ADDENDUM TO COMMENT LETTER FROM KIP HAGOPIAN,
DATED MARCH 29, 2004 ON THE FASB EXPOSURE DRAFT
REGARDING SHARE-BASED PAYMENT

Who Bears the Economic Cost of an Employee Stock Option?

Employee stock options ("ESOs") do have economic value to the employees that receive them. It is understandable, therefore, to expect there to be an economic cost somewhere on the other side of the transaction, since almost all transactions have approximate if not perfect accounting symmetry.

ESOs have economic value to the recipients based on their potential for gain in intrinsic value. Likewise, ESOs have a corresponding economic cost to the shareholders of the issuing entity based on their potential for dilution to shareholder ownership. But are ESOs also a cost to the entity that grants them? This is the central issue in the debate over employee stock option expensing.

The Economic Cost to Shareholders

Before considering whether ESOs are a cost to the granting entity, it is important to be clear on what an ESO's real economic cost to the shareholders is. This requires an agreement on how the treasury stock method ("TSM") of accounting really works and how it affects the shareholders' accounts.

The Treasury Stock Method is Mark-to-Market Exercise-Date Accounting.

The TSM is effectively a mark-to-market version of exercise-date accounting done at the shareholder level rather than the company level. As such, it results in the full option spread at time of exercise being charged to shareholders in the form of a transfer of value from shareholders to employees. This fact is illustrated in Exhibit A, which is a table representing, hypothetically, the amount of value transferred from the shareholders of "Acme Electronics" to Acme's employees. (See pages four, five, ten
and eleven of the author’s original submittal to the FASB. For convenience, this entire submittal is attached as Exhibit B.) What this table shows is that at each period end the full economic cost to shareholders can be measured quite accurately by calculating the dilution percentage (which is determined by the TSM), then translating this dilution into dollars of value transferred. The value transfer is shown for the current period and cumulatively. Since the dilution, and hence the value transfer, is driven by the stock price, this cost to the shareholders will fluctuate up or down as the stock price fluctuates. The greater the spread, the greater will be the value transferred from the shareholders to the employees.

A key figure in the table is the $9 million that appears in the box on line ten in the last column (2004). This is the cumulative value transferred from shareholders to employees resulting from dilution. Note that the putative gain to the employees ($15 million pre-tax and $9 million after tax, assuming the employees have a combined tax rate of 40%), mirrors exactly the cost to the shareholders ($9 million in value transfer assuming the same 40% tax rate), providing perfect accounting symmetry. Thus, the TSM results in exercise-date accounting for the shareholder account.

The $9 million in shareholder cost is exactly the same amount that the granting entity would incur as a cost if it used exercise-date accounting to record option expense on its income statement. (Proof: Assume all one million Acme ESOs were exercised in 2004 at the $10 strike price when the market price was $25. The spread would then be $15. This would produce a $15 million gain to the employee and a $15 million deduction for the company, making the after-tax cost to the company, $9 million, again assuming a 40% combined state and federal tax rate.)

Should an Additional Charge be Made to the Granting Entity?

The option expensing debate centers on whether, on top of the cost to the shareholders, there should be an additional charge made to the entity owned by those
same shareholders. The Exposure Draft ("ED") proposes to do just that by expensing the purely hypothetical and not realizable call premium of the option.

Opportunity Cost.
Since the granting of an ESO does not involve an outlay of cash (or any other asset that is convertible into cash), the using up of an asset, or the incurrence of a liability, the only possible justification for an expense to the entity is that the entity has incurred an opportunity cost. The FASB makes a passing reference to this notion in paragraph C17 of the ED in explaining why minimum value is not an adequate measure of fair value: 
"...minimum value does not result in a measure of the amount of cash an entity forgoes by granting share options to employees rather than issuing similar options to third parties, that is, the fair value of the options."

With due respect to the FASB, this statement does not take into account the unique features of an ESO. First, an ESO, by its terms, may only be issued to employees (or company directors and consultants); thus, issuing "similar options to third parties" would be contrary to its purpose and is proscribed. And if a company were to offer on the open market, options with the exact same terms as ESOs, it is hard to imagine there would be any "willing buyers" for such options. This is because an ESO: (1) is non-transferable, therefore only the intrinsic value of the option, if any, can be realized (meaning that the cash value paid for such an option would disappear at the time of purchase); (2) is cancelable at the will of the issuer (in the case of an ESO by terminating the employee before vesting); and, (3) may have its term drastically shortened at any time after vesting. Would anyone buy an option that loses its cash value the moment it is purchased, is certain to be cancelled before the vesting date if it has gone into the money and, if vested and not in the money, is certain to be accelerated the moment it goes into the money?

Selling ESOs to the employees for cash is not an alternative either. The sole purpose of an ESO is to provide an incentive to employees to increase shareholder value; ergo, any price charged to employees would erode and ultimately nullify the incentive, thereby
negating the value of the ESO to the entity. The combination of these very important features—non-transferability, cancellation or acceleration at the will of the issuer—eliminates opportunity cost as a consideration. If there is no decrement to the assets of the entity and no opportunity cost, there can be no expense.

**Loss of Transactional Symmetry.**
Tacking on a charge to the entity's income statement that is over and above the economic cost that is incurred by the shareholders that own that entity, creates a conundrum. If there is to be a charge to the entity, what is the corresponding value received by the employee who is on the other side of the transaction? Are we to believe that the employee, *in addition* to receiving ultimately the full spread upon exercise of the ESO, has also received at grant date something of value in addition to that spread? If so, how does he or she realize that additional value?

**Over Counting**

Inasmuch as dilution results in a decrement to the shareholders' account that is equal to full exercise-date accounting (which is the most punitive method of accounting for stock options), it is hard to comprehend how an additional expense to the entity laid on top of this charge could be justified.

Stated simply, a call premium on a stock option is the discounted present value of the expected future spread (intrinsic value) in the option during its expected term. Whether the gain results from volatility, or from the performance of the company during the option's term, really makes no difference. In a short-term option (three to nine months), such as the type Black-Scholes and the binomial models were designed to value, volatility plays the largest part; in a long-term option (one to ten years), projected company performance dominates.

This is where over counting comes into play. The call premium the FASB proposes to expense is the discounted present value of the *very same spread* that *might* eventually
result in a decrement to the shareholder account. Only this charge will be recorded in advance of knowing whether in fact it will ever be incurred. Thus, we have two charges for exactly the same thing (the spread), one to the entity and one to the people that own the entity. It seems clear that one of these charges should be eliminated. Since the value transfer is a given as long as there are outstanding ESOs that are in the money, it seems clear that the charge to the entity is inappropriate.

**ESOs are Conceptually Equivalent to Bonuses**

Conceptually, an ESO most resembles a bonus and should be accounted for in a similar manner. When an employee is made eligible for a bonus, the employee rightly perceives he or she has received something of real economic value, namely the possibility of significant cash gain if the conditions of the bonus are met. Likewise, the entity has entered into an arrangement that may result in an economic cost. The accepted method of accounting for this type of arrangement is to accrue the bonus if, as and when it appears that it has a reasonable probability of being earned. If the bonus ends up being more or less than what was accrued, the amount of expense, if any, is trued up.

If bonuses were accounted for in the same way as the FASB proposes for ESOs, a discounted present value estimate of the bonus for each employee would be made and that amount would be expensed linearly over the bonus period. This expense would be charged whether in fact it was ever incurred (as is proposed for ESOs). Presumably, this accounting treatment is not used because of its likelihood of resulting in over or under charges. Rather, a sort of “pay as you go” method is used instead. This has the benefit of being relatively accurate during the period the expense is occurring and precisely accurate when the period ends and the expense gets trued up. It is also consistent with traditional accounting practice which is to record a transaction only when it has actually occurred and its value is readily ascertainable.
Why shouldn't ESOs be accounted for similarly? That is, why isn't the current method of accounting sufficient? As indicated above, the TSM is a calculation of the economic cost of an ESO as it is incurred. But it is even more accurate than bonus accounting because the cost measured by the TSM is not an accrual followed by a truing up for misestimates. Instead, it is a precisely accurate measurement throughout the period the ESO is outstanding, which reflects the full economic cost of the transaction at each reporting date.

Conclusion

If the ED is implemented it will be the most radical change in accounting practice in several decades, dramatically affecting the earnings of countless high-growth companies. This change should only be made if the accounting rationale for doing so is so compelling that it is beyond any reasonable doubt. But this is not the case. There is considerable doubt as to the accounting merits of the action proposed in the ED.

Exhibit C contains a list of just a few esteemed individuals that strongly oppose the expensing of ESOs as proposed in the ED. In each case, these individuals are opposed to expensing on the grounds that the FASB's approach to accounting for ESOs is inappropriate accounting that would impair the usefulness of financial statements. In addition to being very qualified to opine on the subject, these people have arrived at their views through careful thought and analysis. Nine of them have written or testified on the issue. None of them could be considered to be acting out of self-interest. The list includes two former Secretaries of the Treasury, and two former or existing chairs of the accounting departments at major universities. Eight of the people on the list are highly respected economists, including one former Chairman of the President's Council of Economic Advisors. Several are business professors. Two are Deans of major business schools. Almost all are PhDs.

Exhibit D contains excerpts from the comment letters from the six largest accounting firms in the U.S., commenting on the FASB Exposure Draft for FAS 123 in 1993. All of
these firms, speaking for thousands of certified public accountants, vigorously opposed 
expensing of ESOs then. Moreover, their reasons for doing so were forceful, 
comprehensive and trenchant. Since then, nothing has changed in accounting 
concepts or theories that should call their views into question. Nonetheless, currently 
the four largest firms favor expensing. Were they right then or are they right now. 
Whichever it is, the arguments these firms expressed ten years ago should be heard 
because these arguments cast serious doubt on the wisdom of the proposal in the ED. 

Given the fact that an ESO's full economic value to employees and, correspondingly the 
full economic cost to shareholders, is reflected in the form of a value transfer from 
shareholders to employees, the FASB must explain convincingly why there should be 
an additional charge levied on the entity for essentially the same cost that is reflected in 
the shareholder account. The FASB should also explain what is the corresponding 
benefit to the employee in such a transaction and how that benefit can ever be realized. 

Kip Hagopian 
June 30, 2004
Acme Electronics, Inc.
Impact of Stockholder Equity Dilution
Arising from Employee Stock Options

Shares outstanding = 10,000,000; ESOs outstanding = 1,000,000 shares; exercise price = $10 per share

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<th>Year</th>
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<td>(1.) Average Stock Price in the period</td>
<td>$10.00</td>
<td>$11.98</td>
<td>$14.38</td>
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<td>(2.) Fully Diluted Shares Outstanding (000's)</td>
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<td>10,100</td>
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<td>10,310</td>
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<td>(3.) Market Value at year end (000's) ((1)x (2))</td>
<td>$100,000</td>
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<td>$146,400</td>
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<td>(4.) Basic Earnings per share</td>
<td>$0.40</td>
<td>$0.48</td>
<td>$0.58</td>
<td>$0.69</td>
<td>$0.84</td>
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<td>(5.) Shareholder Dilution</td>
<td>-0-</td>
<td>.99%</td>
<td>1.8%</td>
<td>2.47%</td>
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<td>(6.) Diluted Earnings per share</td>
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<td>(7.) Increase in market value during period (000's)</td>
<td>-0-</td>
<td>$21,000</td>
<td>$25,400</td>
<td>$30,700</td>
<td>$37,300</td>
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<td>(8.) Value Transferred from Shareholders to Employees during period (000's)</td>
<td>-0-</td>
<td>$1,200</td>
<td>$1,435</td>
<td>$1,740</td>
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<td>(9.) Net Increase in Shareholder Market Value in period (000's) ((7) - (8))</td>
<td>-0-</td>
<td>$19,800</td>
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<td>(10.) Cumulative Value transferred to employees (000's)</td>
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<td>(11.) Cumulative Gain to Preexisting Shareholders (000's)</td>
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Stock Option Expensing:
Getting the Accounting Right

March 29, 2004
Introduction

In its “Statement of Financial Accounting Standards No. 123” (“FAS 123”), entitled “Accounting for Stock-Based Compensation”, the Financial Accounting Standards Board (“FASB”) set forth its rationale for expensing, which it describes as a “fair value based” method of accounting for employee stock options (“ESOs”).¹ FAS 123, which was first published in October, 1995, is a comprehensive, well-reasoned and articulate case for expensing. Nonetheless, a compelling case can be made that FASB has reached the wrong conclusion, and that the expensing of ESOs would be improper accounting. If this is true, a requirement by FASB to expense ESOs based on FAS 123² will result in significant distortions to financial statements and substantial impairment of their usefulness to investors.

What is an ESO and How Does it Differ from a Tradable Option?

At the heart of the debate over option expensing, is a fundamental difference in estimation, understanding and appreciation of the differences between a tradable stock option³ and an employee stock option. Comprehending these differences is essential to reaching the correct conclusion on this very complex and controversial issue.

¹ The most commonly used employee stock options are fixed options (the exercise of which is not based on performance targets) called “non-qualified stock options” and “incentive stock options” (which are afforded special tax treatment). The stock option expensing issue applies to both. Since only a small percentage of employee options are of the latter type, for the purposes of this paper, “employee stock options” shall mean fixed stock options (not performance based) that are “non-qualified”.
² For the purposes of this paper, FAS 123 has been used as the sole reference in describing FASB’s position on expensing.
³ Typically, transferable stock options issued by a public company or by third party underwriters are publicly traded and are, therefore, called “tradable” stock options. But it is transferability that distinguishes this type of option from an ESO, not its public tradability.
Tradable stock options and ESOs differ in several ways, four of which are critically important. Typically, tradable options when written by a company on its own stock, are used to raise equity capital (usually in conjunction with debt offerings), are sold on the open market to the highest bidder, are exercisable immediately and throughout their term, and are freely transferable. By comparison, employee stock options have a completely different purpose, are limited to a narrowly targeted market, are not exercisable until they vest (usually over a four or five year period) and are non-transferable throughout their entire term. The distinguishing features of ESOs are more fully described below.

- An ESO is an incentive compensation instrument designed to attract and retain the best available employees, and to increase their productivity to a level in excess of that which could be achieved by cash or fringe compensation alone. Accordingly, the express purpose of an ESO is not to raise new equity capital but to increase the value of the issuer's existing equity.

- Whereas tradable options are sold on the open market, ESOs may only be granted to employees. In other words, employees are the only market for ESOs.

- ESOs are not actually stock options until they vest, which may occur on periodic fixed dates or on a single fixed date several years out in the future.

- ESOs are not transferable to anyone at any time, even to another employee of the issuer. This means that neither the ESO agreement nor the option itself can be sold, hypothecated or assigned, either before or after it vests. As a result, the only way that an employee can benefit financially from an ESO is to exercise it and sell the underlying stock.

These unique characteristics of ESOs make up the fundamental basis for the invalidation of the case for option expensing.

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4 The vast majority of tradable options are written by third party underwriters.
5 ESOs also have other significant terms that distinguish them materially from tradable options. The most important of these are: a longer term (typically ranging from five to ten years vs. 30 to 270 days), limitations on sale during "black-out" periods and an accelerated expiration of their term upon termination of employment (usually to 30 days after termination).
Current Tax and Accounting Treatment of ESOs

Tax Treatment

When a non-qualified employee stock option is exercised, the difference between the exercise price and the fair market value on the date of exercise (known as the "intrinsic value", or "spread") is a taxable gain to the option holder and a tax-deductible expense (equal to the full amount of the intrinsic value) to the company that granted it. It is interesting to note that the Internal Revenue Service will not allow the expensing of an ESO for tax purposes until it is exercised. One of the primary reasons for this is that the IRS does not believe that ESOs have a "readily ascertainable market value" at date of grant. In the absence of such, the IRS has opted to wait until a value has been clearly determined.

Accounting Treatment

The fact that ESOs may be a cost to the issuing company or to its shareholders has never been in dispute. The current accounting method for measuring the company's cost incurred at the date of grant is called the "intrinsic value method" and is described in Accounting Principles Board Statement 25. Under the intrinsic value method, the intrinsic value of the ESO on the date of grant is expensed over the period in which the ESO vests. For example, assuming an ESO has a four-year vesting period, is granted with an exercise price of $10, and its fair market value at date of grant is $12, the $2 intrinsic value will be expensed ratably over four years. The vast majority of ESOs are granted at fair market value (intrinsic value, therefore, is zero); in these cases, no expense is charged.

While APB 25 requires that only the intrinsic value at date of grant be expensed, accountants recognize that an ESO is a contingent claim on the net income, net assets and market value of the company that grants it, and as such, represents a potential cost to the grantors' shareholders in the form of dilution. That is, if the stock underlying the employee option rises and the option is subsequently exercised, shareholder ownership will be diluted.
"Statement of Financial Accounting Standards no. 128" ("FAS 128"), entitled "Earnings per Share", describes the methodology by which this dilution is measured. Currently, all companies are required under FAS 128, to present both "basic" and "diluted" earnings per share ("EPS") on the face of their income statements. Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS is calculated as follows: On any reporting date on which the market price of the underlying stock is higher than the ESO's exercise price (meaning it has an intrinsic value, or is "in the money"), the potential dilution is calculated, and reported to shareholders as diluted EPS. Diluted EPS is calculated using what is called the "treasury stock method" of accounting for stock options. This accounting method assumes hypothetically that on the reporting date, all ESOs outstanding and in the money, are exercised and the cash proceeds from exercise, together with any pro forma tax savings resulting from the deduction of the spread, is used to repurchase company stock in the open market at the average market price during the period.

Here is how it works. Assume "Acme Electronics" earned $10 million in a reporting period in which it had 10 million shares outstanding (based on a weighted average). Its basic EPS would be $1.00 per share. Assume Acme also has one million granted but unexercised ESOs. If the exercise price of the ESOs is $10 and the average price of the stock during the period is $25, dilution would be calculated as follows: First, total pro forma proceeds from exercise of the options is calculated by multiplying one million shares times an exercise price of $10, which equals $10 million. On a pro forma basis, deducting the spread of $15 million (the $15 per share intrinsic value times one million shares) from taxable income results in tax savings of $6 million.

[6 This accounting method applies to tradable options as well; for the purposes of this analysis, however, reference is made only to ESOs.

7 Curiously, this includes even ESOs that have not vested. FASB gives only passing reference to this rule on unvested options saying (in FAS 128): "Even though their (ESOs) issuance may be contingent upon vesting, they are not considered to be 'contingently issuable shares' as that term is used in this Statement because to consider them contingently issuable shares would be a change from present practice and the provisions of IAS 33." FASB does not explain in FAS 128 why ESOs should not be considered "contingently issuable" or why changing "present practice" would be inappropriate. By including unvested shares in the dilution calculation, FASB is essentially assuming these shares will all eventually vest and be exercised, even though it is certain that a significant percentage will either expire worthless or be forfeited. The inclusion of unvested shares in the dilution calculation almost certainly results in an overstatement of shareholder dilution and an understatement of earnings per share.
assuming a combined federal and state corporate tax rate of 40%. Aggregating the exercise proceeds with the tax savings, produces a total of $16 million, which would allow the company to purchase 640,000 of its shares at $25 per share, resulting in net shareholder dilution of 360,000 shares (one million new shares created through the exercise of options, less the repurchase of 640,000 shares). In percentage terms, total shareholder dilution, therefore, would be about 3.5% resulting in diluted earnings per share of approximately $0.965.

With respect to net income, the total dollar cost of this dilution, i.e., the additional employee compensation attributable to the ESO program, can be calculated by multiplying the difference between basic and diluted earnings per share ($0.035) times the total number of diluted shares outstanding (10.36 million). In this example, the result would be $362,600. This would be the total decrement to shareholders’ net income and net assets arising from the entire ESO program.

From a shareholder’s perspective, perhaps the most important measure of the cost of the ESO program is in its impact on the value of the Acme shareholders' holdings in the company. In the above illustration, the total market value of the company is $259 million ($25 per share times 10.36 million shares). But because of the ESO program, the original shareholders were diluted by 3.5%, thereby reducing the value of their holdings to $250 million, a reduction of $9 million. This figure represents the cost the shareholders would incur in a scenario in which the value of their ownership had increased by $150 million. As the stock price goes up or down, the amount of dilution (the cost to the preexisting shareholders) will rise or fall accordingly, and so will the value of the shareholders’ ownership.

Fundamental to the current method of measuring and reporting the cost of ESOs is the concept that the granting of an ESO is effectively an arrangement for the sharing of ownership between an entity’s shareholders and its employees; accordingly, it is the shareholders that bear the cost (dilution of shareholder value) and the corresponding benefit (appreciation of shareholder value), if any, of this sharing arrangement.
Expense What?

Implicit in FASB's proposal to charge an expense to the income statement of the issuer of ESOs, is a rejection of the concept that ESOs represent an ownership sharing arrangement between shareholders and employees. Instead, FASB has taken the position that employees work for the entity, not for the entity's shareholders; accordingly, an expense should be charged to the entity itself (more on this later).

According to paragraph 80 of Concept Statement 6: "Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations." In short, a transaction as described is recorded as an expense when it results in the diminution of the net asset value of the enterprise. This simple definition is important to keep in mind when judging the merits and demerits of the opposing parties' cases on expensing.

It is equally important to be clear on what expensing proponents mean when they assert that ESOs should be expensed. There are two components to the value of a transferable stock option. The first of these is the intrinsic value, which comes into being when the stock underlying the option rises above the exercise price. The impact of intrinsic value on shareholder dilution (for both transferable options and ESOs) has always been accounted for using the treasury stock method (described above).

It is the second component of an option's value that is the subject of the option expensing debate. This component is what is typically called the "call premium", or "time value" of the option. The call premium is the premium in excess of intrinsic value that someone would pay to purchase the option. Conceptually, this premium is the purchaser's estimate of the discounted-present-value ("DPV") of the appreciation of the underlying stock at some future date prior to the expiration of the option's term. This calculation depends on a number of variables, including the risk-free interest rate, the dividend rate, the volatility of the underlying stock, the time remaining until expiration of the option, and the extent to which the option (at the time the call premium is valued) is in or out of the money. In the case of short-term (nine months or less) publicly traded
options, the Black-Scholes options pricing model has proven effective at accurately estimating this value and third-party option writers use it extensively.

With a transferable option, there is a call premium that can be readily converted into cash whether the option has an intrinsic value or not. If the option is tradable, the value may be precisely quantified daily based on public market transactions. Proponents of expensing ESOs assert that, like a transferable option, an ESO has a call premium that must be expensed when the ESO is granted.

Before FASB settled on expensing the call premium of ESOs, it considered several other approaches to expensing. The one that appeared most interesting on a surface level, was "exercise-date accounting" which would have charged an expense equal to the ESO's intrinsic value (the spread) on the date it was exercised. Exercise-date accounting (which would be consistent with the tax treatment of ESOs) had particular appeal because of its measurement simplicity and the fact that the measurement would be made after the putative expense had actually occurred rather than attempting to estimate the DPV of this amount years beforehand. This approach suffers greatly, however, from the fact that it would produce huge swings in net income that would be driven solely by fluctuations in stock price (the better the stock performs, the higher will be the expense), and which would bear virtually no relationship to the operating performance of the company. A variation on exercise-date accounting favored by some is to apply this approach on a dynamic, or "mark-to-market" basis. Under this approach, the intrinsic value of all options outstanding would be measured on each reporting date and only changes from prior periods would be recorded in the income statement of the entity. As contrasted with straight exercise-date accounting, the mark-to-market approach has appeal because it would somewhat smooth out the enormous swings in expenses that would be charged if they were recorded only when the actual exercises occurred. In any event these and other possible approaches to expensing were rejected in favor of the expensing of the ESO's putative call premium.

It is quite instructive to note that the treasury stock method is, in effect, mark-to-market, exercise-date accounting done for the shareholder's account. Recall that when dilution is calculated, the first step in the process is to assume that all ESOs (even the unvested ones) are exercised. The end result is that the aggregate intrinsic value of the
ESOs is what determines the dilution to shareholders. If there is no intrinsic value, there is no dilution. As the stock price goes up, intrinsic value goes up and so does dilution.

**The Case for Expensing ESOs**

Paragraph 76 of FAS 123, states: "An option or warrant to buy an entity's stock for a fixed price during an extended future time period is a valuable right, even if the ways in which the holder can exercise the right are limited. Investors pay cash to buy stock options and warrants that generally have fewer restrictions than employee stock options, and unrestricted options and warrants are traded daily in financial markets. The additional restrictions inherent in employee stock options, such as the inability to transfer the option to a third party for cash, cause the value of an employee stock option to be less than the value of an otherwise identical tradable option at any time before the expiration date, but the restrictions do not render employee stock options valueless."

Later, FASB wrote: "An employee stock option has value when it is granted regardless of whether, ultimately, (a) the employee exercises the option and purchases stock worth more than the employee pays for it or (b) the option expires worthless at the end of the option period. The grant date value of a stock option is the value at that date of the right to purchase an entity's stock at a fixed price for an extended time period. Investors pay cash to acquire that right—employees provide services to acquire it."

Effectively, FASB is saying three things: first, an ESO, like a transferable option, has a call premium that attaches to it; second, this call premium has a value that is greater than zero; and third, this value, while difficult to measure, should be reflected as an expense to the issuing company. FASB's current thinking is that the call premium of the ESO would be determined at the date of grant, and then expensed ratably over the ESO's vesting period, which coincides with the period of services required of the employee in order to fully earn the option embodied in the grant.

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8 To date no one has devised an acceptable model for accurately or reliably determining this value. Because of the many differences between an ESO and a transferable stock option, Black-Scholes is considered inadequate for the task. See "ESO Valuation: Measuring the Unmeasurable" on page 26.
While the grant of an ESO does not involve an outlay of cash, the using up of an asset or the incurrence of a liability, some proponents of expensing argue that the grant of an ESO represents an "opportunity cost" to the grantor, meaning that the grantor has foregone cash that it could have received if it had sold the ESO on the open market. Perhaps the most aggressive case for the opportunity cost argument was made by professors, Zvi Bodie, Professor of Finance at Boston College, Robert Kaplan, Professor of Finance at Harvard Business School and Robert Merton, also a Professor of Finance at Harvard and a Nobel Prize winner for his work on the Black-Scholes options pricing model. In a paper published in the March, 2003 Harvard Business Review, entitled "For the Last Time: Stock Options are an Expense," Bodie, Kaplan and Merton rely almost solely on the opportunity cost argument to conclude unequivocally that the grant of an ESO gives rise to an expense. Their argument rests first on the assumption that an ESO does in fact have a call premium, and second that this premium has a market value that could be readily converted into cash and must, therefore, be expensed. They illustrate their point by comparing ESOs to stock grants and tradable options: "If a company were to grant stock, rather than options, to employees, everyone would agree that the company's cost for this transaction would be the cash it otherwise would have received if it had sold the shares at the current market price to investors. It's exactly the same with stock options. When a company grants options to employees, it forgoes the opportunity to receive cash from underwriters who could take these same (emphasis added) options and sell them in a competitive options market to investors."

The Case Against Expensing ESOs

On the surface, the arguments for expensing have considerable merit. This is, to be fair, an extremely complex issue. But the case against expensing is much more compelling.

The strongest argument against expensing is simply that the cost of ESOs is already fully accounted for accurately (excepting FAS 128's inclusion of unvested options; see footnote 7) by the current methods of accounting. As described above, the
cost of ESOs is accounted for, (1) under APB 25, which requires that the intrinsic value at grant date be charged to the company’s earnings over the ESO’s vesting period; and (2) under FAS 128, which measures on a dynamic basis the dilution to earnings per share, net assets and shareholder market value attributable to the ESO program. In the illustration on pages four and five, the granting of almost 10% of the company’s capitalization in ESOs, resulted pro forma in a $362,600 diminution of the shareholders’ net income and net assets, and a $9 million decrement to the shareholders’ value in the enterprise. This is the total cost to shareholders of the ESO program on the date measured, calculated precisely and accurately (see exception noted in footnote 7) in terms of the dilution to net income, net assets and enterprise value. This cost fluctuates with the price of the company’s stock and is measured (effectively “marked to market”) on each reporting date.

The above argument rests in part, but not wholly, on the concept (stated earlier) that the granting of ESOs are an arrangement between shareholders and employees to share ownership of the enterprise for the purpose of increasing shareholder value to a level that could not otherwise be attainable with cash compensation alone. Dilution that might be incurred would therefore affect the financial statement of the shareholder rather than the company, and would be more than offset by an increase in the value of the shareholders’ stock in the company.

In paragraph 90 of FAS 123, FASB rejected this ownership-sharing argument, saying that, “....employees provide services to the entity—not directly to the individual stockholders....”, then going on to say: “Carried to its logical conclusion, that view would imply that the issuance of virtually any equity instrument, at least those issued for goods or services rather than cash or other financial instruments, would not affect the issuer’s financial statements.” With due respect to FASB, this is not a logical conclusion one would draw from that view. To be sure, any equity security that is issued for goods or services and that can be readily converted into cash (such as a share of stock or a transferable option) is clearly an expense and should be recorded as such on the issuer’s financial statements. ESOs are not convertible into cash, however; accordingly they do not clearly meet the definition of an expense. Why then, shouldn’t the cost of an ESO, if and when it occurs, be reflected in the shareholder account rather than the
company account? This is a question that deserves further consideration, particularly in light of the discussion that follows.

The proponents of expensing have advanced several interesting arguments to make their case. As stated above, most of these arguments reflect a fundamentally different view of the importance of the distinctions between an ESO and a typical transferable option. Contrary to FASS’s assertion in FAS 123, an ESO is not merely a transferable option with additional restrictions. It is different in profoundly important ways which render invalid the core arguments for expensing.

Here are the six most common arguments proponents make for expensing, followed by a response.

ESOs have value to the recipient; therefore there must be a corresponding cost to the issuer.

As quoted above, FASB stated in FAS 123 that: “The additional restrictions inherent in employee stock options, such as the inability to transfer the option to a third party for cash, cause the value of the option to be less than the value of an otherwise identical tradable option at any time before the expiration date, but the restrictions do not render employee stock options valueless.”

This statement is essentially accurate but is not relevant in this context. There is no question that an ESO has some value to the recipient, otherwise he or she would be indifferent to receiving it. But this value is contingent upon the performance of the issuer’s stock, and the length of the recipient’s tenure (the vesting period). The value, therefore, is strictly hypothetical and is heavily dependent upon the performance of the holder of the ESO. By its terms, neither the ESO contract itself nor the underlying option, even when vested, can be sold, hypothecated or assigned to anyone (even another employee). Therefore, actual cash value cannot be realized except through an exercise of the option (if and when it vests) and a sale of the underlying stock. If an ESO were transferable, it would have a call premium, the value of which would be realizable to the employee. In that event, its value upon issuance would most certainly be income to the recipient and an expense to the issuer (and the IRS would recognize it
as such). But the cash value of the call premium that always attaches to a transferable option does not exist in the case of an ESO.9

The critical importance of the concept of “realizability” to the recognition of “revenues and gains” is definitively stated in paragraph 83 of “Statement of Financial Concepts No. 5”, entitled “Recognition and Measurement in Financial Statements of Business Enterprises”: “Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration”. This statement is elaborated upon in paragraph 83a: “Realized or realizable. Revenues and gains generally are not recognized until realized or realizable. Revenues and gains are realized when....assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash (emphasis added).” This pronouncement makes it clear that the receipt of an instrument, whose value is not realizable, would not be recognized under GAAP as a gain to the recipient. By only modest extension of this logic, the grant of such an instrument should not result in a loss or an expense to the grantor.

In any event, the fact that something may have hypothetical value to an employee does not mean that it is an expense to the employer. Consider the following scenario: Stagnant Corp. issues one million ESOs to its employees at the fair market value of $10 per share, vesting over four years. After four years, the company’s stock has not appreciated. At this point, the board decides to liquidate the business at its then fair market value of $10 per share. Inasmuch as the ESOs have an exercise price of $10 per share, the intrinsic value of each ESO is zero. And because of its lack of transferability, there is not a realizable call premium. Accordingly, the cost to Stagnant Corp. of the entire one million ESOs is zero. Remember the accounting definition of an expense; has there been a diminution of Stagnant’s net asset value caused by the

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9 It is extremely important to understand why an ESO is not transferable. The sole purpose of an ESO is to provide an incentive to the employee to increase the value of the stock underlying the option. In so doing, the employee will simultaneously increase the intrinsic value of the ESO by a corresponding amount. If the option were transferable, a call premium would attach to it and the holder would be able to realize a profit even if the stock had not appreciated. Allowing this would nullify the ESO’s purpose.
granting of ESOs? The answer is no. In short, the value of an ESO to an employee is 
*contingent* and so is the cost to the company and its shareholders.

**The grant of an ESO is an opportunity cost to the issuer.**

In their Harvard Business Review article, Bodie, Kaplan and Merton state: "If a company were to grant stock, rather than options, to employees, everyone would agree that the company's cost for this transaction would be the cash it otherwise would have received if it had sold the shares at the current market price to investors." Of course they are exactly right. The granting of stock or of a transferable option for no consideration would clearly represent an opportunity cost because both of these securities can be readily converted to cash. Then Bodie, et al, go on to say: "It is exactly the same with stock options. When a company grants options to employees, it forgoes the opportunity to receive cash from underwriters who could take these same options and sell them in a competitive options market to investors."

This is a curious statement since, by its terms, an ESO agreement can *only* be issued to an employee of the issuer. To do otherwise would defeat its purpose and be contrary to the economic interests of the enterprise. Not only are ESOs issued exclusively to employees, but each ESO is written for a specific individual. The ESO grant to the CEO is for him or her alone. It is the same with the director of personnel, the western regional sales manager or the factory worker. *Ergo, there is no "competitive options market" for a company's employee stock options.*\textsuperscript{10} The market for each ESO is a market of one. These unique characteristics of ESOs—their non-transferability and the limiting of their issuance to individual employees—renders invalid

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\textsuperscript{10} Paragraph 161 of FAS 123 states: "In deliberations leading to this Statement, the Board was not able to identify currently available quoted market prices or negotiated prices for employee stock options that would qualify as a price at which a willing buyer and a willing seller would exchange cash for an option." Given the enormous expansion of the options and derivatives market in the last 20 years, it should be instructive that no such market has ever been created (an underwriter does not need the cooperation or permission of an issuer to write options). In fact, it is hard to imagine a competitive public market for ESOs will ever exist. While it is possible that a third-party underwriter might issue such options, and that, at some price, investors might buy them (presumably speculating on whether Mary T. Jones or some other employee will stay with the issuer through the vesting period and that the issuer's stock will rise enough to provide a profit to the purchaser of the ESO), the notion that any *company* would issue such securities is nonsensical.
the premise of Bodie, et al that there is an opportunity cost with respect to a sale of ESOs in a "competitive options market".

But what about the individual recipient of the ESO? Wouldn't he or she be willing to pay some cash price for the ESO? The answer is almost certainly yes. Then doesn't this suggest that there is an opportunity cost as to each individual ESO recipient? The answer is no. Remember that conceptually the value of a call premium is the discounted-present-value of the future profit to be earned in the option. And remember also that the purpose of an ESO is to provide an incentive to raise an employee's productivity to a level that would produce an increase in the value of the enterprise and, concomitantly, of his or her ownership in the firm. Asking the recipient to pay cash for an ESO would effectively erode and ultimately nullify the incentive compensation feature of the instrument. It would be like offering a bonus to an employee for achieving certain goals, calculating the statistical probability of his achieving those goals in order to derive the expected value of the bonus, and then requiring the employee to pay that amount in lieu of the actual bonus. To do so would substantially diminish the incentive to raise his or her level of performance, thereby defeating the purpose of the bonus. A company cannot be charged with an opportunity cost for not doing something that is clearly not in its best interests.

Even though the call premium cannot be converted to cash, it is still a cost to the grantor; this "cost" should be determined at grant date and expensed over the vesting period.

This may be the most important point of contention in the options expensing debate. Proponents of expensing argue that even though a call premium cannot ever be realized, it exists, hypothetically, as the discounted-present-value of the future gain (if any) in the option. This hypothetical call premium, FASB argues, should be calculated at the date of grant and deducted from earnings over the vesting period. Essentially, proponents of expensing are saying that the potential or contingent cost of ESOs should be expensed before it occurs. This argument fails on three counts.

First, as noted on page 12, FASB's own pronouncements on the recognition of revenue and gains are logically inconsistent with such accounting treatment. Concept
Statement 5 makes it clear that a gain in a transaction must be realized or realizable in order to be recognized. If there is no recognized gain to the recipient in a transaction, there should be no recognized expense to the donor; otherwise the transaction would lack the usual accounting symmetry.

Second, in traditional accounting practice, financial statements (with rare exceptions), record what has happened (past tense) in the reporting period, not the discounted-present-value of what is projected to happen in the future. Singling out ESOs for this kind of treatment would seem completely inappropriate unless FASB were to apply this same principle to the many other transactions in which DPV accounting could be used with greater accuracy and to better ends. For example, why shouldn't this DPV, or "statistical probability" accounting approach be applied to revenue recognition? Consider the following hypothetical situation. Intel Corporation receives an order from Cisco Systems for one million dollars. Cisco is a customer that Intel does business with regularly. Based on past experience, