscript{59} Employees at Cisco and other tech companies initiated a letter writing campaign that inundated the FASB with email opposing the proposed amendment. FASB, \textit{Share-Based Payment—an amendment of FASB Statements No. 123 and 95 Comment Letters}, \url{http://www.fasb.org/ocl/fasb-getletters.php?project=1102-100} (Last updated June 30, 2003).
As of mid-July, 2004, the FASB announced that a final statement would be due in the fourth quarter, 2004. While the FASB did not say officially that it might delay the December 15, 2004 implementation date, the board indicated that it would take into account the need for corporations and accountants to assess and prepare for any changes mandated by the final statement.

II. INFORMATIONAL REFORMS: ARGUMENTS FOR AND AGAINST THE FASB RULE

In this section, I review the pros and cons of the FASB rule, using the model goals of an Informational Reform as a point of reference. I compare the goals of Information Reforms versus the goals of Rules of the Game Reforms in order to give a structure for analyzing the FASB rule change. I ask whether FASB's stated goals of reliability, consistency and comparability are furthered by the option expensing rule. I first look at the nature of stock options and ask whether the options incur an expense at the date of grant. I conclude that although the grant itself does not incur a cash flow out of the corporation, the frequent repurchase of stock is a drain on the company's coffers. I then examine the question of how and when to expense the option. I conclude that in the absence of a market for employee stock options, valuation using existing and proposed stock option pricing models yields uncertain results that do not further the FASB’s goals of reliability, consistency and comparability.

In balancing the need for theoretical purity and actual cash flow reality, I come to the conclusion that FASB should adopt the valuation methodology that the IRS uses – intrinsic value at date of exercise. While not theoretically pure from an accountant’s
perspective, the method is practical and better advances the goals of reliability, consistency and comparability than the proposed rules. To address the issue that value passes to the employee at date of grant, I also propose that only fully diluted in-the-money capitalization be used when reporting EPS.

A. Information Reforms v. Rules of the Game Reforms

The principal focus of Information Reforms is to improve the quality of financial information that investors receive about corporations. Professor Blair notes that poor information and misconceptions on how to interpret that information, rather than stupidity, was what caused the 1990s stock market boom and 2000 bust.60 Blair documents the reforms in the Sarbanes-Oxley Act aimed at improving the quality of information so that investors could make more informed investment decisions thereby determining a market price that reflects the true underlying value.61

“Rules-of-the-game” proposals, on the other hand, “shift power and influence away from the directors and toward shareholders.”62 Examples of these measures might include permitting shareholders to approve any option plan, nominate directors, propose charter amendments, and initiate reincorporations in other states.63

This categorization scheme is extremely useful in understanding the motives behind option expensing. By its very nature, the proposed expensing rule clearly falls into the

60 Id. at 39.
61 Id. at 39-40.
62 Id. at 40.
63 In Blair’s article, Rules of the Game reforms are used primarily to examine agency costs in the particular context of takeover defenses. Id. However, such a categorization is also useful for purposes of exploring the attempt to reduce corporate fraud.
category of Information Reforms. However, the shareholder rights activists backing the FASB are interested in more than mere information reform. There are two primary goals driving FASB to propagate the new rule – 1) increasing the reliability, consistency and comparability of financial information and 2) preventing corporate fraud. Clearly, an Information Reform should accomplish the first goal.

As to the second goal, better information in the marketplace might make it harder for executives to commit fraud, but stronger medicine may be needed to accomplish the second goal. Preventing corporate fraud is characterized by behavior modification, which isn’t necessarily accomplished by the passive nature of an Information Reform. In other words, Rules of the Game Reforms may be a better vehicle in accomplishing the second goal.

Another aspect of the Information Reform-Rules of the Game Reform characterization scheme impacts this analysis. Information Reforms should be evaluated purely from the point of view of whether they actually accomplish the first goal stated above. In other words, policy matters, such as preventing fraud, should be independent of

64 FASB maintains that its purpose is to propose and propagate good accounting practices that faithfully represent the financial condition of corporations and to promote standards, which make it easy to compare companies for the purposes of investment. Proposed Statement, supra at 127. The FASB mission statement starts out by stating that the organization acts to “Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency.” FASB Facts, http://www.fasb.org/facts/index.shtml (Accessed August 2, 2004). This is often summarized as providing reliable, consistent and comparable data.

65 There are additional goals stated by the FASB, such as adopting international standards, but as we shall see later, these are not the focus of the debate. The FASB initially tried to focus the entire debate behind the rule as a matter of dove tailing American accounting rules with international rules. Accdg. for Stock-Based Compen.: A Comparison of FASB State. No. 123, Accdg. for Stock-Based Compen., and Its Related Interpretations, and IASB Proposed IFRS, Share-based Payment, Invitation to Comment, 1, 13 (FASB Nov. 18, 2002) However, the opponents to the FASB quickly turned the focus of the debate towards the accuracy of the pricing models and the economic effects of the rule.
an Information Reform. Information Reforms should only be judged on whether the reform is a better reflection of truth in financial reporting.

Information Reform should also not be prohibited because it will have adverse economic consequences. We always assume that truth in reporting will, in the long-term, lead to economic growth. The FASB is in line with this idea. When analyzing whether the proposed rule promotes these values, the FASB admits that while there will presumably be economic consequences to expensing options, the board doesn’t speculate as to what those consequences might be.\(^{66}\) In terms of whether the FASB proposal is a useful Information Reform, we merely have to analyze whether it helps investors make a more informed investment decision? Does it reveal the financial truth of the corporation? In other words, we are after the truth, not the consequences of the rule.

If, however, it can be shown that the rule does not promote truth or is benign in that respect, then at that point, policy implications become important in deciding whether to implement the rule. For instance, one might still implement an Information Reform if it is benign in terms of truth if the reform had positive policy implications, such as economic growth. I shall look at the consequences of the proposed rule in Part IV, but for purposes of this section, the question focuses on whether the proposed rule promotes the truth of the financial condition of the corporation.

**B. Whether an Option Grant Incurs an Expense**

In deciding whether the proposed rule will lead to financial clarity, the threshold question facing the FASB was whether a corporation incurs an expense when it grants an

\(^{66}\) Proposed Statement, supra at 127.
1. Compensation: Do options cost the Company money at the date of grant?

Tech industry advocates have traditionally advanced the argument that options are not compensation and therefore should not be expensed. They contend that options are granted for retention purposes and are separate from the traditional notion of salary. 67

Warren Buffett, investor and a leading advocate for expensing, characterizes this position as the “‘useful fairy-tale’ argument.” 68 Buffett admits that options help “attract, retain and motivate employees” – often more so than cash does. But he contends that companies that use options must expense those options in the same way that they register a cash outlay as an expense. 69 Buffett uses the simple syllogism to counter the tech company argument that options aren’t compensation: “1) If options aren’t a form of compensation, what are they? 2) If compensation isn’t an expense, what is it? 3) And if expenses shouldn’t go into the calculation of earnings, where in the world should they go?” 70

The tech industry's contention that options are not compensation is disingenuous at best. Option grants to executives often result in paydays that are significantly greater than

67 Some companies, which do not use options to replace cash salary, do use options for retention purposes as if the options were a cash bonus based on stock performance. Options may offset the turnover cost to companies. Hassett, Regulation at 52, (Spring 2004).

68 Warren Buffett, Stock Options and Common Sense, Washington Post (Apr. 9, 2002).

69 Id.

70 Id.
the executive’s base salary.\footnote{Seligman, \textit{Transformation of Wall Street}. 717. The use of options mushroomed during the 1990s so that by 2001, around 80\% of executive compensation was in the form of stock options.} For the most part, opponents of the FASB have left behind the argument that options are not compensation. However, the opponents' next argument is not so easily dismissed. FASB detractors contend that the grant of an option incurs no expense because no money leaves the corporate coffers when a grant is made.\footnote{Proposed Statement, supra at 119.}

The tech industry has a valid point as to the timing of the expense. There is no significant reduction in the cash position of the corporation as a result of the grant or establishment of a stock option plan. There might be some administrative costs borne by the corporation in terms of legal and accounting fees, but these are minor in the overall picture. After all, most investors are interested in the actual profits of a company. Investors typically ask questions such as “How much money is the company earning? How much actual cash might an investor get as a dividend? If the company were dissolved, how much cash would be distributed per share?” Consequently, tech companies ask the question "If the cash position of the corporation remains the same, why register an expense?"

