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Expensing Isn't the Only Option:  
Alternatives to the FASB's  
Stock Option Expensing Proposal

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# Expensing Isn't the Only Option: Alternatives to the FASB's Stock Option Expensing Proposal

Benjamin A. Templin\*

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## I. INTRODUCTION

For the second time in just over a decade, the Financial Accounting Standards Board (FASB) proposed a rule requiring companies to treat stock options as an expense on their income statements.<sup>1</sup> 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 lower earnings reports and hence fewer option grants. By removing the options, the incentive to commit accounting fraud is also removed, so the theory goes.

At the other end of the debate, many economists and technology 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 that the decrease in option incentives will derail an innovative form of wealth sharing and threaten America's dominance as a technology 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

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1. At press time, the FASB issued its final statement on the proposed rule as FASB Statement No. 123 (revised 2004), *Share-Based Payment*. Statement 123(R). Carrie Johnson, *FASB Orders Options Counted as Expenses*, WASHINGTON POST (Dec. 17, 2004), at E01 [hereinafter Johnson, *FASB Orders Options*], available at <http://www.washingtonpost.com/wp-dyn/articles/A6198-2004Dec16.html> (last visited Dec. 16, 2004). Although the FASB has issued its final statement, the issue at press time is far from decided. As detailed below, Congressional legislation may delay the FASB's plans. This article tracks the development of the rule as well as the on-going debate. Whatever the outcome, neither side in the debate is likely to capitulate to the other. The issues discussed here will stay with us for a long time to come.

does not 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 too much manipulation to accurately measure the expense. Leading economists, even those who are against the idea of granting options to employees, agree that option pricing models are inaccurate. The opponents of the 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 the FASB's new rule as being in favor of greedy CEOs and fat salaries for executives.<sup>2</sup> 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. The compromise legislation in Congress does little to add clarity to financial statements since it creates a double standard for expensing options.

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 reforms spawned by the corporate scandals that erupted in 2001.<sup>3</sup> Professor Blair splits the types of reforms into two general categories: 1) Those reforms "enhancing the quality of information," which for purposes of this article I will refer to as "Information Reforms" and 2) "'Rules of the Game' reforms," which shift power from management and directors to shareholders.<sup>4</sup>

Part II reviews the FASB proposal and its history. Here I examine the mechanics of the current accounting rules and those of the proposed rule. I conclude that the optional system where companies can choose between using intrinsic value accounting or fair value accounting has led to inconsistencies thereby making the comparison of financial data more difficult for investors. I also 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. Finally, I note the controversy surrounding the issue of whether Congress should have an oversight role in determining accounting policy.

Part III examines the pros and cons of the expensing issue from the perspective of an

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2. *Stock Options Aren't Free*, ST. LOUIS POST-DISPATCH, available at <http://www.chron.com/cs/CDA/ssistory.mpl/editorial/2717595> (last visited Aug. 3, 2004) (article no longer available in electronic form).

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

4. *Id.* Professor Blair's methodology is useful for this analysis because it lends a focus for how different types of reforms can be evaluated. If we slot the FASB reform as an Information Reform then it becomes clear that the standard by which it should be evaluated is whether it improves the quality of the information.

Information Reform, i.e., does the change lead to greater clarity in financial reporting? I conclude that options incur an expense and that the expense should be reflected in the income statement. However, I reject the argument that the FASB's proposed methods of expensing options accurately track the expense. Upon examining the current and proposed methodologies and underlying assumptions, I conclude that the FASB's goals of reliability, consistency, and comparability are not furthered by the proposed expensing rule because there is no accurate method to predict the true cost of options at the date of grant. I analyze data to conclude that the true expense of an option is in the repurchase cost that corporations incur when they buy back stock issued as a result of the exercise of options or, alternatively, in the lost opportunity cost to the corporation by not issuing stock into the market. I examine various theories on how, under the principles of accrual accounting, the expense could be treated so that it is recognized at the date of repurchase rather than at the date of grant. I also find that the compromise legislation in Congress does not further the goal of financial clarity and may do more harm than good because it creates a dual system of accounting.

Part IV looks at alternatives to the FASB's rule. I argue that investors would be better served if the 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 using an option pricing model at the date of grant. The IRS recognizes the inherent uncertainty of option pricing models and therefore, for non-statutory stock options (NSOs), seeks to tax the real gain that an employee receives, that is the accumulated gain at the time he or she elects to exercise their stock option.

I argue that the IRS method more accurately reflects the true compensation cost to the company as a result of the option exercise because it tracks the cost of repurchasing shares issued as a result of the exercise of the options or, alternatively, in the absence of a repurchase, the lost opportunity cost by not selling shares into the market instead of issuing stock based on an exercised option. 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 V turns toward the question of whether the goal of reforming corporate fraud is furthered by the proposed rule. Assuming that the proponents' argument is correct—i.e., that options create an incentive to commit fraud—I demonstrate that the incentive will not be removed by the rule change since studies have shown that rank and file workers rather than executives will suffer a reduction in option grants as a result of the FASB's rule change. Furthermore, I dispel the argument that options create an incentive to commit fraud and look at the overall effects of the proposed rule on the firms and the economy. After discussing the relevant surveys and literature, I conclude that adverse economic consequences for both individual firms and the economy at large will occur if the expensing rule is implemented.

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 might be one such effective reform. Another behavioral rule change 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, proposals have been made that executives be required to hold onto a portion of their stock on a long-term basis. This would better align the interests of shareholders and employees.

## II. 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.<sup>5</sup> Under the original proposed rule, public companies<sup>6</sup> would be required, as of December 15, 2004,<sup>7</sup> to record as an expense on its income statement the "fair market value" of such stock options on the date of grant.<sup>8</sup>

#### 1. Fair Value vs. 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 the sale of an asset.<sup>9</sup> 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."<sup>10</sup> Normally, fair value is the market price. However, no public market exists for employee stock options since they generally are non-transferable.<sup>11</sup> In the absence of a market price, accountants measure fair value

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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 that companies grant 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 an 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. Acct. Series Exposure Draft, No. 1102-100, ix (FASB Mar. 31, 2004) (on file with the Journal of Corporation Law) [hereinafter *Proposed Statement*]. For purposes of this paper, I will focus on the accounting rules regarding public companies.

7. Under political pressure, the FASB in October 2004 delayed implementation of the rule as it applied to public companies until June 15, 2005. The FASB stated at the time that they delayed the measure because companies were implementing new reporting rules related to the Sarbanes-Oxley Act. Melissa Aguilar, *FASB Votes to Delay Rule on Options*, WEBCPA (Dec. 14, 2004), at <http://www.webcpa.com/article.cfm?articleid=7801&print=yes> (last visited Dec. 14, 2004).

8. *Proposed Statement*, *supra* note 6, at xiii.

9. Kevin Hassett & Peter Wallison, *A Troubling Requirement*, 27 REG. 52, 54 (Spring 2004) [hereinafter Hassett & Wallison, *Troubling Requirement*] (outlining the definition of fair value).

10. *Proposed Statement*, *supra* note 6, at viii-ix (discussing the FASB's evaluation of fair value).

11. A handful of notable exceptions to the non-transferability of options exist. In particular, Microsoft in a partnership with the investment banker J.P. Morgan made a one-time offer to its employees to sell their out-of-the-money options to Morgan. Harvard Professor Brian Hall suggests that this one time "transferable stock options" sets a precedent for a new equity instrument called the TSO. Hall argues that by resolving questions about tax, accounting and regulatory issues surrounding the transferability of options, the Microsoft experiment opens the door to other companies likewise inviting the sale of employee options. Brian Hall, *Transferable Stock Options (TSOs) and the Coming Revolution in Equity-Based Pay*, 16 J. OF APPLIED CORP. FIN. 1 (Winter

by using one of two methods—either by finding a proxy market where similar goods are bought and sold or by developing an option-pricing model.

While there is a market for publicly traded options, which might serve as a proxy, publicly traded options differ from employee options in such fundamental ways as to make the public market unreliable to use as a proxy to price 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.<sup>12</sup>

This isn't the first time that the FASB has tackled the issue of how to value stock options.<sup>13</sup> In 1993, the FASB proposed a similar rule, but the accounting board was sidelined by Congress which itself was pressured by the technology industry.<sup>14</sup> 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 Employees*, which was issued in 1972.<sup>15</sup>

Intrinsic value measures the difference between the market price of a stock and the exercise price of the option.<sup>16</sup> For example, consider an option issued with an exercise price of \$15 at the date of grant and a market value of \$25. Since the intrinsic value is the difference between the stock's market value and the cost to the employee (i.e., the exercise price), then the value of the option would be easily calculated at \$10. The intrinsic value merely measures the value to the employee in terms of how much she would gain if she exercised the option at a given time.

In practice, using the intrinsic value 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.<sup>17</sup> 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 because the IRS would view the under-priced option as income. In contrast, companies that elect to use the fair value method typically use the Black-Scholes Option Pricing Model to reflect an expense on the income statement.<sup>18</sup>

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2004). The challenge of TSOs, however, will be whether smaller companies will attract the interest that Microsoft had in the marketplace for such options. At this point, the experiment is too speculative to suggest that enough TSOs would be available on a consistent basis to serve as a proxy market for the purposes of valuing the option.

12. For a more complete discussion on the ways in which publicly traded options differ from employee stock options and issues surrounding option pricing models, see Part III.C.

13. Professor Anthony J. Luppino traces the stock option debate as far back as the 1950s prior to the existence of the FASB. Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 173 (2003) (discussing the prior use of the FASB's "intrinsic value" method).

14. 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 (SEC), *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* 714-17 (Aspen 2003).

15. *Proposed Statement*, *supra* note 6, at 13.

16. *Id.* at xi.

17. *Id.* at ix.

18. See *infra* Part III.C.2. for a more thorough discussion of the pros and cons of using the Black-Scholes

It is not surprising that, given a choice, most companies elected to use the intrinsic value rather than the fair-value method of accounting.<sup>19</sup> The natural effect of recording any expense is to reduce reported earnings. Because earnings are one of the most important factors that drive stock prices on the public markets, the majority of companies have traditionally used intrinsic value.

