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Stacey Sutay

Subject: FW: Expensing of employee stock options

-----Original Message-----
From: O. Waser (CEI-Group) [mailto:o.waser@c-e-i-g.ch]
Sent: Thursday, September 04, 2003 5:00 AM
To: FASB Comments
Subject: Expensing of employee stock options

Dear Sirs:

We would like to comment on the ongoing debate of whether or not, and possibly how, to account for employee stock options. The debate has been launched by your institution and to an extent by IAS. Press coverage on the issue has recently intensified, not only in the US, but also in Europe.

Our major arguments (which are summarized in the attached note) center around the principal accounting treatment of employee stock options, but not on aspects such as which options pricing model to use, when and over which period to account for options, etc.

The arguments in brief:

- Employee stock options constitute a transfer of wealth from shareholders to employees whenever a company issues new stock when employees exercise options. This is the normal case in the US. We believe that the correct accounting treatment is to expense the cost of the options program, but at the same time recognizing an income item which reflects the "gift" from shareholders to employees which the former pay in the form of dilution of their equity holdings. The net effect of the options plan in the income statement is zero which is in accordance with zero cash flows on the part of the company. (A mere expensing of options without an associated income item reflecting shareholder dilution would introduce a non-cash charge to the income statement and further deviate reported income from a company's underlying economic strength which we believe to be best reflected in a company's ability to create free cash flow. Such further deviation of reported earnings from cash earnings would hamper the usefuleness of earnings, in our opinion).
- Our key argument, however, is that disclosure is more important than accounting and certainly no substitute for an expensing of options. We claim that disclosure requirements under SFAS123 should be (1) mandatory also when option costs are expensed and (2) broadened (cf. text for details).
- Some companies (we are only aware of European companies) hedge their employee stock option exposure by purchasing the stocks in the open market. In this case the accounting treatment would be different: expensing of options costs only (no related income item). This would correctly reflect the cash outflow from purchasing stock in the open market.

We hope you find these comments useful.

Please do not hesitate to contact us in case any arguments require further explanation.

Sincerely yours,

Otto Waser,
Partner

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Employee stock options:

„To expense or not“ may just not be the crucial issue

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Employee stock options: „To expense or not“ may just not be the crucial issue

After a series of accounting scandals during the past few years, public discussion has, amongst other issues, identified employee stock options as an area where current accounting procedures may provide misleading information to shareholders. The current debate mainly focuses on the issue of whether or not to expense employee stock options.

The positions in the debate are mostly taken. Proponents of sober accounting, prominently represented by Warren Buffett, but increasingly also by accounting standard setting boards, take the view that employee stock options have a monetary value to employees, therefore represent a wage component and need to be expensed. On the other side we find representatives of the technology industry, the heaviest option users, as well as start-ups, who argue that employee options are necessary to hire the best talents in the industry and that a change to the status quo would unduly harm their businesses.

The issues are complex and are beyond "expensing or not"

Some key aspects of the problem are missing in the current debate, however, and we believe that the mere expensing of employee stock options does not address the problems properly. The answer lies in the nature of employee stock options. Normally, these programs work as follows. In a given year a company grants a number of stock options to its employees. The options carry a certain strike or exercise price (normally above the current share price) and vest after a certain period of time. At the time of the options grant there are no cash flows at the company level (neither on the part of employees, except that they get taxed in certain jurisdictions at the time of the options grant). After the options vest, they are either exercised or not (be this because the employee no longer is with the company, because the stock price is below the strike price, or for other reasons). If the options are exercised the company issues stock and gets a positive cash flow amounting to the number of options exercised multiplied by the strike price. The cash profit of the employee who exercises the option is, of course, the difference between the market price at which the stock is sold and the exercise price of the options. Therefore, everybody involved magically gets positive cash flows, at least for as long as stock prices keep rising – and even falling stock prices do not invoke negative cash flows.

The magical operators of the "stock options cash machine" are, of course, the shareholders. They are the ones who get diluted and have to share their company's profits, cash flows and dividends with an ever growing number of employee shareholders as the company's stock price rises. As shareholders really carry the cost of employee stock option plans, there is no apparent cost to those plans from a company perspective. This line of argument holds for the US companies we track.

The "no cost no charge" argument is flawed only at first glance

The IAS Board argues that the "no cost therefore no charge" argument is flawed. It is pointed out that options are the reward for a service rendered by employees and therefore need to be booked like any other reward. So far correct - but not thought through to the end. The special nature of this reward is that it happens to be paid by a third party, in this case shareholders. If one were to account for stock options, not only the expense would need to be booked but also the gift from shareholders. Therefore an income item equivalent to the options charge which reflects shareholder dilution would need to be recorded. This item in the income statement would be labelled something like "gains from the appropriation of shareholder wealth through employee stock option plan".

