

Stacey Sutay

Subject: FW: Accounting treatment of stock options

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From: John P. Hussman, Ph.D. [mailto:hussman@hussman.com]
Sent: Tuesday, April 15, 2003 2:37 PM
To: jmcrooch@fasb.org; Neel Foster; Robert Herz; gsscheineman@fasb.org;
Katherine Schipper; Edward Trott; John Wulff; Ron Bossio; Halsey Bullen;
Todd Johnson; Bob Wilkins
Subject: Accounting treatment of stock options

Dear FASB members,

As the portfolio manager of one of the top performing U.S. equity funds in recent years (HSGFX), an economist, and a former professor of economics and international finance at the University of Michigan, I am forwarding a proposal for the treatment of corporate stock options in reported earnings. I hope that these comments will be helpful to the Board in its deliberations on this matter.

How and why stock options should be expensed from corporate earnings
<http://www.hussman.net/html/optionex.htm>

Best wishes,

John P. Hussman, Ph.D.
Chairman, Hussman Investment Trust
3525 Ellicott Mills Drive B
Ellicott City, MD 21043
hussman@hussman.com
410-750-3900



How and why stock options should be expensed from corporate earnings

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The iron law of finance is that the price of any security is the discounted value of the future cash flows that it will deliver to investors over time. Every event that affects the price of a security – Fed moves, economic news, Martians landing in Kansas – has its impact by affecting either 1) the stream of cash flows that investors expect the security to deliver, or 2) the rate at which investors discount those cash flows to present value. The quality that separates good analysts from poor ones is an understanding of the cash flows actually commanded by a security, and the appropriate rate at which those cash flows should be discounted to present value (including an appropriate risk premium).

The source of investors' misery in recent years is their refusal to take this iron law seriously. Part of the problem is that they fail to understand the nature of the cash flows actually claimed by a share of stock. The other part is that they have failed to discount those cash flows appropriately. The reason for these failures is clear: investors have been encouraged to focus on operating earnings that beat expectations, rather than analyzing what portion of those operating earnings are actually claimed by their share of stock, or the relationship between those claims and the price they have paid.

Who earns "operating earnings" anyway? A share of stock is not a claim on operating earnings. If an investor values a stock as a multiple of operating earnings, the very next calculation had better subtract the value of debt per share. Even this does not go far enough, but it is a first step in recognizing that operating earnings are not the property of shareholders alone. Operating earnings deduct neither interest owed to debt holders, nor taxes owed to the government. Moreover, in order to provide for growth, companies typically need to make capital investments over and above the amount required to replace depreciation.

Ultimately, investors have a claim not on operating earnings, but on "free cash flow" (what Warren Buffett calls "owner earnings"). Free cash flow subtracts a number of things from operating earnings, including interest, taxes, preferred dividends, and capital spending over-and-above depreciation. In other words, free cash flow measures what is actually available to shareholders after all other claims have been satisfied (including the provision for future growth).

There are two uses for free cash flow. One is to pay dividends, and the other is to repurchase stock for the benefit of shareholders.

Notice how repurchases work. When a company repurchases a share of stock, it buys a claim on a future stream of free cash flows, which will now be allocated among the remaining

shareholders. What is the market value of this future stream of cash flows? The price of the repurchased share, of course. As long as investors in the stock agree that the market price is fair, stock repurchases benefit shareholders just as if the free cash flow had been distributed as dividends.

When one fully understands these facts, one also understands why option grants should be expensed. The reason is simple. If share repurchases are a distribution of free cash flow for the benefit of shareholders, then option grants are effectively a diversion of free cash flow at a cost to shareholders. Accordingly, they are a deduction from the financial results that can be fairly reported to shareholders.

This is true even though grants of options and shares do not incur a cash outlay. When employees, managers and directors are given stock as compensation, the company essentially diverts a portion of *future* free cash flows away from existing shareholders. What is the market value of these future free cash flows? The price of the issued shares, of course. If the shares are issued on the basis of stock options, the cost to shareholders is the market price of the issued shares, minus the strike price paid for those shares.

The relevant question is not whether grants of options and stock should be expensed, but how expense should be handled in the financial statements. Ideally, financial statements would include a "free cash flow" figure directly, subtracting from operating earnings various obligations such as interest, taxes, capital spending over-and-above depreciation, and the cost of stock and option issuance. Even if operating earnings were left alone, shareholders would eventually gravitate toward using the free cash flow figure, since it is the only value to which they have a relevant claim. This would also save investors like Warren Buffett a lot of time.

In the absence of a free cash flow calculation, the most appropriate place to account for stock and option grants is in the statement of operating earnings, as a separate line just under selling, general, and administrative expenses.

For stock issuance, this is straightforward. A share of stock issued to an employee is a diversion of future free cash flows from existing shareholders, and the value - placed by the market - on that stream of cash flows is simply the price of the stock. (The price may differ from the "fair value" calculated on the basis of a particular analysts' *own* assumptions about future cash flows and appropriate discount rates, but the *market's* opinion is summarized in the price of the stock). This market value should be deducted from earnings in the same period in which the stock is issued.

Options are slightly more difficult. One of the objections to expensing options on the income statement is that earnings are considered to be a "flow" account of profitability, whereby options are a seemingly complex financing item - specifically, a non-cash issuance of a contingent claim on a capitalized asset. This apparent complexity invites theoreticians to make the good the enemy of the best, leaving everybody with nothing. For example, they argue that the Black-Scholes model misvalues long-dated options, and that it doesn't take into account vesting or potential repricing of previously issued options.

So giving them a value of zero is better? As Einstein said, "Everything should be made as simple as possible, but no simpler." It is well understood that financial statements involve reasonable estimates, and disclosure when those estimates involve material uncertainties.

The same should be true when accounting for options. The rule for expensing options has to be simple enough to be easily implemented with a basic, commonly available model, and commonly available data.

When an option is issued, you assign it a cost based on the Black-Scholes model, using a volatility derived from an index of companies in that particular industry. (The volatility of an index is typically lower than the average volatility of the component stocks, but using an index volatility is more appropriate for long-dated options). The resulting option value, say \$1000, is deducted from earnings.

Now a year passes. If the stock price has increased and the value of the option is now \$1200, you deduct an additional \$200 from current-year earnings since the issuance of shares has become more likely. This *additional* expense is *not* being deducted in the year the option was issued. It is being matched to the year in which the effective depletion in shareholder value occurred. This kind of accrual continues until either the option is exercised, or it expires.

Suppose instead that a year has passed since issuance, and the value of the option has declined to \$700. In this case, you add back \$300 to current-year earnings because shareholders have been relieved in the current year of the potential dilution to their interests, and the value of that potential dilution is \$300. One minor difficulty would be a boost to earnings results for previously high-flying companies whose prices have crashed. But this could be handled simply by classifying option related add-backs as "extraordinary gains." This treatment would not get much opposition, since it would be difficult for managements to argue that gains attributable to a plunge in their stock price should instead be classified as "ordinary."

Of course, companies have a strong tendency to lower the strike price of existing options when the stock price declines, thus raising the value of those options. In this case, the threat of potential dilution is not reduced. **If the reduction in the strike price is so aggressive that the repriced options are worth more than they were in the previous year, the repricing will result in a further deduction to current-year earnings, rather than an add-back.**

Notice that the value of option grants should be deducted whether or not these grants actually create incentives. If the grants create an incentive to produce more operating income than their cost, the net effect will be higher operating earnings on the financial statements. If not, the option grants will impact operating earnings as a pure deduction.

In any event, the idea is simple. **Options are alive until they are exercised or expire. The *initial* charge for option grants should be incurred in the year that they are granted, but *additional* costs (or credits) should be accrued until the option is exercised (or expired). If it turns out that the option is exercised, the total deduction to earnings over the life of the option will be the share price at exercise minus the strike price. If the option expires worthless, the total deduction to earnings over the life of the option will be zero. This approach makes a reasonable attempt to match the cost of the options to the period in which shareholders effectively experience the dilution.**

Would shareholders really be better served by assigning option grants a cost of zero and burying the details in a footnote?

Dr. Hussman is the portfolio manager of the Hussman Funds.