## 2. Does a Footnote Inform the Market?

If a company used the intrinsic value method under the 1995 compromise, then it would still have to include a fair market value calculation in the footnotes to its financial statements. The requirement that fair value be reflected somewhere in the financial statements reflects the FASB's position that fair-value accounting more accurately reflects an economic transaction than the intrinsic value method.<sup>20</sup> 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. Accounting theory requires that an expense be recorded when a valuable equity instrument is exchanged for receipt and consumption of employee services. Hence, the requirement that fair value be reflected somewhere in the financials, albeit in a footnote, was an attempt to get the information about the expense out into the marketplace so that investors could make informed decisions. In reality, the footnotes probably had little impact in disclosing fair-value accounting to the public since the footnoted information is not typically included in press releases or summary accounts of earnings figures.<sup>21</sup> Moreover, few investors read the detailed financial disclosures, and if they do, it is not critical to their investment decision.<sup>22</sup>

In a flawed argument, the technology industry argues the footnotes constitute full disclosure.<sup>23</sup> 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.<sup>24</sup> In

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option pricing model.

19. 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. *Proposed Statement, supra* note 6 at 116-17.

20. *Proposed Statement, supra* note 6, at x.

21. Hassett & Wallison, *Troubling Requirement, supra* note 9 (concluding that fair value of employee stock options should be included in footnotes until the FASB settles on a reliable method to determine value of employee stock options).

22. The numbers contained on the actual income statement carry more weight than the numbers that are buried in the footnotes. Luppino, *supra* note 13, at 101.

23. 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* (Apr. 21, 2004) [hereinafter Hassett, *Testimony*], available at <http://financialservices.house.gov/media/pdf/042104kh.pdf> (last visited Oct. 28, 2004).

24. *Proposed Statement, supra* note 6, at 125.



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 technology 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 rarely the one reported in the footnote) and will probably never read the footnote or be aware that there were different methods applied.<sup>25</sup> Consequently, an investor might make a decision to buy or sell a stock based on imperfect information, i.e., without knowing the whole story hidden in the footnotes.

One response to the FASB's objections that footnotes don't inform the market would be to give "equal time" to both methods of valuing options. This could be done in conjunction with SEC reporting requirements such that all disclosures to the market—through press releases and disclosure documents such as 10Ks and 10Qs—include both methods of accounting. The SEC's rules regarding disclosure could easily be reworked so that it is mandated that the information be displayed in such a way that both methods would be communicated to the market on an equal footing.

But more importantly, one of the downsides to the 1995 compromise is that it perpetuated two methods of accounting.<sup>26</sup> 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. Presumably, this difference would go away if an investor read the footnotes, though as already shown, that rarely happens.

Initially after 1995, the two methods of accounting—intrinsic value and fair value—did not create much of a problem in comparing financial data since few companies elected the intrinsic value method prior to 2002.<sup>27</sup> If given a choice between promoting a higher or lower EPS, any company's public relations 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. The comparability problem, however, rose in importance as the markets began to drop.

### *3. Bear Markets and Disgruntled Shareholders*

The compromise settled on in 1995 might still be with us today had it not been for the corporate scandals that erupted in the public markets after the stock market bubble

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25. Luppino, *supra* note 13, at 101.

26. The FASB seeks to simplify existing accounting standards for the recognition of employee expense. *Proposed Statement*, *supra* note 6, at 119.

27. *Id.* at 117.

burst in early 2000. From its highest to its lowest point, the S&P 500 Index dropped from over 1500 to below 800 in the following two and half years—losing forty-eight percent of its value.<sup>28</sup> There are many speculations on what caused the bubble and the subsequent bust, but public scrutiny began to focus on corporate misconduct beginning 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.<sup>29</sup> Of those six, he notes, four of the companies involved executives who used questionable accounting practices to pump up the share price.<sup>30</sup> The executives often cashed in by exercising their options and then pocketing their gains by selling the stock.<sup>31</sup> The option grants were often generous, as they were granted by a friendly board of directors.<sup>32</sup>

There was also increasing dissatisfaction with executive compensation.<sup>33</sup> The disparity between a company's lowest paid worker and the CEO had grown substantially in the previous two decades.<sup>34</sup> "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."<sup>35</sup> A large portion of the executive's compensation was reflected in options.<sup>36</sup> 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 the deduction for executive compensation to one million dollars.<sup>37</sup> This restriction on CEO compensation led to the rise of boards granting option packages to executives since certain types of options qualify as deductions.<sup>38</sup> The rise in the use of options to compensate executives coincided with the widespread instances of accounting fraud.<sup>39</sup> Commentators blamed options as an incentive for executives to manipulate earnings and drive the share price up in order to cash out.

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28. 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. Yahoo, *Finance Historical Quotes: S&P 500 Index*, at <http://finance.yahoo.com/q/hp?s=%5EGSPC&a=00&b=1&c=2000&d=11&e=31&f=2002&g=d> (last visited Nov. 12, 2004).

29. Roshan Sonthalia, Comment, *Shareholder Voting on All Stock Option Plans: An Unnecessary and Unwise Proposition*, 51 UCLA L. REV. 1203, 1204 (2004).

30. *Id.*

31. *Id.*

32. 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, *supra* note 14, at 717.

33. Scott Spector, *Developments and Trends in Compensation in the Last Year—Best and Worst Practices, in Hot Issues in Executive Compensation*, Tax Law and Estate Planning Course Handbook Series, PLI Order Number J0-0088, Westlaw 576 PLI/Tax 155, 241 (Practicing Law Institute September, 2003) (Max J. Scharz & Scott P. Spector eds., 2003) [hereinafter Spector, *Developments and Trends in Compensation*].

34. *Id.*

35. *Id.* (citing in part *Executive Pay*, BUSINESS WEEK ONLINE (May 6, 2002), at [http://www.businessweek.com/magazine/content/02\\_18/b3781703.htm](http://www.businessweek.com/magazine/content/02_18/b3781703.htm) (last visited Oct. 28, 2004)).

36. *Id.*

37. FRANK PARTNOY, *INFECTIOUS GREED* 156-59 (Henry Hold & Co. 2003).

38. Options granted under a non-statutory, performance based option plan that is approved by shareholders are eligible for deductions. I.R.C. § 162 *et. seq.* (2004)

39. PARTNOY, *supra* note 37, at 159.

As the financial scandals came to light in 2001, a significant number of companies choose to expense options thus leading to difficulties in comparing data. With more companies choosing fair-value instead of intrinsic value, it became more difficult for investors to make meaningful comparisons of financial statements.<sup>40</sup> Clearly, there is an uneven playing field if companies are using different standards of accounting. 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 using fair value accounting was not a decision based on the FASB's higher principles of reliability, consistency, and comparability.<sup>41</sup> Rather, the company's decision to expense the fair value of an option 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.<sup>42</sup> 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 their peak in the summer of 2002.<sup>43</sup>

This disparity in accounting practice grew to the point that by February 2004, companies that represented forty-one percent of the market capitalization of S&P 500 index had elected fair-value accounting instead of intrinsic value.<sup>44</sup> Clearly, one standard was needed if investors were meant to make easy comparisons of financial data.<sup>45</sup>

#### *B. The FASB Acts and Congress Responds: The Stock Option Accounting Reform Act*

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 principal legislation was the Sarbanes-Oxley Act.<sup>46</sup>

One change not addressed by the Sarbanes-Oxley Act, but within the purview of the FASB, was the reexamination of the financial reporting rules surrounding option

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40. *Proposed Statement*, *supra* note 6, at 118-19. The proposed statement would eliminate the ability to account for share-based compensation transactions, and generally would require evidence that such transactions be accounted for using a fair-value-based method.

41. The FASB mission statement starts out by stating that the organization acts to "[i]mprove the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency." Financial Accounting Standards Board, *FASB Facts*, at <http://www.fasb.org/facts/index.shtml> (last visited Sept. 23, 2004). This is often summarized as providing reliable, consistent and comparable data.

42. 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 data exists 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* (Oct. 2003), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=461760](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=461760) (last visited Sept. 24, 2004).

43. *Id.*

44. *Proposed Statement*, *supra* note 6, at 117.

45. 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 usefulness 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.

46. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) [hereinafter Sarbanes-Oxley Act] (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

grants.<sup>47</sup> 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 also drop 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.<sup>48</sup> Second, shareholders initiated shareholder proxy proposals to compel companies to expense options.<sup>49</sup> The proxy 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.<sup>50</sup>

The FASB also cites feedback from investor groups, which requested that the FASB eliminate the dual-reporting structure of the 1995 Statement 123.<sup>51</sup> A 2001 survey of stock analysts and fund managers by the Association for Investment Management and Research Fund show that eighty-three percent supported expensing stock options.<sup>52</sup> Over ninety percent of the respondents to a survey by stockbroker Merrill Lynch of thirty institutional investors supported a compensation expense for employee options.<sup>53</sup> In the Merrill survey, over seventy percent said that an analysis of employee options is a significant factor in their valuation of a company's shares.<sup>54</sup>

The response from the opposition to the latest FASB attempt took shape in Congress in much the same way that it did in 1994. Technology 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 technology companies that would be adversely affected by the FASB proposal.<sup>55</sup> The bills enjoyed an unusual show of bipartisan support during a contentious presidential election year.<sup>56</sup>

Corporate executives fought hard for legislation blocking the FASB since their executive and employee compensation packages were at risk. If a corporation had to register an expense whenever an option is granted, then the company's reported earnings could be reduced dramatically. If earnings decrease, then it is likely that the share price would follow. With the drop of the share price, the executives own options would likely

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47. *Proposed Statement*, *supra* note 6, at 117.

48. *Id.* at 117.

49. Spector, *Developments and Trends in Compensation*, *supra* note 33.

50. 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* note 6, at 117.

51. *Id.* at 125-26.

52. *Id.* at 126.

53. *Id.*

54. *Id.*

55. Of the eight initial sponsors in the House of Representatives, five were from California including: Dreier (R), Eschcoo (D), Honda (D), Lofgren (D), and Tauscher (D). H.R. 3574, 108th Cong. (2003), available at <http://financialservices.house.gov/media/pdf/108hr3574ai.pdf> (last visited Sept. 23, 2004).

56. As of May 12, 2004, there were 52 Democrats and 59 Republicans sponsoring the House bill and six Democrats and twelve Republicans sponsoring the Senate bill. S. 1890, 108th Cong. (2003).

become worthless.

However, self-interest is not 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. In addition, opponents contend that the economy and America's technology leadership could be affected if the measure is put into place.