For example, if a company has one dollar per share in earnings but the accountants use the FASB formulas to value all options grants as reducing those earnings to ninety cents, the fact remains that the options haven’t cost the company a dime even though earnings have been reduced. If the company decided to distribute all of the cash it earned during that period as a dividend then investors would get $1.00 per share and not $0.90 even though it reports $0.90. So, if the cash position isn’t changed, why should earnings
be reported differently? In other words, the expense, the tech industry argues, is merely a theoretical one.

2. FASB Theories of Timing the Expense at Date of Grant

Again, the technology industry has a point, but to understand the FASB's position requires that one understand the theory behind the phantom expense. There are four lines of reasoning that FASB advances -- 1) registering the cost savings to the company, 2) registering an expense at the time that the employee renders service to the company, 3) dovetailing the accounting treatment of employees and non-employees in the granting of options and 4) opportunity cost.

The primary argument is that the theoretical expense captures a cost that the corporation saved by issuing an option. In other words, since the corporation saved money in compensation costs by issuing the option, the cost savings should be registered as an expense. Here's how the FASB logic works. Although no money shifts out of the corporation, a company often saves cash by reducing its salary expense when it grants options to compensate an employee.73

For example, a young, small but growing technology company wants to attract a seasoned executive from a larger corporation in order to take the company to the next level. Normally, such an executive would demand a salary of $1 million – money that the company doesn’t have. So, instead, the company offers the executive $600,000 and a handsome stock option grant. The company has saved $400,000 which does not have to appear as an expense on the income statement.

73 Hassett, Testimony, supra.
FASB argues that not including that extra $400,000 on the income statement will overstate the true earnings of the company because it understates the costs of acquiring the services of the CEO. In other words, FASB argues that even though the company did not expend $400,000, the mere fact that it saved the same amount by issuing an option is enough evidence to value the option. FASB is trying to measure these cost savings by forcing a hypothetical expense at the date of grant.

However, Economist David Hassett argues that the logic of trying to register cost savings as an expense is flawed. Hassett contends that there are a number of non-monetary inducements used to entice employees to a company which also result in a reduction of the company's cash compensation costs but which aren't considered expenses. He notes that large, stable companies can pay less in salary than companies that need a turn-around because there is less risk of the company going bankrupt. Likewise, he states that companies located near desirable cities or facilities (schools, recreation, etc.) may have to pay less than companies that are located in less desirable locations. Hassett points out that such benefits are not monetized and deducted from earnings.74

Hassett is also troubled by the FASB's focus on the cost savings that a company incurs as a justification for fair value accounting. Fair value accounting, Hassett argues, is rooted in a determination of the price that a willing buyer and seller would agree on in a sale of an asset and that's what the option pricing models are geared towards determining. However, the option may be worth something different to the employee, who ultimately is bargaining with the company on salary and is a determining factor in just how much

74 Hassett, Regulation at 53 (Spring 2004).
the company saves in cash by issuing the option. In other words, what price does an employee put on the option – i.e. with everything else being equal, how much would it cost another employer to have the employee forgo his option and switch jobs? However, the FASB rejected this approach because valuing the employees’ services is also uncertain.

Hassett finds it incongruous that the FASB would justify the expensing of options based on a desire to capture cost savings to a company but then turn around and use fair value accounting to determine a market price for the options. He argues that one cannot determine cost savings by looking at a market price when there is no market for the asset. He argues that fair value accounting is not an appropriate measure to expense employee stock options. In other words, it's not fair to the company, employees or investors to use fair value accounting since it doesn't yield an accurate figure.

However, Hassett's argument is also flawed since it's the grant of the option, and not the circumstances surrounding employment, which can be monetized. Since an asset (the option) is given to the employee, it's common sense to try and value that asset. Still, trying to use cost savings as the measure is troublesome. Is cost savings accurate enough to really place a market value on an asset that cannot be sold in the marketplace?

The second way in which the FASB analyzes the concept of an expense is to look at the exchange of the option for services. The board contends that options are exchanged for an asset – i.e. employee services. The assets (i.e. services) are immediately consumed

75 Id.
76 Proposed Statement at Appendix C.
77 Hassett Regulation at 54 (Spring 2004).
by the corporation. FASB says that it is at the point of consumption of the services that the expense should occur. In accounting theory, the receipt of any asset results in an immediate expense.\textsuperscript{78} FASB’s position is dogmatic. It elevates form over substance. It relies on the fact that employment services can’t be capitalized as the conceptual reason that the valuation of the option has to occur on the date of grant. In reality, the value of an option will fluctuate dramatically between the date of grant and date of exercise. In fact, options often expire without any value. As will be seen below, the valuation of an option at the date of grant is so uncertain, that to require the valuation only to advance a theoretical accounting concept of timing is neither practical nor sensible.

Third, FASB also draws an analogy comparing the grant of an option to issuing a share of stock. If a share of stock were given to an employee, then the fair market value of that share would be registered as an expense. Moreover, if an option or warrant were given to non-employee in return for services, then the option or warrant would be valued and counted as an expense.\textsuperscript{79} Hence, FASB reasons that employee option grants should be treated the same as non-employee grants for consistency's sake. However, typically, policy concerns have come into play in the variation in treatment between employee and non-employee options. In an effort to promote employee stock ownership, favorable tax and accounting treatment has been accorded to employee options.

\textsuperscript{78} Proposed Statement, supra at 120.

\textsuperscript{79} Id. at 121. As already noted, there are differences between employee stock options and the options and warrants that might be given to a non-employee. Normally there is no vesting period in the latter type of option. The value of the non-employee option is more likely to conform to the characteristics of publicly traded options, and therefore a more accurate estimate of value can be made. But perhaps, more important, is the argument of the fundamental policy behind employee stock options – retention and the alignment of shareholder and employee interests. This later policy consideration carries considerable weight in the development and popularity of stock options. If employees think like shareholders, then they will maximize the value of the enterprise.
Finally, proponents of the FASB also point to an opportunity cost that the company forgoes by giving the option to employee instead of selling it into the market. In other words, the company could have made money selling the equity rather than giving it away.\textsuperscript{80} However, as Economist Alan Reynolds notes, "Before there can be an opportunity cost,…there must be an opportunity."\textsuperscript{81} Companies do not have an outlet for selling options comparable to employee options on the open market.\textsuperscript{82}

While there is no market for employee options, a market for public options exists between third party buyers and sellers, who are usually investment bankers or hedge funds. A corporation is unlikely to take the risk of selling puts or calls since to do so would put them on the hook for settling the contracts at the expiration date. As a practical matter, most corporations do not want to take the risk of selling options in the marketplace. If they bet wrong, then they will have to settle the contracts. Settlement of an in-the-money option contract requires the payment of the difference between the exercise price and the trading price on the day that the option expires or is exercised. Seldom is a share actually issued. Traders prefer to just take the money. While the theoretical opportunity exists to sell an option, the fact that companies do not in any broad way sell options reflects that the lost opportunity is not real. As we shall see below, when the option is exercised, there is a lost opportunity cost for the company, but I maintain that as to the option grant, no lost opportunity exists.

\textsuperscript{80} Luppino, 2003 Colum. Bus. L. Rev. at 89.


\textsuperscript{82} \textit{Id.}
I conclude that while FASB argues legitimate accounting theory in support of its proposed rule, the theoretical basis for each of these four arguments in support of valuation at date of grant does stand up to scrutiny when met with the real world constraints and circumstances.

3. Follow the Money: The Expense is in the Repurchase

But one doesn't need to bother with this rhetorical debate or conceptual matters in order to see how options represent an expense to the corporation. The simple answer to that question can be found by taking the advice that Watergate source Deep Throat gave to reporters Bob Woodward and Carl Bernstein -- follow the money. An expense, in the ordinary sense of the word, occurs when money flows from one person to another. If we can track a flow of money out of the corporation and relate it to the option grant, then that outflow of cash naturally becomes the true expense to the corporation.

The only time that cash actually leaves the corporate coffers in relation to an option grant is when a company repurchases the shares that were granted when an option is exercised. Companies routinely repurchase shares on the open market when options are exercised so that there is no dilution. Thus, the repurchase is the real cost to the company of an option grant. But for the grant, the repurchase never would have occurred.

Companies repurchase shares for a number of reasons, but executives especially try to repurchase shares issued from option grants because, otherwise, there would be a dilution of earnings. Prior to the option exercise, the company has a certain number of shares issued and outstanding. When calculating earnings, the company reports earnings per
share (EPS) which is simply the profit divided by the number of shares outstanding. For example, if a company earned $10 million and has 10 million shares outstanding, then the company reports $1 per share as its EPS.

Naturally, when a large number of options are exercised, earnings will drop. In our example above, let’s hypothesize that an executive exercises 100,000 shares representing 1% of the company, so earnings drop to $0.99 per share. One penny is not too much in light of one dollar's worth of earnings, but remember that a company which reports earnings off, even a few cents from its expected target, often gets downgraded by Wall Street analysts, which can then lead to further price declines. Consequently, executives will use corporate funds to repurchase those 100,000 shares in order to keep EPS high.

Let’s hypothesize that our company’s share price is $10 per share. That means $1 million or one tenth of the company’s $10 million profit is spent on repurchases. But this expense is never reflected on the income statement. If it were, then the company would have reported $0.90 instead $1.00 per share.

The repurchase cost is a significant cash flow drain in the real world. To understand the problem, one need look no further than Adobe Corporation, one the leaders in the tech economy. Adobe generates huge amounts of cash selling its popular Acrobat and Photoshop products. In a recent three fiscal year period, cash from operations topped $1.193 billion.\(^8^4\) However, Adobe is also among the leaders in the tech industry in terms of option grants. While most large public companies grant only 2% or less of outstanding

\(^{83}\) Carl Bernstein & Bob Woodward, *All the President’s Men*, 78 (Simon and Schuster 1974).

shares to employees each year, Adobe granted 20% of its outstanding shares during the same three year period from 2000 through 2002. Adobe routinely repurchased the shares that were exercised by employees. A total of $541 million was spent in repurchases during the three-year period studied. This buyback represents 43% of the total cash generated by the corporation. Nearly half of the company's profit -- over half a billion dollars -- was used to repurchase shares related to option exercises but none of that cost was reflected in the income statement or EPS.

Given outstanding shares of about 240 million during this period, Adobe could have declared a dividend for this period of the amount used in repurchases and delivered approximately $2.25 per share in stead of repurchasing shares. Likewise, the company could have engaged in acquisitions that raised the overall value of the enterprise. Using Adobe as an example, one can begin to see why shareholder rights activists are so angry and have driven the FASB to try and limit the incentives to issue options by requiring an expense. For various conceptual reasons explored below, accountants traditionally do not consider a repurchase a matter to be recorded on the Income Statement. I make some suggestion in Part III regarding how and why the repurchase can be expensed.

In the final analysis on this issue, I conclude that options are tangible assets that have value as compensation. Money leaves the corporation through repurchases, and the repurchase is a quantifiable number. However, for theoretical and conceptual reasons, FASB tries to account for the option value at the date of grant. The next problem is

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85 The total amount in option related repurchases was actually $830 million but the $541 million figure is used to reflect that the company actually brought in $289 million in proceeds when employees paid the exercise price. During this period, Adobe actually spent over $1 billion in repurchase but only $830 million related to options buybacks. Id. at 17-18.
whether that asset can be accurately valued at the date of grant. In other words, since an item of value is given from the corporation to the employee, how and when does one expense the option?

**D. The Valuation Equation: How and When to Expense**

Most economists agree that the issue is not whether options should be expensed but how and when to expense such options. The aim of FASB is to get at the "fair value" of the option. Ideally fair value is defined as the price at which a willing buyer and willing seller would exchange an asset. In practice, the term “fair value” usually refers to an estimate rather than an actual “market value.” A market price is still the optimum way of valuation. However, there is no market for employee stock options -- i.e. employees can only exercise the option and purchase the underlying stock. Employees cannot sell the option contract itself.

**1. Option Pricing Models -- The Attempt to Capture a Market Value**

In the absence of an actual market, accountants turn to option pricing models. Some economists maintain that since there is no market, a model can never be an objective measure of the "fair value" of options. However, for purposes of this discussion, we

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87 Hassett, *Testimony, supra*.


will assume that an option-pricing model -- if accurate -- would reflect fair value. The next question to answer is whether an accurate option pricing model exists.

In the simplest terms, an option’s value is measured as the difference between the exercise price and the market price with additional value added for the length of time before the option expires. The exercise price on most employee options equals the market price on the date of the grant. Consequently, there’s no inherent value except for the time element. The argument that FASB brings to bear against using the intrinsic value method of Opinion 25 is that it fails to measure the time element – i.e. the future possibility of gain in value.\(^90\)

To value the time element, FASB noted that the actual trading price of identical or similar options is the best indicator of the fair value of an option.\(^91\) Since there is no public market for employee stock options, the only other possible market is the public market for options in which market participants barter to sell options contracts.\(^92\) Some advocates for the FASB suggest that this market in options should serve as a sufficient proxy for the employee options. In other words, the price of an employee option can be extrapolated from the publicly traded options.\(^93\)

However, employee stock options differ significantly from publicly traded options.

\(^90\) The FASB goes on to note that in the marketplace, a 6 month option with an intrinsic value of $20 will always sell for more than $20 because the 6 month time frame yields the potential for the intrinsic value to be even more. *Proposed Statement, supra* at 121-122.

\(^91\) *Id.* at ii.


\(^93\) *Proposed Statement* at Appendix C.
Most publicly traded options generally expire in a matter of months. Whereas an employee stock option is typically good for up to ten years. An employee option usually has a vesting provision – i.e. only a certain number of options become exercisable over time. For example, on December 31, 2004 a company might grant an option to purchase 100,000 shares at $10 a share. The vesting requirement might be 25% every year for four years. Consequently, on December 31, 2005, the employee can purchase 25,000 shares. On December 31, 2006, she can purchase an additional 25,000 shares and so on. Vesting requirements insure that the employee stays with the company in order to take advantage of the option.

2. Type of Models and the Problem of Inherent Uncertainty

Given the significant differences between employee stock options and publicly traded options, the public market for options is an inadequate proxy to determine the worth of employee stock options.\(^94\) The Board admitted that in absence of an actual market for employee options some uncertainties exist as to the price.\(^95\)

FASB recognized that since no market exists for employee options, most of the valuation would have to be done using an option pricing model.\(^96\) The FASB gave voluminous advice on how to price the options using an option pricing model yet the

\(^{94}\) Hassett, *Testimony, supra.*

\(^{95}\) Id.

\(^{96}\) Option pricing models are normally used, however, for publicly traded options. Consequently a liquidity discount needs to be built into any model in order to accurate evaluate fair value. In other words, since the employee asset is not liquid (i.e. cannot be bought and sold) a discount should be applied. Id.
Board failed to identify one specific model to use.\textsuperscript{97}

There are a variety of models to choose from but two types emerged initially -- Black-Scholes Option Pricing Model and a binomial pricing method. Prior to the latest FASB proposal, the leading valuation model was the Black-Scholes Option Pricing Model.\textsuperscript{98} Black-Scholes is widely used in the public options market and supporters of the model maintain that it can be modified to take into account the differences between employee options and publicly traded options. While FASB endorsed Black-Scholes as an acceptable method to price options in the 1995 version of Statement No. 123, there has since been considerable debate among economists as to the reliability of Black-Scholes when pricing the long term options that are characteristic of employee options.\textsuperscript{99}

A number of problems have been identified with the Black Scholes model all related to the differences between employee options and publicly traded options. These differences include vesting requirements, non-exercised options that have vested, non-transferability of options, and employment conditions related to the option such as non-compete agreements, holding periods and ownership requirements.\textsuperscript{100} Hassett details that Black-Scholes can underprice options given one scenario and overprice in another because there is wide fluctuation in the terms accompanying a stock option in terms of

\begin{footnotesize}
\footnotesubscript{97} The Board indicated that at minimum the factors that should be taken into account are the exercise price, the term of the option, current price of the underlying stock, expected volatility of the price, expected dividends on the stock and the risk-free interest rate. \textit{Proposed Statement, supra} at ii.


\footnotesubscript{99} Hassett, \textit{Testimony, supra}.

\footnotesubscript{100} Benston, \textit{Quality of Corporate Financial Statements, supra}.
\end{footnotesize}
contractual conditions, vesting arrangements and duration.  

In addition, the Black-Scholes model requires that accountants make assumptions as to the variables – volatility, risk-free interest rate, dividends and option duration – and these assumptions are subjective and often speculative. Minor variation or errors in these assumptions can yield drastically different results. Hassett maintains that there is no pricing model that is sufficient to accurately predict the true cost of an option. For any given company, the results can vary significantly depending on the type of valuation method that would be used.

Warren Buffett counters that there are a number of areas in accounting where uncertain estimates are made, such as the calculation of depreciation. FASB takes up the argument by saying that the estimation and inherent uncertainty of valuing options is not greater than in estimating deferred tax assets, pensions and post-retirement benefit obligations. Management has a number of judgment calls to make using imperfect data, but FASB contends that it is better to have an estimate that is “approximately right” as compared to having no estimate at all.

However, real world experience, suggests that some estimates may never yield an "approximately right” answer. Maxim Integrated Products, Inc., is a case in point where different results can widely vary depending on the assumptions made by the company’s

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101 Hassett, Regulation at 53 (Spring 2004).


103 Hassett, Regulation at 53. (Spring 2004).

financial advisors. In a comment letter to FASB, Maxim CEO John Gifford noted that his company’s six year’s of experience in expensing shows that the value placed on the options is “neither real nor useful.”106 Gifford details how employee options that vested in 2003 had strike prices of $7.50 and $87 at a time when the stock was trading at $32. Clearly, the $7.50 were worth something, while the $87 option were underwater and not worth exercising. Gifford shows that using Black-Sholes on a hypothetical 1,000 shares results in an incongruous $53,000 charge for the worthless $87 option and $5,000 for the very valuable $7.50 option.107 If the best models developed by the leading economists have such anomalous results, have can a fair value estimate ever be fair?

Another problem that arises from stock option valuation models which price at the date of grant is that many options -- at least in the recent past -- have gone out-of-the-money and may expire worthless and unexercised. Companies argue that requiring an expense on such worthless options unfairly penalizes the company's bottom line. Not only does no cash flow out of the corporation in regard to such options, there is never a diluting episode where a share is issued.

3. Inherent uncertainty will lead to inevitable lawsuits

In a worst case scenario, Hassett maintains that the variation and potential inaccuracies involved in using option pricing models may lead to a new type of lawsuit.108 Hassett argues that since the choice of a pricing model is up to the corporation

105 Proposed Statement, supra at 123.
106 Ltr. from John F. Gifford at 1.
107 Id. at 3.
108 Hassett, Testimony, supra.
and the various models can be manipulated for different results, this may leave companies open to legal risks in the form of class action lawsuits for failure by a company to calculate its option expense correctly.

Although mere negligence in performing the calculation isn’t likely to lead to liability (intentional misrepresentation is necessary under the securities laws) many companies have been sued by class action plaintiffs’ attorneys on lesser charges.\textsuperscript{109} Despite the likelihood that such suits would result in a summary judgement dismissal in favor of the corporation if the company followed FASB rules to the letter, the company would still incur substantial costs in litigating or settling such suits. If FASB had indicated a specific model should be used, then this potential harm would lessen considerably and companies would have a defense.\textsuperscript{110} Hassett thinks the FASB has left companies at risk for lawsuits because they specify that an accounting practice must be done and then leaves little guidance to the company on how to do it.

4. FASB fails to endorse a Model; Economists go back to the drawing board

FASB did not endorse any specific model and stopped just short of endorsing a binomial model. The FASB initially favored the binomial method because such a model takes into account the changes in price that occur with shares over time and other characteristics of employee options. However the board did not advocate a binomial model in this amendment because companies do not have “in a usable format information about employees’ exercise patterns…needed to provide appropriate input to those

\textsuperscript{109} \textit{Id.}

\textsuperscript{110} \textit{Id.}
models.”\textsuperscript{111} Some critics of the binomial model contend that the complexity of the model will make it easier for companies to manipulate the price of options in order to control earnings.\textsuperscript{112}

Hassett maintains that the uncertainty over the pricing models is so great among economists that the underlying goals of the FASB – reliability, consistency and comparability – are undermined by the lack of a specific method to actually perform the calculation.\textsuperscript{113} Since there are so many competing models and reasonable accountants can disagree on which one is best suited to adequately predict options, the data produced will not accurately predict fair value, will vary from company to company and make comparisons of economic data problematic.\textsuperscript{114}

It’s not just economists who are confused by the pricing models. The companies themselves have a significant lack of understanding of the binomial pricing model. In a recent survey, approximately two thirds of the companies surveyed indicated that they did not understand or only had a low understanding of the binomial model – the favored model of the FASB. These numbers come despite the fact that 90\% of the respondents indicated that they had the FASB’s guidelines on the matter and discussed the option expensing schemes with financial experts. Although option expensing was on the horizon at the time of the survey, 82\% of the participants indicated that they were undecided on

\textsuperscript{111} Proposed Statement, supra at 124.

\textsuperscript{112} Have accounting regulators chosen the best way of expensing share options?, Economist (Nov. 9, 2002) (available at 2002 WL 7248128).

\textsuperscript{113} Hassett, Regulation at 55 (Spring 2004)

\textsuperscript{114} Id.
which option pricing methodology to use should the rule be mandated.\textsuperscript{115}

Hassett proposes that the FASB wait to impose expensing until an accurate model can be developed.\textsuperscript{116} The mere fact that the FASB can't decide on one method suggests that the board should wait.\textsuperscript{117}

One of the creators of the binomial model doesn't support its use to value employee options, thereby further suggesting that the FASB current plan is seriously flawed. Just prior to the June 30, 2004 deadline for comment on the proposal, one of the inventors of the binomial pricing model and a leading expert in option pricing, Mark Rubinstein, surprised the FASB by rejecting the binomial model and proposing yet another model -- the so-called "Service Period" method.\textsuperscript{118} Rubinstein maintains that the binomial model is not suitable for employee options because of the "difficulty of measuring volatility and dividends over the long times-to-expiration, the seeming necessity of forecasting employee option forfeiture and departure rates, and the effects of non-transferability on the optimal timing of exercise."\textsuperscript{119} In other words, the developer of the binomial model and recognized expert confirmed what the opponents to the FASB had been saying all along -- employee options are so different from publicly traded options that any pricing


\textsuperscript{116} \textit{Id.}

\textsuperscript{117} It is interesting to note that in the letters received by the FASB in the initial request for comment, even the accountants who commented strongly suggested that the FASB definitively choose one model for everyone to use.

\textsuperscript{118} Block, \textit{Professor Unveils}, supra.

\textsuperscript{119} Ltr. from Mark Rubinstein & Richard Stanton , Professor, Univ. of Calif., Berkeley, to FASB, \textit{Letter of Comment on Proposed Statement No. 123.}, Ltr. No: 3218, 1 (June 17, 2004) (copy on file with FASB).
model used in the public market is inappropriate for use on employee stock options. Rubinstein's and Stanton's model still uses the public market as a proxy for the value of an employee option but it does so in a sequence of one year periods rather than valuing the option once at date of grant. Rubinstein maintains that the Service Period model is much simpler to understand than the binomial model thus making it easier for companies to implement.

At this time, the feedback from other experts and the FASB on the Service Period model has not yet materialized, but critics of expensing at large are not likely to be any more receptive to it. The problem with the Rubinstein-Stanton model is that it still uses a market that does not share similarities with the actual asset as a proxy, albeit in smaller chunks of time. Moreover, it doesn't address the issue that there is no cash flow out of the company at the date of grant or during these periods when the asset is being valued and an expense occurs. It doesn't get to the underlying issue of timing of the expense.

5. Even more confusion in Congress

Of course, the question must be asked, does the Stock Option Accounting Reform Act change the FASB proposal positively from an Information Reform point of view? Does it add clarity where the FASB measure does not? The answer is no. The House bill was an attempt to compromise with the different constituencies. The bill tries to appease shareholder activists by expensing executive grants and at the same time retain the benefits of options in stimulating small start-ups. But the bill is ultimately misguided in

120 Id.
121 Block, Professor Unveils, supra.
its compromise. To treat executive options differently from rank and file options confounds the principles of consistency in accounting. Is one dollar paid to an executive any different than one dollar paid to a janitor? Of course not. Consequently, there should be no difference in accounting for stock options just because the title of the employee who receives the options is different.

Because the FASB did not specify a specific model, there will inevitably be inconsistency in how accountants calculate the expense under the amended Statement No. 123. Moreover, because none of the existing models are accurate, I conclude that any current or proposed option-pricing model and the Stock Option Accounting Reform Act fail to promote the FASB’s goals of reliability, consistency and comparability.

**III. INFORMATION REFORMS: TWO ALTERNATIVE PROPOSALS TO IMPROVE FINANCIAL CLARITY**

Given my position that the FASB proposal and the Congressional alternative fail to meet the objectives of Information Reform, I propose a two-pronged alternative. The first prong would value the option at date of exercise using an intrinsic value measure. This idea would fall in line with the IRS treatment of options and is supported by various economists. Moreover, it would more accurately track the true cost to the corporation since an actual dollar figure cost can be established either through a repurchase price or a lost opportunity cost.

While the first prong would not address the issue that accounting theory establishes that a value exists at the date of grant, this unresolved problem could be addressed by a second prong that requires that companies only use a fully diluted in-the-money
capitalization when reporting EPS. I argue that this accounting treatment is an adequate substitute for an actual expense until such time as that expense is more accurately known.

1. Intrinsic Value at Date of Exercise

The FASB goals of certainty, reliability and comparability would be better served if corporations were required to expense options at the date of exercise using the intrinsic value method rather than valuation at the date of grant. This simple and easy-to-understand method of expensing would require no guesswork, no complicated models and would more accurately track the true flow of money out of the corporation -- i.e. it more accurately reflect the repurchase cost to the corporation.

a. Repurchase accounting doesn't track the real expense

As already established, the real cost to the company is in the repurchase. However, accountant would never consider a repurchase to be an expense. In accounting theory, repurchases of stock are not reflected as an expense to the company. Repurchases, conceptually, are one way in which a company returns value to shareholders. For example, suppose that a company is worth $10 million and has 10 million shares outstanding at $1 per share. The company decides to repurchase 1,000,000 shares at $1 per share. Naturally, those shareholders who did not sell their shares, now own on a per share basis the value of the company -- $10 million – divided by 9 million shares or $1.11. Of course, it’s not that simple because some value has left the company in the repurchase. After a repurchase, shareholders have a bigger piece of the pie.

From an accounting perspective, repurchases are not a cost that subtracts from income but a way to return value to the shareholders, therefore, the repurchase is
reflected not on the Income Statement but on the Balance Sheet. The repurchases of course reduce the cash in the Asset portion of the Balance Sheet, but, at the same time, Shareholder Equity is reduced (or alternatively Treasury Stock increases since it is a contra account in the Equity portion of the Balance Sheet).

However, in the case of repurchasing shares that were issued as a result of an option grant, the repurchase never returns value to the shareholders. The shares issued as a result of an option grant dilutes the interest of existing shareholders, so any subsequent repurchase by the company just returns the shareholder to the same position he or she was in prior to the option exercise in terms of percentage ownership of the company. However, the company now has less money because of the repurchase of shares issued from options. Since it's established that options are compensation, can’t we then extrapolate that any cost associated with the options – i.e. the repurchase – are an expense? Borrowing from the FASB's cost savings valuation theory, another conceptual way to look at it is that the difference between the exercise price and the market price is the value that the employee added to the corporation, hence, that amount is the cost savings to the company in compensation and should therefore be expensed.

In large measure, the accountants are stuck in theoretical constructs. They would find it to be inconsistent to treat some repurchases as expenses and other repurchase as equity matters. Rather, in order to keep the theory pure, they would rather develop an accurate option-pricing model to reflect this repurchase cost plus the time value of the option at the date of grant.

However, tracking the option-related repurchase cost is a simple and accurate alternative to option pricing and one that does not have the inherent problems of options
pricing models discussed above. The easiest method to track this cost would be to measure the intrinsic value of an option at the date of exercise. This extremely simple measure would capture the true cost of option grants in terms of the repurchase cost to the company. This idea, although not widely supported by the opponents of the FASB, has found support from some experts.122

The FASB rejects this idea for the conceptual reasons already noted -- i.e. they want the expense to occur on the grant date because an item of value is given to the employee at that point in time. The opponents to the FASB don't like it because the method still reflects a charge against earnings. They would rather take their chances with Congress than come to a compromise solution like this one. The opponents of the FASB proposal may find the Repurchase Expense option to be an even harder pill to swallow – i.e. the expense could be greater than using option pricing models to calculate a theoretical expense. In the case of a stock which has risen dramatically over the average exercise price, the expense could be substantial. However, as we saw earlier, an Information Reform, which this proposal clearly is, is independent of considerations about economic effect. The question is merely, does the Information Reform track the truth of the financial condition of the company more accurately. I contend that it does since the repurchase cost (as related to option grants) is then reflected in the Income Statement.

Even if the company does not engage in a repurchase, then this method is still a valid because it measures the opportunity cost of not selling the share at the full market value. At exercise, the company receives cash from the employee in the amount of the exercise

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price, however, if the share is not repurchased then the real cost to the corporation is the
difference between the exercise price and the market price – i.e. the amount company did
not make by selling the same share into the market, which is the same as the repurchase
price. Since the company gave up the opportunity of selling the shares into the market
through the option grant, the difference reflects a legitimate expense.

**b. Practical Lessons Learned from the IRS**

Probably the strongest example of why the expense should be valued at the date of
exercise comes unexpectedly from the Internal Revenue Service (IRS). For tax purposes,
options are accorded two different tax treatments depending on whether the options are
characterized as statutory stock options granted under an employee incentive stock option
(ISO) plan or non-statutory stock options (NSOs). NSOs are, by and large, used with
non-employees. Employees generally are granted under ISOs because there is a more
favorable tax treatment for the employee.\(^{123}\)

Since the IRS generally does not recognize any taxable event at the date of grant but
does recognize an event at date of exercise (income for NSOs and limited AMT for
ISOs), that provides for a strong argument that the FASB should follow the IRS' lead.
Professor Luppino notes that the IRS prefers the date of exercise over date of grant
because of "administrative difficulties frequently inherent in valuing the 'wait and see'

\(^{123}\) For an ISO, there is no tax at the date of grant or exercise though employees may be subject to the
Alternative Minimum Tax at the date of exercise. When the employee sells the stock the employee is
subject to capital gains tax. Generally, holders of NSOs are taxed as income the difference between the
exercise price and the market price at the date of exercise. *Tax Topics: Topic 427 - Stock Options* (available
at [http://www.irs.gov/taxtopics/tc427.html](http://www.irs.gov/taxtopics/tc427.html)) (accessed Aug. 2, 2004). There are limited situations, such as
golden parachutes and gratuitous transfers, where valuation of the option at date of grant is required using
right that been passed to the employee.”¹²⁴ Professor Luppino, however, comes to a
different conclusion saying that the IRS approach ignores the fact that compensation
event is the option grant and not the exercise. He notes that in addition to administrative
problems in valuation, there is also the issue that the employee may not be able to pay the
tax at date of grant. He concludes that GAAP and tax regulations should be "allowed to
go their separate ways."¹²⁵

I contend that the reasons that the IRS finds it difficult to value options are sufficient
reasons to compel the FASB to do likewise. Some consistency in treatment between the
IRS and the FASB as to options would be desirable and stop perpetuating the myth that a
model can be accurate in accounting. Of course, there are difference between GAAP and
IRS treatment on many issues¹²⁶, but in this respect, there are compelling reasons for the
FASB to follow the IRS' lead.

c. Why date of expense accounting more accurately reflects financials

The idea of expensing at the date of exercise instead of grant also finds support
among some economists. Alan Reynolds rails against the FASB for the notion that the
true cost of an option occurs at the grant date. "In essence, FASB is proposing to treat a
possible future expense if it were as an actual expense."¹²⁷ Reynolds notes that the
estimated value of an option at the date of grant is usually not at all what it might be at
the date of exercise since stock prices fluctuate considerably. William Niskanen echoes

¹²⁵ Id. at 175.
¹²⁶ Id. at 35.
¹²⁷ Reynolds, FASB fumbles stock options, supra.
Reynolds' position noting that there is "no cash outlay or share dilution" at the grant date and hence no expense should be registered. 128 Niskanen maintains that "the accounted value of these forms of compensation should be based on their market value when exercised, not on some non-objective formula when granted." 129

In support of the position that an expense be registered at the exercise date rather than at the grant or vesting date is the reality that some options end up expiring worthless or for reasons of their own, the employee does not exercise the option. Consequently, it’s unfair for a company to incur an expense for an event that never happens. FASB counters this argument by shifting the risk and benefit of stock price fluctuations to the employee. Consequently, FASB considers the transaction to have been completed so any changes should not be reflected. The employee has rendered the service and been duly paid through the options. If the option gains in value, FASB contends that no additional expense should accrue to the corporation because under accounting theory the company has received the services and granted its consideration. Likewise, if the option drops in value, the expense is not adjusted downwards.130

The problem with the FASB analysis is that ignores the effect of the eventual repurchase on the company’s cash position. If we can assume that the repurchase (and hence the true expense) occurs at the point of exercise, then the intrinsic valuation measure at date of exercise is the most accurate reflection of true cost.

128 Niskanen, FASB is Still Wrong about Stock Options, supra.
129 Id.
130 Proposed Statement, supra at 122.
Admittedly this solution to the problem of expensing opens up some legitimate questions about the timing of repurchases and matching actual repurchase costs to the timing of option exercises. It's probable that companies don't repurchase immediately on a date of exercise, and some companies may not repurchase at all. However, most companies admit in 10Qs that a repurchase occurs because of the issuance of shares from option plans. (Another conceptual way to think of the repurchase, however, is to regard the measure as the cost to the company of going into the open market and purchasing shares in order to issue them to the employee. In reality, however, companies issue shares from a reserved stock option pool rather than purchasing the shares in the market.)

Since it would be problematic to match a particular repurchase to a particular option exercise, an easier solution is to just expense at time of exercise and make the assumption that the current repurchasing efforts match the expense being made.

I believe that the intrinsic value measure at date of exercise more accurately represents the financial picture of a corporation. The only time that money flows out of the corporation in relation to an option is when shares are issued. Either the corporation has to repurchase shares on the market to prevent dilution or issue new shares thereby incurring an opportunity cost by not selling the same shares on the open market. Under the current FASB proposal, the option expense does little to clarify how money actually flows into and out of a corporation nor does it necessarily help investors come to a clearer picture in making their investment decision. In some respects, the FASB proposal actually muddies the waters. It trades one uncertainty for another. In intrinsic value measure at date of exercise would also be simple to implement. It's a known and easily captured cost that would not require expensive modeling or excessive accounting costs to
2. Fully Diluted Capitalization at Date of Grant for Purposes of EPS Reporting

Proponents of FASB will look at the timing issue discussed above and object that the true measure should be made at the date of grant for reasons already discussed. One way to reflect the issuance of options at the date of grant without expensing is to require that only fully diluted capitalization be used when reporting EPS.

FASB Statement No. 128, *Earnings Per Share* requires companies to report two types of EPS – basic EPS and diluted EPS. Basic EPS is merely the net earnings from the income statement (the numerator) divided by the weighted-average number of common shares outstanding for the period (the denominator). In diluted EPS, the outstanding shares must include all in-the-money options – i.e. those options that are priced below the stock’s trading price. In common parlance, this is the “fully diluted” capitalization of the company. The result of fully diluted EPS is that EPS drops because earnings are spread over a greater number of shares. Although fully diluted EPS drives down earnings, it’s a more accurate figure to report since employees will inevitably exercise in-the-money options.

Some shareholder activists contend that out-of-the money options should also be counted in the denominator of diluted EPS. However, this would needlessly penalize a company whose stock performance is lagging. It would do nothing to clarify the financial

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132 Arguing that the potential dilutive effect of out-of-the money options is enough to warrant their inclusion in diluted EPS. John H. Briggs, Chief Executive Officer, TIAA-CREF *Testimony Before the U.S. Senate Finance Committee*, April 18, 2002.
picture since no economically rational person would exercise an option at a price that is over the trading price of the shares.

Shareholder rights activists point out, however, that there were widespread repricings of out-of-the-money options during the economic downturn of 2000-2002. However, whenever an option is repriced, it would then have to be counted into diluted EPS. To count out-of-the-money options takes the concept of diluted capitalization too far to be fair to the corporation and to be accurate as to distribution of earnings.

What is surprising is that there isn’t a move at FASB to require companies to only report diluted EPS. The same arguments used against the dual systems of reporting endemic to Statement No. 123 also apply to Statement No. 128. As noted above regarding earnings, a company’s public relations machine will naturally report the higher rather than the lower EPS if given a choice. It is a company’s nature to push the higher figure since that will likely raise the stock price. Since the holders of options will naturally exercise those options if they are in the money, the only true reflection of EPS is a diluted figure.

I believe that a movement to require only diluted EPS would do more to reflect an accurate financial picture of the corporation than the expensing of options. Since earnings are spread over the likely number of shares, the financial picture is more accurate. Since earnings are reduced, the shareholder rights activist’s argument that executives will less likely make large grants should also come to pass.

I conclude that in the absence of a market price, fair value accounting’s reliance on
stock option pricing models yields at most a speculative and uncertain price for employee stock options. Relying on a stock option pricing model is also open to manipulation since many of the determining factors used to calculate the price are merely estimates made by the company. Since FASB has not determined that any one model should be used but leaves the choice up to the company, the goals of certainty, reliability and comparability are not furthered by the use of fair value accounting. Use of the models is a costly solution to companies that will drive down revenues and not further any of the aims of the FASB. Rather, a simple, elegant and reliable solution exists that will more accurately track the outflow of cash from a corporation -- an intrinsic value measure at the date of exercise coupled with the requirement that companies only report fully diluted EPS.

**F. Complying with International Standards as an Informational Reform**

No discussion of the option expensing proposal would be complete without discussing the desire by the FASB to comply with international standards. Initially, the FASB tried to focus the attention on the proposal as an attempt to compel the international convergence of accounting standards. In February 2004 the International Accounting Standards Board (IASB) issued an International Financial Reporting Standard (IFRS) 2, Share-based Payment, which requires that all companies recognize an expense when equity instruments are exchanged for employee services. IFRS 2 is substantially similar to the amended Statement No. 123. FASB’s official position is to promote international standards in order to improve the ability to make comparisons of financial data around the world.\(^\text{134}\) The accounting profession is in near unanimous

\(^{133}\) Id.

\(^{134}\) Proposed Statement, supra at xi.
agreement that “the capital markets would benefit from a single global standard for financial reporting on this item as well as others.”

Berkeley categorically rejects the notion that the United States should follow the European lead on this accounting issue. His argument is that the IASB really represent Europe and not a global standard. Moreover, he contends that European wealth is largely in the hands of a few families who maintain their grip by different classes of shares with control ceded to the classes owned by the families. In Europe, the system spreads wealth over generations with little opportunity to foster intellectual capitalism.

In Berkeley’s view, this lack of opportunity to share the wealth is a prime reason that Europe doesn’t lead the world in innovation and, when it does (as in the wireless technology), the wealth is not shared beyond the richest families. The attempt to bring American standards in line with European accounting standards is an attempt to derail America’s competitive advantage in technology innovation, according to Berkeley.

Niskanen also urges caution. He maintains that convergence of international standards is not reason alone to perpetuate a new rule. I agree with the positions of Berkeley and Niskanen. Moreover, since the IASB just passed the measure, there’s no data on how well it worked internationally. Even if this standard is good for America, it would be prudent to wait and see how it plays on the international stage first. The focus should be on whether the FASB is a useful Information Reform and not whether the US is in

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135 Schneider, Who Rules Accounting?, supra.

136 Ltr. from Alfred R. Berkeley, III at 3.

137 Id.

138 Niskanen, FASB is Still Wrong about Stock Options, supra.
compliance with the mores and standards of other nations, which do not reflect the unique nature of American culture.

IV: LIMITING CORPORATE FRAUD THROUGH "RULES OF THE GAME" REFORM

In light of my conclusion that the FASB rule will not lead to financial clarity, we then turn to what other ramifications the proposed rule might have. Will the proposed expensing rule reduce corporate fraud as its proponents contend? Will it have other economic effects? If the proposed Information Reform is ineffective in promoting a reduction of corporate fraud, are there other Rules of the Game Reforms that can be taken to achieve the goal?

A. The Effect on Corporate Fraud, the Economy, Employee Ownership and American Global Competitiveness

The FASB admits that there would be economic consequences to the new rule, but the board doesn’t speculate as to what those consequences might be. 139 If the proposal were designed only to promote greater clarity and truthfulness in financial reporting, then this would be a valid omission. But since I have already concluded that reasonable people can disagree as to whether the rule promotes clarity, I contend that FASB had a duty to analyze the consequences of its actions.

As noted above, the Stock Option Accounting Reform Act includes a provision to determine the economic effect of option expensing on the economy. While no doubt that

139 Proposed Statement, supra at 127.
the study will shed some light, there already exists a volume of data on the matter.

1. Prediction: Companies will issue fewer options to rank and file employees while maintaining executive option grants

Professor Douglas Kruse found substantial evidence that in anticipation of the accounting rule change, companies starting in 2002-2003 began cutting back on stock option grants to rank and file employees while maintaining the grants made to executives.\(^\text{140}\)

While non-executive employee option grants are being cut, executive employees are getting a larger percentage of the options being granted. The percentage increase wasn’t just a matter of the executives’ portion being a larger slice of the pie when rank and file didn’t get options. The raw number of options going to executives increased in 2002-2003.\(^\text{141}\) Moreover, when many companies, after the downturn, repriced options that were no longer in-the-money, 60% of the companies engaged in repricing only did it for the executives and directors and not for rank and file employees.\(^\text{142}\)

Kruse’s testimony was supported by a follow-up survey done by Mellon Financial Services, which found that 45% of the respondents would cut eligibility in option plans for non-exempt employees yet none of the respondents had any plans to cut executive


\(^{141}\)\textit{Id.}

\(^{142}\)John H. Briggs, Chief Executive Officer, TIAA-CREF \textit{Testimony Before the U.S. Senate Finance Committee}, April 18, 2002 citing a 2001 study down by Institutional Shareholder Services.
option plans. Moreover, 83% of the respondents said they would keep the option grants virtually the same in the amount granted for executives while 54% of the respondents would cut the amount of option grants for non-exempt employees.\footnote{Mellon Survey at 10.} Moreover, the survey revealed that 78% of the companies which cut options for executives would “make up” the difference with some sort of other benefit – e.g. increased base salary, bonus or retirement benefits – while 54% would not do so for non-exempt employees.\footnote{Id. at 11.}

Proponents of the FASB argue that companies which believe in employee ownership will continue to grant options. However, Kruse thinks the argument has little merit based on past corporate behavior in relation to changes in the accounting and tax benefits according retirement plans. Kruse notes that corporations significantly reduced defined benefit plan obligations, post-retirement health benefits and Employee Stock Ownership Plans (ESOPs) when accounting rules changed to require expensing of these items. This happened despite a belief in the overall concept of saving for retirement.\footnote{Kruse, Testimony, supra.} Kruse concludes that clearly companies need an economic incentive in order to pursue some of these desirable social goals.

The work of Kruse and Mellon is significant when considering the goal of preventing corporate fraud. The premise of this particular goal is that large option grants to executives created the incentive to commit fraud. The executives, motivated by greed, sought short-term profits for the corporation in order to drive up the stock price, exercise the options and sell the stock, thereby pocketing large gains.
If, in fact, the rule would not reduce option grants then the goal cannot be achieved through the rule change. Of course, we should consider briefly whether less corporate fraud will occur if rank and file workers' options are decreased? Sonthalia found that “reducing options for the rank and file will not have a major effect on corporate governance and honesty.” The effect of one individual outside of senior management is only going to have a minor effect, if any at all, on stock price. 146 The obvious answer is, as Sonthalia concluded, executives (and not the rank and file) are in the position to control whether or not fraud occurs.

Some commentators believe that the FASB should not, as a policy matter, attempt to control fraud by reducing option grants. In Berkeley's view, the argument in favor of expensing as a deterrent to fraud misses the point of the issue. "The fact that a handful of allegedly crooked CEOs made more than they should have out of options, compounds the confusion and muddies the argument. The heart of this debate is about [broad] based ownership of options, not the abuses of a concentrated elite." 147 The goal to eliminate options in order to prevent executive fraud is, in the words of policy analysts Kevin Hassett and Peter Wallison, like "eliminating automobiles in order to prevent highway accidents." 148

Based on the data presented I conclude that the one of the primary goals of the FASB measure -- to prevent corporate fraud by removing the incentive of stock options -- will

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146 Sonthalia, 51 UCLA L. Rev. at 1224.
147 Ltr. from Alfred R. Berkeley, III at 6.
148 Hassett, Regulation at 53 (Spring 2004).
not be achieved by the proposed rule. If the FASB rule will not prevent fraud, then what will be the economic consequences of the proposal?

2. Prediction: Companies will become less competitive under the new rule.

The new rule will dramatically reduce earnings in the overall economy. A study done by Standard and Poor’s estimated that if every company in the S&P 500 had expensed options, the overall worth of the index would have fallen by 10.6% in 2003, 19.2% in 2002 and 21.5% in 2001.\textsuperscript{149}

The net effect of reduced profits will result in some start-up companies being less competitive in the marketplace. If such companies have to report lower earnings then the share price of the company will fall or fail to rise even if it makes compelling strides in earning cash from operations. This will affect its ability to go into the marketplace to raise capital. With a lower share price, the company will not be able to raise as much money in the capital markets.

Options are also a useful mechanism for employing and retaining talented employees. Start-up companies with little cash may turn to options as an alternative to paying high salaries. Without such strategies to rely on, start-up companies again will be hampered in the marketplace for talent. The Stock Option Accounting Reform Act seeks to resolve these problems by exempting companies that recently went public or are worth less than $25 million.

Alternatively, when companies issue options, there is an increase in company value. Kruse notes that companies which award options to rank and file employees results in improved productivity and total shareholder return.\textsuperscript{150} In one study, workers who had options or some other form of equity behaved more like owners and monitored fellow employees more often thereby reducing poor performance.\textsuperscript{151} Whereas companies which focus awards on the top five executives rather than the rank and file do not perform as well as companies engaged in broad-based plans.\textsuperscript{152}

The proposal may also affect America’s competitiveness in the global marketplace. Many opponents argue that outsourcing to India and China is a threat to the American economy, which will be compounded if options are discouraged. If offshore labor can compete with American companies because of lower wages, American companies need to have innovative ways of compensating employees, such as options, in order to keep salaries low. There also the real possibility that overseas companies will use options to benefit employees as well as having lower wages than the US, thereby further hampering the ability for US companies to compete.\textsuperscript{153}

\textbf{3. Options: Partnership Capitalism or Wealth Transfer?}

\textsuperscript{150} Joseph Blasi, \textit{In the Company of Owners, supra} at Chapter 7.


\textsuperscript{152} Gretchen Morgenson, \textit{Option pie: Indulgence by executives is a health hazard for shareholders}, Milwaukee J. & Sentinel 1D (Apr 4, 2004) (available at 2004 WL 58807954). Kruse supported the Congressional legislation to limit expensing to the top five executives. Alternatively, he would give companies that engaged in broad based option plans to rank and file employee a tax credit to offset the option expense. Kruse, \textit{Testimony, supra}.

\textsuperscript{153} Reynolds, \textit{FASB fumbles stock options, supra}.
As a policy matter, are stock options a desirable incentive? The detractors of options contend that options are a "wealth transfer" from shareholders to employees.\textsuperscript{154} Despite gains that might be made in productivity as a result of options the question arises among some shareholder rights groups that any option grants are merely an unjustified transfer of wealth from the legitimate owners. One of the primary proponents of the FASB plan, Warren Buffett, routinely rails against option plans for any employee. When Mr. Buffett’s investment vehicle, Berkshire Hathaway, purchases a company, Mr. Buffett routinely buys out any existing option plans as a condition of the purchase. Kruse contends that expensing actually threatens the very existence of America’s “nascent economic democratic system of capitalism.”\textsuperscript{155} In Kruse’s view, “partnership capitalism” incentivizes workers, leads to innovation, bottom-up decision making, better teamwork and a change in attitude among all workers where profit is a priority.\textsuperscript{156}

Historical precedent exists for the culture of stock options, according to former NASDAQ Vice Chairman Alfred R. Berkeley, III. In Berkeley’s view, the first option program in the United States was the Homestead Act where pioneers were given land by the U.S. government in return for improving, cultivating and otherwise employing “sweat equity” in order to get title.\textsuperscript{157} Berkeley maintains that this sense of ownership in the productive assets of society insures political stability and financial security. “In a tax system promoting consumption and penalizing savings, we compound the difficulty of

\textsuperscript{154} Andrew Bary, \textit{Living Large: Adobe's lush option grants pit insiders against public shareholders}, \textit{Barrons} 17 (Nov. 10, 2003).

\textsuperscript{155} Kruse, \textit{Testimony, supra} at 3.

\textsuperscript{156} Joseph Blasi, \textit{In the Company of Owners, supra} at 40-43.

\textsuperscript{157} Ltr. from Alfred R. Berkeley, III at 1-2.
saving with forced retirement and medical advances that will keep us alive for twenty years after we retire. Equity is the only financial instrument that offers the possibility of growth, and is essential for millions of Americans.” In Berkeley’s view, America benefits from “broad, democratic ownership of productive assets of the economy, not a small financial elite controlling more and more of the economy.”

One issue that should be addressed is whether the alternative proposals that I outline above would reduce option grants to the same measure as predictions about the FASB proposal. I argue that since the expense is not focused on a hypothetical cost that hits the bottom line before the actual outflow of cash, then there won't be any serious impact on the bottom line reporting. In other words, executives won't shy away from plans since the expense is delayed until the date of exercise. In fact, it may encourage companies to put forward incentives to exercise early -- before the stock price goes up -- in order to minimize the expense.

Spreading the wealth through stock options, is not a matter of wealth transfer via socialistic means, but an important characteristic of the modern capitalistic system that has helped pushed the United States to the forefront of the global economy. There is a strong body of evidence to suggest that productivity and efficiency gains made by corporations in the 1990s were driven by employees who held options and started to think like owners interested in bottom line earnings rather than employees just getting a paycheck.

What has been lost in the stock option debate, is that stock options for the most part

\[158\] Id.
are benefiting the middle class rather than the wealthy. While a few high profile wealthy executives have abused their stock options, this has led the financial elite to propose to put a cap on the use of stock options altogether. The irony is that the movement to halt stock options is based on the premise that it will prevent the rich from getting richer, when in fact it will hurt the more modest rank and file worker harder than it will wealthy individuals.

B. "Rules of the Game" Reforms: Fraud Prevention Alternatives

The objective of fraud prevention could be addressed by changing the “Rules of the Game” regarding executive options. These changes fall into several types of reforms but are often implemented as shareholder driven proxy proposals.

In a 2003 review of shareholder driven proxy resolutions, it was noted that some trends are developing to control executive option grants. One theory behind shareholder proposals aimed at preventing fraud is to take away the incentive from the executive to manipulate the stock price for short-term gains. The proposals seek to incentivize executives to act toward long term gains on the theory that a more stable stock price will be the result.159 The theory seeks motivate executive to act in the interest of the corporation in order to insure the long-term wealth creating potential of the entity. In essence, the proposals seek to align the interests of shareholders and employees.

Proposals such as CEO compensation caps and restrictions on the number of options CEO might receive would also remove the incentive of options. Although not receiving broad support, some proposals sought to prohibit "future stock option grants to senior
executives without violating any existing employment agreement or equity compensation plan.”

A more sophisticated proxy proposal, though not widely used in the 2003 proxy season, was a proposal that required executives to retain most of their equity (typically 75% is suggested) during the course of their employment. Consequently, the proponents of such proposals contend, the executives cannot cash out and short-term thinking is discouraged. In other words, the holy grail of equity compensation is achieved -- the interests of shareholders and executives become aligned.

Another way in which this idea plays out is in the projected increased trend in the use of restricted stock instead of options. Restricted shares are the actual equity shares in the corporation held in the name of the employee. However, covenants require the employee to not sell the stock for a period of time, much like the vesting provisions of options.

With options, the employee can play a quick turnaround game. If the options are in the money, they need only exercise and then can sell shortly thereafter. By holding restricted stock, the employee takes a risk – much like a shareholder – that the trading price could go below his purchase price. Consequently, with restricted stock, there is more of a likelihood of interests being aligned. Surveys indicate that the projected use of restricted stock and full value share vehicles are increasing over current practices with

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159 Spector, Developments and Trends in Compensation, supra.

160 Id.

161 Id.

162 Under SEC Rule 16(b) large shareholders (holding over 10%), officers and directors of a publicly traded company cannot buy and sell within six months of each transaction, otherwise they must disgorge the profits to the company. Securities Exchange Act of 1934, § 16(b) (SEC).
full value likely to one third of long term incentives for executives in the near future. 163

Another method widely discussed as motivating long term value maximization are performance based options, which come in a number variations. One common type of performance based option causes the exercise price of the option to be "indexed or linked to an industry peer group stock performance index so that the options have value only to the extent that the company's stock price performance exceeds the peer group performance level." None of the 2003 proposals for performance based indexing were reported as winning approval, but it’s likely that this proposal will continue to be favored by shareholders even though unfavorable tax and accounting treatment results for the company through the use of these options.164

It is interesting to note that existing structures within the corporation could have prevented fraud and short-term running up of the stock but there was a break down in the mechanism. In theory, procedures are already in place so that boards of directors and compensation committees have the ability to rein in out of control executives or to not grant them large option packages. More rigorous enforcement of the fiduciary duties of such entities might be needed in order to reduce excessive grants and monitor executive behavior. This could be accomplished by holding some of the directors responsible for wrongs done by the executives or through shareholder derivative suits.165

163 Mellon Survey, supra at 12.

164 Spector, Developments and Trends in Compensation, supra.

165 One of the widely discussed reforms that Sarbanes-Oxley Act propagated was a requirement that the CEO and CFO of a corporation sign off on the accuracy of its financial statements in order to hold them accountable for fraud. Sarbanes-Oxley Act, supra.
Preventing executive wrongdoing ultimately requires strong enforcement of existing laws prohibiting accounting and securities fraud. While many states' attorneys general are emulating the successful investigations of Elliot Spitzer in New York, it's too early to gauge whether the cases of high-profile executives going to jail will have a deterrent effect on future corporate fraud.

CONCLUSION

The FASB amendment to Statement No. 128 Accounting for Stock-based Compensation was driven by two primary forces -- 1) shareholder rights activists outraged over executive compensation packages and 2) accountants in a good-faith belief that the measure would yield a more accurate financial picture of a company for investors. As to shareholders, the reasoning was that since expensing would substantially reduce reported earnings, companies would grant fewer options. Accountants, however, justify the measure by holding that even though no money leaves the corporation when an option is granted, a theoretical expense should be registered because the company receives services from the employee and exchanges a valuable equity interest.

In practice, expensing becomes complicated and uncertain because there is no accurate way to price options at the date of grant. There is no market in employee options and the existing public options market shares too few characteristics with employee options to be an adequate proxy. Thus, FASB must turn to option pricing models, which in themselves are problematic. The models rely on variables that are subjective estimates.

and are easily manipulated which then results in widely varying numbers. The FASB method of accounting for options yields such uncertain results that it is no longer practical to consider it. Consequently, I conclude that any use of option pricing models will not further the FASB's stated goals of reliable, consistent and comparable financial data. The U.S. Congressional response to FASB in the form of the *Stock Option Accounting Reform Act* does little to clarify the issue and calls into question the independence of FASB.

Alternatives to FASB's proposed method already exist. Lessons can be learned from the IRS, which values options at the date of exercise. Measuring the worth of options at the date of exercise using the intrinsic value method reflects a more accurate cost to the corporation since it registers either the repurchase cost or, in the absence of a repurchase, the lost opportunity cost to the corporation in granting the option. FASB proponents would argue that this valuation method does not address the issue that the employee receives a valuable asset. However, I argue that their concerns could be addressed if the company were required to only use in-the-money fully diluted capitalization when computing earnings per share (EPS).

If implemented, the FASB amendment will not lead to a downturn in corporate fraud or a reduction in executive compensation as argued by shareholder rights activists. Studies show that the only likely reduction in option grants will be among rank and file workers. However, the FASB measure will drive down earnings and depress an already depressed economic climate. In balancing the need for accuracy in corporate accounting and incentives for industry, neither need is met by the FASB proposal. Moreover, I argue that the FASB rule on expensing options is more appropriately considered as an
Information Reform, which by its nature is meant to improve the clarity of information rather than modify behavior. Modifying the behavior of executives who commit fraud or boards of directors who make large option grants requires more fundamental Rules of the Game Reforms. Measures exist to control excessive executive option grants, such as accountability at the board of directors level and shareholder proposals that restrict grants or require executives to hold onto 75% of their shares for as long as they are employed by the company.