The amount of dilution is, of course, nothing else than the employees' benefit at exercise, i.e. the number of options times the difference of the market price and the exercise price of the options (cf. also above). The *expected* value of the employee profit as well as the *expected* value of shareholder dilution is equivalent to the price of the options at grant date, based on market prices or options pricing models. The net result of the cost of the options programs and the shareholder gift to finance the program would be a zero charge to the income statement. Employee stock options are somewhat similar to a transaction involving shareholders paying EUR 10'000, say, to each employee as a year-end gratification and the company being in charge of collecting the money from shareholders and distributing it to employees, which also results in a net zero charge to the income statement.

This result may come as a surprise to many, but it simply reflects the mechanics of employee stock options.

Disclosure rules are key

The issue of dilutive employee stock options programs is therefore not predominantly an accounting issue, but a disclosure issue. Shareholders have to get all the necessary information to fully understand their option position and its potentially dilutive impact. SFAS123 (US-GAAP) provides disclosure rules under certain circumstances and is a starting point, although the rules are not fully satisfactory from a shareholder perspective.

Necessary disclosure can be summarised as follows. (1) The amount of options outstanding, strike prices and vesting schemes (this information is provided under SFAS123; under IAS, where the expensing of employee stock options is on the agenda by 2005 at the latest, disclosure rules appear not to be decided upon yet). (2) In order to get an idea of the potential dilution, shareholders would need to see options outstanding as a percentage of the total number of shares outstanding rather than the options outstanding alone (believe it or not, the number of options outstanding and the number of total shares outstanding are often pages away from each other in most annual reports, as if companies deliberately tried to hide the connection between the two). (3) Investors with a basic familiarity with options (a majority) would also like to see the delta and gamma of the options position.

Given the nature of options, i.e. the shareholder-employee relationship, it is obvious that the mere change towards expensing of options does not give a more accurate picture of earnings. Options invoke no cash flow at the company level when they are written to employees. Options also never lead to a cash charge when they are exercised. From this line of argument it is clear that expensing is no panacea.

The case is somewhat different for companies who purchase the stocks to cover employee stock options in the open market (we are aware of some European companies going that route). These purchases certainly create measurable cash flows and easily qualify as expenses (even though currently, IAS treats these cash flows as balance sheet items only). There is also no offsetting dilution related to such type of option plan.

Should options be expensed?

Our analysis suggests that options should be expensed, but only if at the same time income items related to potential shareholder dilution were accounted for. For companies hedging employee stock option plans by purchasing stock in the open market, no such offsetting item would be recorded.

A mere expensing of options without offsetting items, on the other hand, does not reflect the reality of most stock options plans and should therefore not be considered. Regulators have to be aware that this route would have a serious cost attached to it: earnings would go farther away from displaying a company's ability to create free cash to pay dividends, buy back stocks, invest in future growth or buy other businesses. Some commentators pointedly warned that a simple expensing of options could easily turn out to be "another nail in the EPS coffin".

Even though the net effect on the income statement would be zero in the case of dilutive plans, the implications on the use of options

could be significant. One could expect that options programs would be less frequent and less generous if the income statement would carry an item such as "gains from the appropriation of shareholder wealth through employee stock option plan". Or companies would more frequently choose to purchase options related stocks in the open market instead of issuing them.

Most importantly, however, any expensing of options should not free companies from fully disclosing all elements of their stock option programs as described above. Also the fact whether stocks are purchased in the market or newly issued when options are exercised should have to be disclosed.

Expensing is no substitute for disclosure

We believe that better and more comprehensive information on option programs in financial reports is paramount. Disclosure requirements under SFAS123 (intrinsic value method) are a starting point, but are not sufficient. SFAS123 allows companies to choose whether to expense options or not (but only in the latter case, the aforementioned disclosure rules apply). Some companies, in anticipation of a likely change towards the expensing of employee stock options, have started to expense options. At the same time, they no longer need to provide the disclosure information under SFAS123 demanded when options are not expensed. We firmly believe that the expensing of options cannot substitute for disclosure.

We would also favour shareholder friendly disclosure rules under IAS.

In addition, options programs raise corporate governance issues: the fact that shareholders actually grant the options would argue for a shareholder involvement in determining options programs.

Finally, the expensing of options should reflect cash flows. In the case when stocks are purchased in the open market to hedge employee stock option plans, the expensing of options relates to the associated cash outflow of stock purchases. In the much more frequent case of dilutive plans where new stock is issued at the time when options are exercised, an associated income item to reflect the dilution would need to be recorded. The net zero effect in the income statement of stock option plans correctly reflects the zero cash flow implication for the company. Such accounting treatment would support rational decision making by investors who ultimately wish earnings to reflect a company's economic strength which is probably best represented by its ability to create cash flow. This line of argument, of course, leads to a general claim towards a more cash flow oriented accounting.

Sincerely yours,

Otto Waser,
Partner

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