The strength of the lobbyists in 2003 and 2004, however, 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 did not have enough public support to accomplish that goal. Politicians supporting the technology industry introduced compromise legislation that required expensing of options only for 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 including the ability to manipulate option-pricing models in order to drive the expense downward.<sup>57</sup> 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., had its initial public offering (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.<sup>58</sup>

The FASB does not think that a study is warranted, and took the position that economic

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57. One provision of H.R. 3574 requires that when a company uses an option-pricing model, 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 Cong. (2004). Since there was pushback in the Senate on setting volatility at zero, three leading technology companies, Cisco Systems, Inc., Genetech Inc. and Qualcomm Inc., in September 2004 presented the FASB with a plan to estimate volatility by using an index such as the S&P 500 instead of individual share prices. Since risk and volatility are lower when spread over a greater number of companies (technology companies are usually volatile while brick and mortar companies are less so) the use of an index's volatility would result in a lower number and hence a lower estimate when using a stock pricing model. Rachel Beck, *Analysis: Battle Heats Up Over Stock-option Rules*, (Sept. 21, 2004), at [http://www.mercurynews.com/mld/mercurynews/business/personal\\_finance/9722344.htm](http://www.mercurynews.com/mld/mercurynews/business/personal_finance/9722344.htm) (last visited Oct. 28, 2004).

58. H.R. 3574 § 3.

impact was not relevant to its rule-making role.<sup>59</sup>

On July 20, 2004, the U.S. House of Representatives passed legislation restricting the FASB by 312-211—a significant margin of victory.<sup>60</sup> Getting the Senate to pass similar legislation will be a much more difficult win according to news reports at the time of the House passage of the bill.<sup>61</sup> 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 procedural tool available to oppose any legislative vehicle that seeks to block a FASB rule.”<sup>62</sup> Presumably the Illinois Republican means that he would have started a filibuster if the measure ever came to a vote in the Senate. In hindsight, however, the FASB will have to look to someone else to be its champion in the Senate since Senator Fitzgerald, known for “tilting at windmills,” retired before the fight over option expensing concluded.<sup>63</sup> The FASB also has a powerful ally in Federal Reserve Chairman Alan Greenspan who supports the measure.<sup>64</sup> But the FASB isn't without its opponents in the Senate. The opponents to the FASB measure have a friend in Wyoming Republican Mike Enzi who has sponsored the Stock Option Accounting Reform Act. Enzi, the sole accountant in the Senate, is expected to use the FASB's delay of the implementation of the measure to garner support among colleagues to stop the measure.<sup>65</sup>

### 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.<sup>66</sup> In a press release, the agency stated: “We believe

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59. Carolyn Lochhead, *Silicon Valley's Political Clout: The Battle to Save Stock Options*, SFGATE.COM (Apr. 5, 2004), at <http://sfgate.com/cgi-bin/article.cgi?file=/c/a/2004/04/05/MNGGP60LO51.DTL> (last visited Sept. 23, 2004).

60. H.R. 3574, 108th Cong. (2003).

61. Roy Mark, *House Votes to Block Stock Option Expensing*, INTERNETNEWS.COM (July 20, 2004), at <http://www.internetnews.com/bus-news/article.php/3383781> (last visited Sept. 23, 2004).

62. Press Release, PR Newswire, Sen. Fitzgerald Vows to Block Any 11<sup>th</sup> Hour Attempt by Congress to Reverse Crucial Stock Option Expensing Reform (July 28, 2004).

63. Deirdre Shesgreen, *Obama arrives, and Fitzgerald says goodbye*, ST. LOUIS POST-DISPATCH, Nov. 18, 2004, at A01.

64. Robert Schroeder, *FASB delays options expensing rule*, CBS MARKETWATCH (Oct. 13, 2004), at <http://cbs.marketwatch.com/news/story.asp?guid=%7BC0A6C1BD-D3D7-456C-9425-499597FD94FC%7D&siteid=google&dist=google> (last visited Mar. 7, 2005).

65. *Enzi Rallies Expensing Opponents to Block FASB Proposal*, WEBCPA (Oct. 18, 2004), <http://www.webcpa.com/article.cfm?articleid=7817> (last visited Dec. 14, 2004).

66. The FASB is a private organization established in 1973 to set standards for financial reporting. The organization does not retain any legislative or administrative rule making authority. See *FASB Facts*, available at <http://www.fasb.org/facts/index.shtml> (FASB) (last visited Oct. 28, 2004). The Securities and Exchange Commission (SEC) recognizes the FASB as the primary authority devoted to setting standards for financial and accounting reporting. However, the SEC also has the right to overrule the FASB on any particular issue since they have statutory authority to create standards for financial reporting for public companies under the Securities Exchange Act of 1934. *Fin. Rep. Release No. 1*, Section 101 (SEC). The American Institute of Certified Public Accountants also recognizes the FASB as the primary authority for setting accounting standards. *Rules of Professional Conduct*, Rule 203, (Am. Inst. of Certified Pub. Accountants May, 1979).

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.”<sup>67</sup> 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 other countries seek to override the decisions of the competent professional standard setters . . . accounting standards will inevitably lose consistency, coherence, and credibility.”<sup>68</sup> However, opponents to the FASB measure state that it is part of Congress’s job to oversee the FASB. If Congress does not 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.<sup>69</sup>

In a broader context than the current FASB rule change, Professor Tony Luppino has advocated that the “SEC and the Treasury Department should not be constrained by the traditional notions that the government should defer to the private sector bodies to set financial accounting rules” if the tax treatment used by the IRS yields a “more appropriate conclusion than GAAP.”<sup>70</sup>

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.<sup>71</sup> Rubinstein’s method would probably throw off the timetable if it is adopted by the FASB.<sup>72</sup>

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67. Financial Accounting Foundation Trustees Issue Statement Opposing Legislative Proposals to Curb FASB Independence, News Release (June 14, 2004), available at <http://www.fasb.org/news/nr061404.shtml> (last visited Oct. 28, 2004).

68. Craig Schneider, *Who Rules Accounting? Congress Muscles in on FASB – Again* (Aug. 1, 2003), [http://www.cfo.com/article.cfm/3010039/c\\_3036074](http://www.cfo.com/article.cfm/3010039/c_3036074) (last visited Mar. 7, 2005) [hereinafter Schneider, *Who Rules Accounting?*].

69. Ltr. from Alfred R. Berkeley, III, Vice Chairman, NASDAQ, to FASB, *Letter of Comment on Proposed Statement No. 123*, Ltr. No: 44. (Jan. 30, 2003), available at <http://www.fasb.org/ocl/1102-001/14268.pdf> (last visited Oct 28, 2004).

70. Luppino, *supra* note 13, at 181.

71. See *infra* Part III.C.4 for more information on Rubinstein’s proposal.

72. Steven Taub, *FASB Might Delay Options Expensing*, CFO.COM (Jul. 1, 2004) [hereinafter Taub, *FASB Might Delay*], at [http://www.cfo.com/article.cfm/3014987/c\\_3042605?f=archives&origin=archive](http://www.cfo.com/article.cfm/3014987/c_3042605?f=archives&origin=archive) (last visited

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.<sup>73</sup> 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.<sup>74</sup> The two constituencies—investors and employees—are obviously at odds in the debate.

However, this is not a question of who has more lobbying power. The issue at stake is good accounting practice. 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. A decision needs to be made as to whether to use fair value or intrinsic value—not one or the other.

On December 16, 2004, the FASB announced that it had adopted a final statement that largely reflected the proposed statement. The political forces already in place and detailed above used the announcement by the FASB to once again lobby against the measure.<sup>75</sup> The SEC considered postponing the implementation of the rule and the SEC’s chief accountant Donald Nicolaisen is considering offering companies some “guidance” presumably with the intention of creating safe harbors for a company in terms of how they implement the rule.<sup>76</sup> Regardless of whether the FASB prevails or the technology industry blocks the measure with the Stock Option Accounting Reform Act, there are alternatives to both proposals that deserve consideration. I predict that whatever the outcome, the losing side is not going to capitulate but will regroup and continue to strategize on revisiting the issue.

### III. INFORMATIONAL REFORMS: ARGUMENTS FOR AND AGAINST THE FASB RULE

In Part A of this section, I review the pros and cons of the FASB rule. However, first I analyze the purpose behind accounting rule reforms. Using Professor Blair’s Rules of

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Nov. 12, 2004)

73. *Id.*

74. Employees at Cisco and other technology companies initiated a letter writing campaign that swamped the FASB with email opposing the proposed amendment. FASB, *Share-Based Payment—an amendment of FASB Statements No. 123 and 95 Comment Letters* (June 30, 2003), available at <http://www.fasb.org/ocl/fasb-getletters.php?project=1102-100> (last visited Sept. 23, 2004). The FASB compiled an overview of the responses in a 70-page document including representative arguments for and against the proposal. However, the document does not compile statistics on the overall support or lack thereof of the proposal. The FASB’s analysis only reports on the responses to the specific questions raised by the FASB. FASB, *Board Meeting Handout Equity Based Compensation Comment Letter Summary* (Aug. 4, 2004), available at [http://www.fasb.org/project/ebc\\_comment\\_letter\\_analysis.pdf](http://www.fasb.org/project/ebc_comment_letter_analysis.pdf) (last visited Dec. 15, 2004).

75. Johnson, *FASB Orders Option*, *supra* note 1.

76. Robert Schroeder, *Business regulators set for tug of war*, CBS MARKETWATCH (Jan. 17, 2005), available at <http://cbs.marketwatch.com/news/story.asp?guid=%7B7162B2F81EDF4282A1540A3E391518B8%7D&siteid=google&dist=google> (last visited Jan. 21, 2004).



the Game Reforms vs. Information Reforms dichotomy, I conclude that the purpose behind the reform of accounting rules should be a matter of improved information, and that we should not reform accounting rules in order to shift power from executives to shareholders if such a reform would negatively affect the quality of the information. In other words, the FASB rule should be judged from the point of view of an Information Reform and whether the rule achieves the FASB's stated goals of reliability, consistency, and comparability? I suggest that if we want to change the behavior of executives, then we need to consider changing the Rules of the Game by creating true power shifting rules in corporate governance.

Part B looks at the nature of stock options and asks whether 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. Part C examines how and when to expense the option. In the absence of a market for employee stock options, I conclude that 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.

#### *A. Information Reforms vs. Rules of the Game Reforms*

As already noted, Professor Blair breaks post-Enron reforms into two categories—Rules of the Game reforms and Information 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 bad judgment, were what caused the 1990s stock market boom and 2000 bust.<sup>77</sup> 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.<sup>78</sup> Rules of the Game proposals, on the other hand, “shift power and influence away from the directors and toward shareholders.”<sup>79</sup> Examples of these measures might include permitting shareholders to approve any option plan, nominate directors, propose charter amendments, and initiate reincorporations in other states.<sup>80</sup>

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 category of Information Reforms. However, the shareholder rights activists backing the FASB are interested in more than mere Information Reforms. I identify two primary goals driving FASB to propagate the new rule: 1) increasing the reliability, consistency and comparability of financial information<sup>81</sup> and 2) preventing corporate fraud.<sup>82</sup>

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77. Blair, *supra* note 3, at 39.

78. *Id.* at 39-40.

79. *Id.* at 40.

80. 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.

81. 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* note 6, at 127.

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 measures may be needed to accomplish the second goal. Preventing corporate fraud is characterized by behavior modification, which is not 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—i.e., furthering truth. In other words, policy matters, such as providing economic incentives for the technology industry, should be independent of an Information Reform. Information Reforms should only be judged on whether the reform is a better reflection of truth in financial reporting.

An Information Reform should 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 readily admits that, while there will presumably be economic consequences to expensing options, the Board does not speculate as to what those consequences might be.<sup>83</sup> 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 of a corporation's financials, 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 option.

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82. There are additional goals stated by the FASB, such as adopting international standards, *id.*, 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. *Acctg. for Stock-Based Compen.: A Comparison of FASB State. No. 123, Acctg. 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.

83. *Proposed Statement*, *supra* note 6, at 127.

*1. Compensation: Do Options Cost the Company Money at the Date of Grant?*

Technology 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.<sup>84</sup>

Warren Buffett, the notable investor and a leading advocate for expensing, characterizes this position as the “‘useful fairy-tale’ argument.”<sup>85</sup> 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.<sup>86</sup> Buffett uses a simple syllogism to counter the technology company argument that options are not compensation: “1) If options aren’t a form of compensation, what are they?; 2) If compensation isn’t an expense, what is it?; and 3) If expenses shouldn’t go into the calculation of earnings, where in the world should they go?”<sup>87</sup>

The technology 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 the executive’s base salary.<sup>88</sup> However, it is important to note that the cash realized from that payday does not occur at the date of grant. 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.<sup>89</sup>

The technology 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. Later, we will see that there is a cost attributed to options in the repurchase of shares but registering the expense at the date of grant leads to inaccuracy of the financial position of the corporation at that point in time.

Many sophisticated investors are more interested in the actual cash flow generated by the operations of a company than the earnings statements. Earnings statements can be more easily manipulated such that a company can show positive earnings yet still not be able to pay its bills.<sup>90</sup> If the cash flow from operations represents a truer reflection of a

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84. 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 & Wallison, *Troubling Requirement*, *supra* note 9, at 52.

85. Warren Buffett, *Stock Options and Common Sense*, WASHINGTON POST, Apr. 9, 2002, at A19.

86. *Id.*

87. *Id.*

88. SELIGMAN, *TRANSFORMATION OF WALL STREET 717* (2003). The use of options mushroomed during the 1990s so that by 2001, around 80% of executive compensation was in the form of stock options. *Id.* (citing ARTHUR LEVITT, *TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON’T WANT YOU TO KNOW*, 111 (2002)).

89. *Proposed Statement*, *supra* note 6, at 119.

90. See *Investopedia.com Dictionary*, <http://www.investopedia.com/terms/o/operatingcashflow.asp> (last

company's potential, technology companies might ask the question: "If the cash position of the corporation remains the same after the grant of an option, 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 option grants as reducing those earnings to \$0.90, the fact remains that the options have not cost the company a dime at the date of grant even though earnings have been reduced. If the company decided to distribute all of its earnings during that period as a dividend, then investors would get \$1.00 per share and not the \$0.90 that it was forced to report because of the FASB rule. Consequently, a company that is forced to report lower earnings might actually have more cash on hand than is reflected in the earnings reported. This could cause some holders of stock to sell when they should have bought or held onto their positions.

Still, if the cash position is not changed at a particular point in time, why should earnings be reported differently? In other words, the expense, the technology industry argues, is merely a theoretical one at the date of grant. For various reasons, the accounting profession is married to the idea that the expense must occur at the date of grant. Here is why.

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

To understand the FASB's position requires discussion of some of the principles of accrual accounting. In accrual accounting, which is the system of accounting used by public companies, all revenue and expenses are allocated to the period in which they were incurred regardless of whether the revenue was received or the expense actually paid out. Accrual accounting attempts to match the expense that relates to the revenue earned in the time period in which the revenue was earned.<sup>91</sup> Compare this with cash accounting, which recognizes revenue when the cash is actually received and recognizes expenses when the money is actually paid out.<sup>92</sup> Under accrual accounting, if a company incurs an expense at the date of grant of an option, then it must recognize that expense unless an exception is present.

Within this context, I examine four primary lines of reasoning that proponents of the FASB's position advance in support of expensing options at the date of grant: 1) the option expense registers a cost savings to the company; 2) the option expense registers an expense at the time that the employee renders service to the company; 3) the expense dovetails the accounting treatment of employees and non-employees in the granting of options; and 4) the expense registers a lost opportunity cost since the company could theoretically issue similar options into the open market as an alternative to issuing employee options. Assuming that options should be expensed, I then examine four possible exceptions to the general rule under which the expense could be delayed rather than being taken at the date of grant.

The first argument put forth by proponents for the FASB is that the theoretical

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visited Feb. 15, 2005) (defining operating cash flow).

91. DAVID R. HERWITZ & MATTHEW J. BARRETT, ACCOUNTING FOR LAWYERS, 64-65 (3rd ed. 2001) [hereinafter, HERWITZ & BARRETT, ACCOUNTING FOR LAWYERS].

92. *Id.*

expense of an option captures a cost that the corporation saved by issuing an option. Consequently, since the corporation saved money in compensation costs by issuing the option, the cost savings should be registered as an expense on the income statement. To not do so would be to overstate earnings since a cost is not registered, or so the argument goes.<sup>93</sup> One point in this analysis is certain. 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.

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 might demand a salary of one million dollars—money that the company does not 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.

Proponents of the FASB's position contend 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, the FASB holds 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 that companies use to entice employees, which also results in a reduction of the company's cash compensation costs but which are not considered expenses.<sup>94</sup> For example, 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.<sup>95</sup> Hassett points out that such benefits are not monetized and deducted from earnings.<sup>96</sup>

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, he argues, is rooted in a determination of the price that a willing buyer and seller would agree on in the sale of an asset and that is what the option pricing models are geared toward 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 the company saves in cash by issuing the option.<sup>97</sup> 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 forego his option and switch jobs? However, the FASB rejected this approach because valuing the employee's services is also

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93. Hassett, *Testimony*, *supra* note 23.

94. Hassett & Wallison, *Troubling Requirement*, *supra* note 9, at 53.

95. *Id.*

96. *Id.*

97. *Id.*

uncertain.<sup>98</sup>

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.<sup>99</sup> He argues that fair value accounting is not an appropriate measure to expense employee stock options. In other words, fair value accounting is not fair to the company, employees, or investors since it does not yield an accurate figure.

However, Hassett's argument is also not totally sound because it is the grant of the option, and not the circumstances surrounding employment, which can be monetized. Since a valuable asset (the option) is given to the employee, it is common sense and good accounting practice 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? While the FASB uses cost savings as a justification for expensing, the Board opted to value the option instead of valuing the cost savings since valuing the latter would lead to uncertainty.<sup>100</sup>

The second principal way in which the FASB analyzes the concept of an expense is by looking 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 by the corporation. The FASB says that it is at the point of consumption of the services that the expense should occur. In other words, the receipt of any asset results in an immediate expense.<sup>101</sup> Moreover, accrual accounting calls for the expense being registered at the date of grant because the obligation has arisen in that period by the mere issuance of the option.<sup>102</sup>

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. In essence, requiring an expense at date of grant will result in unfairness to the company and elevates form over substance. The value of an option often fluctuates dramatically between the date of grant and date of exercise. In fact, many options often expire without any value. Valuing at a later date—when the actual cost is certain—will result in a more accurate picture of a company's finances and support the FASB's goals of reliability, consistency, and comparability.

In the third line of reasoning in support of expensing at date of grant, the FASB also draws an analogy comparing the grant of an option to issuing a share of stock. If a share of stock was 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 a non-employee in return for services, then the option or warrant would be valued and counted as an expense.<sup>103</sup> Hence, the FASB reasons that employee option grants should be treated the

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98. *Proposed Statement*, *supra* note 6, at 121.

99. Hassett & Wallison, *Troubling Requirement*, *supra* note 9, at 54.

100. *Proposed Statement*, *supra* note 6, at page 121.

101. *Id.* at 120.

102. HERWITZ & BARRETT, *ACCOUNTING FOR LAWYERS*, *supra* note 91, at 64.

103. *Proposed Statement*, *supra* note 6, 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

same as non-employee grants for the sake of consistency. 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.

Another common argument is to draw an analogy between options and granting some other thing of value to the employee. If an automobile company gave an employee a car then the company would have to register that vehicle as an expense. Professor Luppino takes the analogy a step further to include items of uncertain value at the date of grant.

[I]f an employee were given, for example, a piece of unique artwork created by a relatively unknown artist as compensation for services, he would have to take a position on its fair market value in reporting compensation income on his tax return upon receipt of the artwork, even if there is no easily ascertainable market value. He would not be able to argue that he can defer recognizing the income until a discernable market develops and provides a better measure of how his bargain turned out.<sup>104</sup>

Luppino focuses on the fact that the intrinsic value measure “ignores the fact that value has been passed to the employee” with the grant of the option.<sup>105</sup>

While Professor Luppino’s analogy to options is accurate in terms of seeing that the option has uncertain value, it is not completely on point since an option is not a tradable item. In either the car or artwork example, the employee can go out into the market and sell the item. However, in the case of an option, the employee has no such opportunity. To refine the artwork example, one would have to say that the company has granted the employee the right to hold onto the artwork for a certain period of time with a condition that if the employee hangs the artwork on his wall for four years, then the art becomes his to do with as he pleases. This would integrate the concept of vesting discussed below.<sup>106</sup>

Finally in the fourth line of reasoning, proponents of the FASB also point to an opportunity cost that the company foregoes by giving the option to employee instead of selling it into the market. In other words, the company could have made money selling

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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 latter 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.

104. As has been previously noted, Professor Luppino’s main concern is with whether there should be conformity between book and tax accounting. This illustration focuses on the tax treatment of a thing of uncertain value granted to an employee. Professor Luppino ultimately concludes that the historical reluctance for book accounting to follow tax treatment should be altered in those cases where the IRS has a more accurate solution that doesn’t conflict with the goals of financial accounting. Moreover, Professor Luppino suggests that interaction between the IRS, FASB and SEC to address standards and seek a solution would help resolve the debate. Luppino, *supra* note 13, at 174.

105. *Id.* at 173.

106. Stock options typically vest over time such that the employee can only exercise a certain amount of shares after staying with the company. This insures employee retention.

the equity rather than giving it away.<sup>107</sup> However, as economist Alan Reynolds notes, “Before there can be an opportunity cost, . . . there must be an opportunity.”<sup>108</sup> Companies do not have an outlet for selling options comparable to employee options on the open market.<sup>109</sup>

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.<sup>110</sup> A corporation is unlikely to take the risk of selling puts or calls since to do so would put it 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. Corporations, after all, are in the business of their companies and not selling options. Options are the business of investment bankers and traders—not the companies on which such speculation takes place.

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.

Reasonable minds can disagree on whether there is an expense under these different theories; however, assuming that the expense is legitimate, the question arises whether such an expense has to be recognized at the time of grant. As previously noted, accrual accounting requires the recognition of an expense during the period in which it was incurred. However, there are some exceptions to the general rule. As will be seen later, options are difficult to value at the date of grant. Therefore, the FASB should consider different theories of timing the expense in order to have more certainty as to the value of the expense.

I consider four possible ways to treat the expense at a different time period rather than the date of grant: 1) characterizing the option as a prepaid expense for retention of the employee; 2) capitalizing the compensation expense of the option into an intangible retention benefit which is realized at the date of exercise; 3) creating an exception to valuation at date of grant based on the uncertainty of accurately valuing the option; and 4) creating a new dual based reporting system that includes both present payout and future estimates.

To examine these ideas in detail, we need to return to the idea that options represent a form of retention bonus. The FASB assumes that the services that employees render in return for the option have occurred at the date that the option is granted. While it is legitimate that an immediate expense should be recorded at the point that an asset (e.g.

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107. Luppino, *supra* note 13, at 89.

108. Alan Reynolds, *FASB Fumbles Stock Options*, TOWNHALL.COM [hereinafter Reynolds, *FASB fumbles stock options*], at <http://www.townhall.com/columnists/alanreynolds/ar20040415.shtml> (last visited Sept. 23, 2004).

109. *Id.*

110. See *supra* note 11, for a recent exception to the general rule that employee options are not transferable.



labor) is consumed, an option is more likely, by its nature, to purchase something different from an employee than mere services at a point in time.

Companies often grant options purely as a retention mechanism.<sup>111</sup> In effect, the option is a bonus for staying with the company. If the employee stays at the firm then she is rewarded with the ability to exercise the option, once the option becomes vested. With this view of options in place, then so long as the option remains unexercised, the value to the corporation for that compensation has not been realized. I contend that, since the employee determines how long she stays with a company, then the value of that option to the company (i.e. the “retention benefit”) is not realized until the option is exercised. If the employee leaves the company, she loses the right to exercise. Once exercised, the retention benefit is finally realized and consumed, and the company either has to grant more options to retain the employee or risk her finding other opportunities. Since the benefit to the company of the option is finally consumed at the point of exercise (i.e., the company realized the benefit of retention of an employee at the point of exercise), then the expense associated with such a benefit would be recognized at the same time as well, but not before.

Thinking of options as purchasing a retention benefit would then allow companies to treat as a prepaid expense for a benefit that the corporation has not yet consumed. Such deferral of prepaid expenses is allowable under accrual accounting.<sup>112</sup>

A second way in which compensation expenses are deferred occurs when the compensation is capitalized into an asset. The FASB argues that employment services cannot be capitalized in most circumstances as the conceptual reason that the valuation of the option has to occur on the date of grant.<sup>113</sup> Employee compensation could be capitalized into an asset in some circumstances under GAAP. For example, in the development of software, all costs related to that development, including salaries, can be capitalized over the life of the software.<sup>114</sup> To capitalize the compensation expense, however, would require that companies treat the “retention benefit” as some sort of intangible goodwill asset carried on the balance sheet. As that asset is consumed—i.e. the options are exercised—the expense would then occur. This idea is admittedly a bit of a stretch in terms of accounting theory but serves as a justification for deferring the expense to a time when it is the value can be determined with certainty rather than speculation.

A third way in which one could rationalize deferring the expense after the date of grant would be to merely create an exception based on the uncertainty of valuing the option at the date of grant. Such an exception has some limited precedent. The FASB actually carves out an exception in Statement 123 where valuation is done at the date of settlement of the option using intrinsic value if the “option or other equity instrument . . . make[s] it virtually impossible to reasonably estimate the instrument’s fair value at the

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111. Hassett & Wallison, *Troubling Requirement*, *supra* note 9, at 52.

112. HERWITZ & BARRETT, ACCOUNTING FOR LAWYERS, *supra* note 91, at 73.

113. *Proposed Statement*, *supra* note 6, at page 120.

114. FASB, *Statement of Financial Accounting Standards No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, 4 (Aug. 1985), available at <http://www.fasb.org/pdf/fas86.pdf> (last visited Dec. 15, 2004).

date it is granted.”<sup>115</sup> In the previous version of Statement 123, this provision called for valuation at the “first date at which it is possible to reasonably estimate [the options’] value.”<sup>116</sup> It seems significant that the FASB chose to change the date of valuation from some theoretical date to the actual settlement date. This seems to indicate that the FASB acknowledges that intrinsic value at date of exercise is the correct measure when uncertainty arises. If the FASB is willing to acknowledge this measurement as valid, then the next step is to merely get the FASB to acknowledge that uncertainty as to measuring fair value at the date of grant always exists in the case of employee options.

Another exception to accrual accounting can be found in an approach called “modified accrual accounting.” The FASB notes that a mixture of cash and accrual accounting has been used by some non-profits.<sup>117</sup> The modified accrual accounting system is also used by many state and local school systems for certain types of funds.<sup>118</sup>

While the FASB should not be quick to create exceptions to the general rules of accrual accounting, some situations may require a cash treatment because using accrual methods creates too much uncertainty. It will be argued below that given the uncertainty of valuation techniques, financial reporting would be more accurate if the valuation occurred not at the date of grant but at the time when valuation and cost to the company is certain—the date of exercise.

A fourth alternative to the accrual concept would be to create a dual based reporting system that includes both present payout and future estimates as has been proposed in a working paper by Carnegie Mellon accounting professors.<sup>119</sup> The authors of that innovative approach have noted that accounting standards have developed more and more forecasts lending uncertainty at a time when the public expects more accuracy. The approach simply breaks reporting into three categories “realized,” “expected,” and “total.” The realized transaction includes any transactions that have been completed or are all cash. Any future estimates would fall in the “expected” column and the “total” column is merely the sum of the “realized” and “expected” columns.<sup>120</sup>

Although the Carnegie Mellon authors do not discuss option valuation, one would expect that at the date of grant, the “realized” column would remain zero, while the “expected” column would be an estimate of the final expense to the corporation. The FASB would likely argue that valuation of the option belongs in the “realized” column since the transaction is completed using the ideas already explored above. However, if such a system were adopted, this bifurcation of the expense would serve several purposes. It would allow those advocates of non-expensing to see cash flows without the theoretical expense and vice versa. In essence, it would be an evolution of the current

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115. *Proposed Statement, supra* note 6, at page 21.

116. *Id.* (see paragraph no. 22 strike out text for a comparison of the 1995 version of Statement 123 and the proposed version.)

117. FASB, *Statement of Financial Accounting Standards No. 93 Recognition of Depreciation for Not-for-profit Organizations*, 7 (Aug. 1987), available at <http://www.fasb.org/pdf/fas93.pdf> (last visited Feb. 5, 2005).

118. U.S. Dep. Of Education, *Financial Accounting for Local and State School Systems*, 7 (1990), available at <http://nces.ed.gov/pubs97/97096R.pdf> (last visited Feb. 5, 2005).

119. Jonathon C. Glover et al., *The Emerging Needs to Separate Facts and Forecasts: Exploring ‘Intertemporal Financial Statement’ with Two Time-Phases* (Dec. 2002), available at [http://web.gsia.cmu.edu/display\\_paper.aspx?id=11568](http://web.gsia.cmu.edu/display_paper.aspx?id=11568).

120. *Id.* at 1.

system, but it would bring the fair value calculation out of the footnote and put it squarely on the income statement.

Although the FASB argues legitimate accounting theory in support of its proposed rule, options, as will be seen below, are unlike any other form of compensation with unique characteristics and challenges. As will be seen in Part V, options motivate employees to produce measurable productivity gains for the corporation in ways that money compensation does not. Using a common legal designation, options are *sui generis*. As seen in Part III, the value of an options cannot be accurately established at the date of grant. As such, options deserve unique accounting treatment. The methods of accounting that might serve well for the valuation of a car or a piece of artwork will not work well for options because such options are of a uniquely different nature.

In the law there are a number of situations where courts carve out exceptions to the consistent application of the rules because the application of the general rule would have inequitable results in certain situations. For instance, closely held corporations (i.e., close corporations) are often treated differently than publicly held corporations.<sup>121</sup> In the same way, the FASB should recognize that options are not like other forms of compensation and deserve to be capitalized or deferred until the true cost can be determined with reasonable certainty.

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

One does not need to bother with 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.<sup>122</sup> 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 of the stock and hence a lower EPS because of the large capitalization. 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.

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121. The close corporation is often considered to be in a class by itself—separate from the characteristics of its larger brothers, the publicly held corporation and even larger private companies. It is generally recognized that in a closely held corporation there is often little distinction between the shareholders and management. Consequently, some courts interpret cases using the principles of partnership law rather than corporate law to reflect the reality of the operations of such a corporation. 18 AM. JUR. 2D *Corporations* § 38.

122. CARL BERNSTEIN & BOB WOODWARD, *ALL THE PRESIDENT'S MEN* 78 (Simon & Schuster 1974).

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 us hypothesize that an executive exercises an option for 100,000 shares representing one percent 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 when a company reports earnings off by even a few cents from its expected target Wall Street analysts often downgrade the stock. The analyst downgrade can lead to further selling by investors creating downward pressure on the stock price. Consequently, executives will use corporate funds to repurchase those 100,000 shares in order to keep capitalization low and EPS high. Let us hypothesize that our company's share price is twenty dollars per share, and the exercise price for the executive was ten dollars per share. The executive gives the company one million dollars to purchase the shares but the company spends \$2 million dollars buying the shares back on the market—i.e. \$1 million that the executive gave the company and an extra million from the company's coffers. That means \$1 million dollars, or one tenth of the company's \$10 million dollar profit, is spent on repurchases. In essence, the true cost to the corporation is the intrinsic value measure at date of exercise—i.e. the difference between the exercise price and the market value. But this expense is never reflected on the income statement. If it were, then the company would have reported \$0.90 instead of \$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 of the leaders in the tech economy. Adobe generates huge amounts of earnings selling its popular Acrobat and Photoshop products.<sup>123</sup> In a recent three fiscal year period, cash from operations topped \$1.193 billion.<sup>124</sup> However, Adobe is also among the leaders in the technology industry in terms of option grants. While most large public companies grant only two percent or less of outstanding shares to employees each year, Adobe granted twenty percent of its outstanding shares during the same three year period from 2000 through 2002.<sup>125</sup> Adobe routinely repurchased the shares that were exercised by employees. A total of \$542 million was spent in repurchases during the three-year period studied.<sup>126</sup> This buyback represents forty-three percent 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 instead of repurchasing shares. Alternatively, the company could have engaged in acquisitions that raised the overall value of the enterprise. Using

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123. Andrew Bary, *Living Large: Adobe's Lush Option Grants Pit Insiders Against Public Shareholders*, BARRONS MAGAZINE, Nov. 10, 2003, at 17.

124. *Id.*

125. *Id.*

126. The total amount in option-related repurchases was actually \$830 million but the \$542 million figure is used to reflect that the company actually brought in \$288 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.

Adobe as an example, one can begin to see why shareholder-rights activists are so angry and have driven the FASB to try to limit the incentives to issue options by requiring an expense. For various conceptual reasons explored below, accountants traditionally do not consider a repurchase to be a matter that needs to be recorded on the income statement. I make some suggestions in Part IV regarding how and why the repurchase can and should be expensed.

In the final analysis on this issue, I conclude that options are tangible assets that have value as compensation and should be expensed though not necessarily at the date of grant. 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 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?

### *C. 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.<sup>127</sup> 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.<sup>128</sup> In practice, the term “fair value” usually refers to an estimate rather than an actual “market value.”<sup>129</sup> 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.<sup>130</sup> However, for purposes of this discussion, we 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 is no inherent value except for the time element. The argument that the FASB brings to bear against using the intrinsic value

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127. *Have Accounting Regulators Chosen the Best Way of Expensing Share Options?*, ECONOMIST, Nov. 9, 2002, available at 2002 WL 7248128.

128. Hassett, *Testimony*, *supra* note 23.

129. George J. Benston, *The Quality of Corporate Financial Statements and Their Auditors before and after Enron*, Policy Analysis No. 497, 5 (Nov. 6, 2003) [hereinafter Benston, *Quality of Corporate Financial Statements*], at <http://www.cato.org/pubs/pas/pa497.pdf> (last visited Oct. 29, 2004).

130. William A. Niskanen, *FASB is Still Wrong about Stock Options*, Cato Institute, (May 14, 2004), [hereinafter Niskanen, *FASB is Still Wrong about Stock Options*], available at <http://www.cato.org/dailys/05-14-04.html> (last visited Oct. 29, 2004).

method of Opinion 25 is that it fails to measure the time element—i.e., the future possibility of gain in value.<sup>131</sup>

To value the time element, the FASB noted that the actual trading price of identical or similar options is the best indicator of the fair value of an option.<sup>132</sup> 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.<sup>133</sup> 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.<sup>134</sup>

However, employee stock options differ significantly from publicly traded options. 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 per share. The vesting requirement might be twenty-five percent 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. Types 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.<sup>135</sup> The Board admitted that in absence of an actual market for employee options some uncertainties exist as to the price.<sup>136</sup>

The FASB recognized that since no market exists for employee options, most of the valuation would have to be done using an option pricing model.<sup>137</sup> The FASB gave voluminous advice on how to price the options using an option pricing model, yet the FASB Board failed to identify one specific model to use.<sup>138</sup>

There are a variety of models to choose from, but two types emerged initially—

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131. The FASB goes on to note that in the marketplace, a six month option with an intrinsic value of \$20 will always sell for more than \$20 because the six month time frame yields the potential for the intrinsic value to be even more. *Proposed Statement, supra* note 6, at 121-22.

132. *Id.* at ii.

133. In 2003, the Chicago Board Options Exchange, the nation's largest exchange for the trading of options, traded 270 million options contracts. *2003 CBOE Annual Report 13* (2003), available at <http://www.cboe.com/AboutCBOE/AnnualReportArchive/AnnualReport2003.pdf> (last visited Oct. 29, 2004).

134. *Proposed Statement, supra* note 6, at Appendix C.

135. Hassett, *Testimony, supra* note 23.

136. *Id.*

137. 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 accurately 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.*

138. The FASB Board indicated that at minimum the factors that should be taken into account are exercise price, term of the option, the current price of the underlying stock, the expected volatility of the price, and the expected dividends on the stock and risk-free interest rate. *Proposed Statement, supra* note 6, at ii.

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.<sup>139</sup> 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 the 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.<sup>140</sup>

A number of problems have been identified with the Black-Scholes model, and all are 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.<sup>141</sup> Hassett details that Black-Scholes can under-price options given one scenario and overprice in another because there is wide fluctuation in the terms accompanying a stock option in terms of contractual conditions, vesting arrangements, and duration.<sup>142</sup>

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.<sup>143</sup> 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.<sup>144</sup>

Warren Buffett counters that there are a number of areas in accounting where uncertain estimates are made, such as the calculation of depreciation.<sup>145</sup> The FASB takes up the argument by saying that the inherent uncertainty of estimating the value of options is no greater than the uncertainty involved in estimating deferred tax assets, pensions and post-retirement benefit obligations. Management has a number of judgment calls to make when 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.<sup>146</sup>

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 financial advisors. In a comment letter to FASB, Maxim CEO John Gifford noted that his

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139. Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973).

140. Hassett, *Testimony*, *supra* note 23, at xx.

141. Benston, *Quality of Corporate Financial Statements*, *supra* note 129.

142. Hassett & Wallison, *Troubling Requirement*, *supra* note 9, at 53.

143. Ltr. from John F. Gifford, CEO, Maxim Integrated Products, Inc., to FASB, *Letter of Comment on Proposed Statement No. 123*, Ltr. No: 66, 1-2 (Jan. 30, 2003) [hereinafter Ltr. from John Gifford], available at <http://www.fasb.org/oc/1102-001/14393.pdf> (last visited Nov. 12, 2004).

144. Hassett & Wallison, *Troubling Requirement*, *supra* note 9, at 53.

145. Warren Buffett, *Fuzzy Math And Stock Options*, WASH. POST, July 6, 2004 at A19.

146. *Proposed Statement*, *supra* note 6, at 123.

company's six years of experience in expensing shows that the value placed on the options is "neither real nor useful."<sup>147</sup> 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 options were valuable, while the \$87 options were underwater and not worth exercising. Gifford shows that using Black-Scholes 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.<sup>148</sup> If the best models developed by the leading economists have such anomalous results, 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, but 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.<sup>149</sup> Hassett argues that since the choice of a pricing model is up to the corporation and the fact that various pricing models can be manipulated for different results, a corporation is exposed to legal risks in the form of class action lawsuits for the company's failure to calculate its option expense correctly.

Although mere negligence in performing the calculation is not 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.<sup>150</sup> Despite the likelihood that such suits would result in a summary judgment dismissal in favor of the corporation if the company followed FASB rules, 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.<sup>151</sup> Hassett thinks the FASB has left companies at risk for lawsuits because they specify that an accounting practice must be done and then leave little guidance to the company on how to accomplish it.

### *4. FASB Fails to Endorse a Model; Economists go Back to the Drawing Board*

The 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

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147. Ltr. from John F. Gifford, *supra* note 143, at 1.

148. *Id.* at 3.

149. Hassett, *Testimony*, *supra* note 23, at 109.

150. *Id.*

151. *Id.* at 17 (discussing the effects of the FASB's failure to specify a model).



about employees' exercise patterns . . . needed to provide appropriate input to those models."<sup>152</sup> 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.<sup>153</sup>

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.<sup>154</sup> 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.<sup>155</sup>

It is 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 ninety percent of the respondents indicated that they had the FASB guidelines on the matter and had discussed the option expensing schemes with financial experts. Although option expensing was on the horizon at the time of the survey, eighty-two percent of the participants indicated that they were undecided on which option-pricing methodology to use in the event that the rule becomes mandated.<sup>156</sup>

Hassett proposes that the FASB wait to impose expensing until an accurate model can be developed.<sup>157</sup> The mere fact that the FASB cannot decide on one method suggests that the board should wait.<sup>158</sup>

One of the creators of the binomial model does not support its use to value employee options, thereby further suggesting that the current plan of the FASB 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 Service Period model.<sup>159</sup>

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

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152. *Proposed Statement*, *supra* note 6, at 124.

153. *Have accounting regulators chosen the best way of expensing share options?*, *ECONOMIST*, Nov. 9, 2002, available at 2002 WL 7248128.

154. Hassett & Wallison, *Troubling Requirement*, *supra* note 9, at 55.

155. *Id.*

156. *Responding to Mandatory Option Investing: A Mellon HR&IS Flash Survey*, Mellon Fin. Corp. Human Resources & Investor Solutions, 13-14 (July 2004) (available from Mellon Financial Corp.) [hereinafter *Mellon Survey*].

157. *Id.*

158. It is interesting to note that in the letters received by the FASB in the initial request for comment, even those accountants who commented favorably on the expensing of options suggested that the FASB definitively choose one model for every company to use.

159. Donna Block, *Professor unveils expensing model*, *DAILY DEAL*, June 29, 2004.

rates, and the effects of non-transferability on the optimal timing of exercise.”<sup>160</sup> In other words, the developer of the binomial model and recognized experts confirmed what the opponents to the FASB had been saying all along—employee options are so different from publicly traded options that any pricing model used in the public market is inappropriate for use on employee stock options. Rubinstein 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 the date of grant.<sup>161</sup> Rubinstein maintains that the Service Period model is much simpler to understand than the binomial model, thus, making it easier for companies to implement.<sup>162</sup>

The problem with the Rubinstein-Stanton model is that it still uses the public market for options as a proxy for the option, and the public market does not share similarities in the characteristics of the option. Moreover, it does not 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 does not 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 this Congressional legislation add clarity where the FASB measure does not?” The answer to both questions is no. The final version of 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 retaining the benefits of options in stimulating small start-up companies. But the Bill is ultimately misguided in 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, there is no difference. 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.

#### *D. 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

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160. Ltr. from Mark Rubinstein & Richard Stanton, Professor, Univ. of Calif., Berkeley, to FASB, *Letter of Comment on Proposed Statement No. 123.*, Letter No.: 3218, 1 (June 17, 2004), available at <http://www.fasb.org/oc/1102-100/24535.pdf>.

161. *Id.*

162. Taub, *FASB Might Delay*, *supra* note 72.

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. The FASB's official position is to promote international standards in order to improve the ability to make comparisons of financial data around the world.<sup>163</sup> The accounting profession is in near unanimous agreement that "the capital markets would benefit from a single global standard for financial reporting on this item as well as others."<sup>164</sup>

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 represents 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.<sup>165</sup>

In Berkeley's view, this lack of opportunity to share the wealth is a prime reason that Europe does not lead the world in innovation and, when it does (as in wireless technology), the wealth is not shared beyond the richest families.<sup>166</sup> 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.<sup>167</sup> I agree with the positions of Berkeley and Niskanen. Moreover, since the IASB just passed the measure, there is no data on how well it works internationally. Even if this standard is good for America, it would be prudent to wait and see how it plays out 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 compliance with the mores and standards of other nations, which do not reflect the unique nature of American culture.

#### IV. INFORMATION REFORMS: TWO ALTERNATIVE PROPOSALS TO IMPROVE FINANCIAL CLARITY

Given my position that both the FASB proposal and the Congressional alternative fail to meet the objectives of an Information Reform, I propose a two-pronged alternative. The first prong would value the option at the 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 of the option to the corporation since an actual dollar figure cost can be established either through the repurchase price or as a lost opportunity cost. This approach would not create an exception to accrual accounting concepts if we assume that the services rendered by

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163. *Proposed Statement*, *supra* note 6, at xi.

164. Schneider, *Who Rules Accounting?*, *supra* note 68.

165. Ltr. from Alfred R. Berkeley, III, *supra* note 69, at 3.

166. *Id.*

167. Niskanen, *FASB is Still Wrong about Stock Options*, *supra* note 130.

the employee to the corporation (e.g., the retention benefit) does not occur until the date of exercise, as discussed in Section III.

The second prong addresses the issue that a value exists at the date of grant and this value should be recognized since a transfer of value is made to the employee. Under the second prong companies would be required to 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.

#### *A. 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 reflects the repurchase cost to the corporation. In addition, this method would factor out options that are never exercised—i.e., out-of-the-money options that expire worthless and hence impose no real expense on the corporation.

##### *1. Repurchase Accounting Doesn't Track the Real Expense*

As already established, the real cost to the company is in the repurchase. However, accountants 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.

From an accounting perspective, repurchases are not a cost that is reflected on the Income Statement, rather, with the repurchase a shift occurs on the Balance Sheet. The repurchases, of course, reduce the cash in the Asset portion of the Balance Sheet since the company spends money to buy back shares, but at the same time, Shareholder Equity on the right side of the Balance Sheet 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 dilute 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.

Furthermore, the company now has less money because of the repurchase of shares issued from options. Since it is established that options are compensation, can we not then extrapolate that any costs 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 repurchases as equity matters. In order to keep the theory pure, they would rather develop an option-

pricing model to reflect this repurchase cost plus the time value of the option at the date of grant. However, as was shown in Part III, even the creators of those models consider the models to be too inaccurate to measure the true worth of an option.

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. Moreover, the FASB carves out an exception in Statement 123 that explicitly covers situations where intrinsic value at the date of exercise is used for options that cannot be valued with certainty at date of grant.<sup>168</sup> 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.<sup>169</sup>

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 this 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 that 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, this method is still 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 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 the 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.

## *2. 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 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-

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168. *Proposed Statement*, *supra* note 6, at 21.

169. JOSEPH BLASI ET AL., *IN THE COMPANY OF OWNERS: THE TRUTH ABOUT STOCK OPTIONS (AND WHY EVERY EMPLOYEE SHOULD HAVE THEM)* 241 (2003) [hereinafter *BLASI ET AL., IN THE COMPANY OF OWNERS*] (suggesting that a company could expense only its true cost by deducting the expense of buying back its shares from its employees).

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.<sup>170</sup>

The IRS generally does not recognize any taxable event at the date of grant, but does recognize an event at date of exercise (taxable as income for NSOs and limited alternative minimum tax adjustment for ISOs).<sup>171</sup> That provides for a strong argument that the FASB should follow the IRS' lead. Professor Luppino has suggested that consideration be given to better alignment between the FASB's GAAP and tax accounting for nonqualified stock options under Treasury Regulations for Section 83 of the Tax Code.<sup>172</sup> Luppino acknowledges the difficulty in harmonizing the two methods. From the IRS perspective, the Service prefers to value at the date of exercise rather than the date of grant because of "administrative difficulties frequently inherent in valuing the 'wait and see' right that has been passed to the employee."<sup>173</sup> On the other hand, financial accounting "must often use estimates and educated guesses in trying to provide an accurate picture of a company's financial condition."<sup>174</sup>

Luppino ultimately suggests that there "would be some potential value in the Treasury Department joining with the SEC and FASB in studying the book and tax accounting for typical compensatory options and considering the degree to which more conformity is desirable and feasible."<sup>175</sup> This is not to suggest that Professor Luppino thinks the IRS method of taxation of NSOs at date of exercise is the standard these various agencies should settle on. He notes that a leading factor in tax avoidance by large companies has been because the companies are entitled to a deduction on federal tax liability for the value of stock options.<sup>176</sup> Yet such companies do not have to claim a corresponding reduction in earnings if they elect the intrinsic value method of accounting

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170. 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*, at <http://www.irs.gov/taxtopics/tc427.html> (last visited Sept. 23 2004) (comparing taxable income under an ISO or NSO). There are limited situations, such as golden parachutes and gratuitous transfers, where valuation of the option at date of grant is required using GAAP-like methodologies. Luppino, *supra* note 13, at 174 n.349.

171. Internal Revenue Service, Department of the Treasury, 26 C.F.R. § 1.83-7(b) (2004). This code section allows that when the value of an NSO option is "readily ascertainable" then a taxable event occurs at the date of grant. See below for a further discussion of this regulation. Treas. Reg. § 1.83-7 (2003).

172. Professor Luppino looks at three areas where financial accounting under GAAP diverges from tax accounting—"synthetic leases" of real estate, "off-balance sheet" partnerships and "nonqualified" employee stock options—and suggests that consideration be given to aligning financial and tax accounting on all three. Luppino, *supra* note 13.

173. *Id.* at 173-74.

174. *Id.* at 92-94. Professor Luppino cites to the U.S. Supreme Court case *Thor Power Tool Co v. Commissioner of Internal Revenue*, 439 U.S. 522 (1979) for the proposition that sometimes financial and tax accounting practices should go their separate ways because of different objectives of the two systems of accounting.

175. *Id.* at 176.

176. *Id.* at 92. A bill in the U.S. House of Representatives would require that a company only receive a deduction for stock options to the extent that such options were expensed on the company's income statement. H.R. 626, 108th Cong. (2003), available at <http://thomas.loc.gov/cgi-bin/query/z?c108:H.R.+626>. (last visited Sept. 23, 2004).

under the current FASB rules. The anomalous result can be that a company reports huge earnings but has a substantially lower tax bill because of the option exercises.<sup>177</sup>

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. Moreover, we need to stop perpetuating the myth that an options pricing model can accurately predict the cost of options. Of course, there are differences between GAAP and IRS treatment on many issues,<sup>178</sup> but in this respect, there are compelling reasons for the FASB to follow the IRS' lead.

In particular, Congress should compel the SEC to adopt a provision similar to Treasury Regulation § 1.83-7 for purposes of valuation of options. The regulation provides that an NSO option is taxable at grant "if the option has a readily ascertainable fair market value." The value of an NSO option is "readily ascertainable" only if it is "[a]ctively traded on an established market" or if "fair market value can otherwise be measured with reasonable accuracy."<sup>179</sup> The IRS preempts most employee stock options since it determines that an option cannot be measured with reasonable accuracy if it is non-transferable or cannot be exercised in full at the date of grant.<sup>180</sup>

As noted previously, most employee options cannot be transferred and have vesting conditions. Likewise, the FASB should adopt a similar provision as to valuation for purposes of expensing the options. If these conditions of vesting and non-transferability apply, and they do for most employee options, then a waiver of valuation seems in order until a time when the fair market value can be measured with reasonable accuracy.

### 3. Why Date of Exercise 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."<sup>181</sup> 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 Reynolds' position noting that there is "no cash outlay or share dilution" at the grant date and hence no expense should be registered.<sup>182</sup> Niskanen maintains "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."<sup>183</sup>

In support of the position that an expense should be registered at the exercise date rather than at the grant, or vesting date is the reality that some options end up expiring

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177. *Id.* at 128 (citing Abraham J. Briloff, *Pooling and Fooling*, BARRON'S MAGAZINE, Oct. 23, 2000, at 26, 28-29) (criticizing Cisco Systems for reducing its tax by \$837 million through deducting stock option expenses but not reporting any reduction in earnings).

178. Luppino, *supra* note 13, at 39.

179. *Supra* note 171.

180. *Id.*

181. Reynolds, *FASB Fumbles Stock Options*, *supra* note 108.

182. Niskanen, *FASB is Still Wrong about Stock Options*, *supra* note 130.

183. *Id.*

worthless or, for reasons of their own, the employee does not exercise the option. Consequently, it is 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.<sup>184</sup>

The problem with the FASB analysis is that it 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 the date of exercise is the most accurate reflection of the true cost to the company.

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 is probable that companies do not repurchase immediately on the date of exercise, and some companies may not repurchase at all. In the latter case, the expense then reflects a lost opportunity cost to sell shares to the public as previously noted. 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.

More problematic to the intrinsic valuation at date of exercise solution to the option problem is that it is likely to result in a larger expense than the FASB method. Professor Luppino notes that the IRS method of valuation for NSO options probably overstates an employee's income as well as the employer's "corresponding compensation deduction."<sup>185</sup> Likewise, if this method is adopted for valuing options, the drag on earnings can be enormous. However, I disagree with Professor Luppino that it overstates the compensation expense. 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. If this method means that companies continue to get a tax break, then that break is deserved since earnings will also be adjusted downwards and the cash outflow, that used to be tied to an equity repurchase, will now be more accurately characterized as a compensation cost.

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184. *Proposed Statement*, *supra* note 6, at 122.

185. Luppino, *supra* note 13, at 174-75.



As will be seen below, the drag on earnings is likely to cause a reduction in the grant of options, which, in turn, has adverse economic and social consequences. However, as previously stated, Informational Reforms should be based on the truth of the financial statement independent of economic effect. Moreover, corporations which see the benefit of employee equity ownership could always put in place incentives, such as bonuses to purchase stock, to encourage their employees to exercise their options early when the expense is small. This strategy might be combined with one where employees “early exercise” an NSO option before vesting and then hold onto the restricted stock with a buyback option by the company if the employee leaves the corporation before the stock vests.

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. An intrinsic value measure at date of exercise would also be simple to implement. It is a known and easily captured cost that would not require expensive modeling or excessive accounting costs to the corporation.

#### *B. 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.<sup>186</sup> 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).<sup>187</sup> 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.<sup>188</sup> 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.<sup>189</sup> However, this would needlessly penalize a company whose stock performance is lagging. It would do nothing to clarify the financial picture since no economically rational person would exercise an option at a price that is

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186. *Statement of Financial Accounting Standards No. 128: Earnings Per Share*, FASB (Feb. 1997), available at <http://www.fasb.org/pdf/fas128.pdf> (last visited Sept. 23, 2004).

187. *Id.*

188. *Id.*

189. John H. Briggs, Chief Executive Officer, TIAA-CREF, *Testimony Before the U.S. Senate Finance Committee* (Apr. 18, 2002) (arguing that the potential dilutive effect of out-of-the-money options is enough to warrant their inclusion in diluted EPS), at <http://finance.senate.gov/hearings/testimony/041802;bttest.pdt> (last visited Sept. 23, 2004).

over the trading price of the shares.

Shareholder rights activists point out, however, that there were widespread re-pricings of out-of-the-money options during the economic downturn of 2000-2002.<sup>190</sup> However, whenever an option is re-priced, 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 is not 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 leaves the choice of which model should be used 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.

#### V. 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

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190. *Id.*

the board does not speculate as to what those consequences might be.<sup>191</sup> If the proposal was 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 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.<sup>192</sup> While non-executive employee option grants are being cut, executive employees are getting a larger percentage of the options being granted. The percentage increase was not just a matter of the executives' portion being a larger slice of the pie when rank and file did not get options. The raw number of options going to executives increased in 2002-2003.<sup>193</sup> Moreover, when many companies, after the downturn, re-priced options that were no longer in-the-money, sixty percent of the companies that engaged in re-pricing did it for the executives and directors only and not for rank and file employees.<sup>194</sup>

Kruse's testimony was supported by a follow-up survey done by Mellon Financial Services, which found that forty-five percent of the respondents would cut eligibility in option plans for non-exempt employees yet none of the respondents had any plans to cut executive option plans.<sup>195</sup> Moreover, eighty-three percent of the respondents said they would keep the option grants virtually the same in the amount granted for executives while fifty-four percent of the respondents would cut the amount of option grants for non-exempt employees.<sup>196</sup> Moreover, the survey revealed that seventy-eight percent 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 fifty-

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191. *Proposed Statement*, *supra* note 6, at 127.

192. Professor Kruse cites four studies in 2003 done by consultants, accountants and analysts Sibson Consulting, Mellon Financial, Mercer Human Resources, and Deloitte & Touche that covered hundreds of companies. Douglas Kruse, *Testimony before the U.S. House of Representatives Committee on House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises* (Apr. 21, 2004) [hereinafter Kruse, *Testimony*], available at <http://financialservices.house.gov/media/pdf/042104dk.pdf> (last visited Oct. 18, 2004).

193. *Id.* at 4.

194. John H. Briggs, Chief Executive Officer, TIAA-CREF, *Testimony Before the U.S. Senate Finance Committee* (April 18, 2002) (citing a 2001 study done by Institutional Shareholder Services), available at <http://finance.senate.gov/hearings/testimony/041802;ttest.pdf> (last visited Sept. 23, 2004).

195. *Id.* at 11.

196. *Mellon Survey*, *supra* note 156, at 10.

four percent would not do so for non-exempt employees.<sup>197</sup>

Proponents of the FASB argue that companies that 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.<sup>198</sup> Kruse concludes that clearly companies need an economic incentive in order to pursue some of these desirable social goals.<sup>199</sup>

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 creates 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 the premise is true that option grants to executives create the incentive to commit fraud and if, in fact, the rule would not reduce option grants to executives then the goal of reducing fraud clearly 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."<sup>200</sup> The effect of one individual outside of senior management is only going to have a minor effect, if any at all, on stock price. 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.<sup>201</sup>

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."<sup>202</sup> 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."<sup>203</sup>

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 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?

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197. *Id.*

198. Kruse, *Testimony*, *supra* note 192.

199. *Id.*

200. Sonthalia, *supra* note 29, at 1224.

201. *Id.*

202. Ltr. from Alfred R. Berkeley, III, *supra* note 69, at 6.

203. Hassett & Wallison, *Troubling Requirement*, *supra* note 9, at 53.

## 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 Credit Suisse First Boston estimated that if every company in the S&P 500 had expensed options, the overall worth of the index would have fallen by 8% in 2003, 19% in 2002, and 20% in 2001.<sup>204</sup>

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.<sup>205</sup>

Alternatively, when companies issue options, there is an increase in company value. Kruse notes that companies which award options to rank and file employees see results in improved productivity and total shareholder return.<sup>206</sup> 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.<sup>207</sup> 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.<sup>208</sup>

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 is the real possibility that overseas companies will use options to benefit employees as well as having lower wages than the U.S., thereby further hampering the ability for U.S. companies to compete.<sup>209</sup>

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204. Matt Krantz, *Stock options must be expensed*, USA TODAY, Dec. 17, 2004, at B1.

205. See *supra* note 55.

206. Blasi et al., *In the Company of Owners*, *supra* note 169, at Ch. 7.

207. Kruse, *Testimony*, *supra* note 192, citing Richard Freeman et al., *Monitoring Colleagues at Work: Profit Sharing, Employee Ownership, Broad-Based Stock Options and Workplace Performance in the United States*, Paper presented at 2004 Association for Comparative Economic Studies Conference, San Diego, CA, available at <http://financialservices.house.gov/media/pdf/042104dk.pdf> (last visited Mar. 7, 2005).

208. Gretchen Morgenson, *Option Pie: Indulgence by Executives is a Health Hazard for Shareholders*, MILWAUKEE J. & SENTINEL, Apr. 4, 2004, at 1D, 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 employees a tax credit to offset the option expense. Kruse, *Testimony*, *supra* note 192, at 6.

209. Reynolds, *FASB fumbles stock options*, *supra* note 108.

### 3. Options: Partnership Capitalism or Wealth Transfer?

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.<sup>210</sup> 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.”<sup>211</sup> In Kruse’s view, “partnership capitalism” incentivizes workers, leading to innovation, bottom-up decision-making, better teamwork and a change in attitude among all workers where profit is a priority.<sup>212</sup>

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.<sup>213</sup> 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 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.<sup>214</sup>

In Berkeley’s view, America benefits from “broad, democratic ownership of the productive assets of the economy, not a small financial elite controlling more and more of the economy.”<sup>215</sup>

One issue that should be addressed is whether the alternative proposals that I outline in Part IV 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 will not 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

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210. Andrew Bary, *Living Large: Adobe’s lush option grants pit insiders against public shareholders*, BARRONS MAGAZINE, Nov. 10, 2003, at 17.

211. Kruse, *Testimony*, *supra* note 192, at 3.

212. BLASI ET AL., *In the Company of Owners*, *supra* note 169, at 40-43.

213. Ltr. from Alfred R. Berkeley, III, *supra* note 69, at 1-2.

214. *Id.* at 2-3.

215. *Id.* at 3.

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.<sup>216</sup>

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

The 2003 review of shareholder driven proxy resolutions noted that some trends are developing to control executive option grants.<sup>217</sup> 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.<sup>218</sup> The proposals seek to incentivize executives to act toward long term gains on the theory that a more stable stock price will result.<sup>219</sup> The theory seeks to motivate executives 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 a 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.”<sup>220</sup>

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 seventy-five percent 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.<sup>221</sup> 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

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216. BLASI ET AL., *In the Company of Owners*, *supra* note 169, at Ch. 7.

217. Spector, *Developments and Trends in Compensation*, *supra* note 33.

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.*

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. If the employee leaves the company before the covenants expire, then the company has a repurchase right as to the stock.

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.<sup>222</sup> By holding restricted stock, the employee takes a risk—much like a shareholder—that the trading price could go below the 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 full value likely to be one-third of long term incentives for executives in the near future.<sup>223</sup>

One interesting piece of legislation offered by Massachusetts Democrat Barney Frank would require executives to disgorge profits made by exercising options and selling the stock if the share price declines by a “material amount” within one year of the sale.<sup>224</sup>

Another method widely discussed as motivating long-term value maximization is performance based options, which come in a number of 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.<sup>225</sup>

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 necessary 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.<sup>226</sup>

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,<sup>227</sup> it is too

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222. Under 15 U.S.C.S. § 78p large shareholders (holding over ten percent), 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. 15 U.S.C.S. § 78p (Law. Co-op 2004).

223. *Mellon Survey*, *supra* note 156.

224. H.R. 4208, 108th Cong. (2003) (as introduced).

225. Spector, *Developments and Trends in Compensation*, *supra* note 33.

226. 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* note 46.

227. Spitzer was named “Crusader of the Year” and dubbed “Wall Street’s Top Cop” by Time Magazine in 2002 for his breakthrough investigation of financial manipulation by investment banks and corporations. Adi



early to gauge whether the cases of high-profile executives going to jail will have a deterrent effect on future corporate fraud.

#### VI. CONCLUSION

The FASB amendment to Statement No. 123 *Accounting for Stock-based Compensation* was driven by two primary forces: 1) shareholder rights activists outraged over executive compensation packages and 2) accountants who had 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 because 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, the FASB must turn to option pricing models, which in themselves are inherently unreliable and problematic. The models rely on variables that are subjective estimates and are easily manipulated, which 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. Moreover, the U.S. Congressional response to the FASB in the form of the *Stock Option Accounting Reform Act* does little to clarify the issue since it creates a dual system of accounting, and it 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 because 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 use only in-the-money fully diluted capitalization when computing earnings per share (EPS).

If the FASB rule survives the Congressional challenge then I predict that it 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. The need for accuracy in

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Ignatius, *Wall Street's Top Cop*, TIME.COM, (Dec. 22, 2002), available at <http://www.time.com/time/personoftheyear/2002/poyspitzer.html> (last visited Sept. 23, 2004).

corporate accounting must be balanced with incentives for industry, but 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 director accountability restrictions on the issuance of option grants or requirements that executives to hold onto seventy-five percent of their shares for as long as they are employed by the company.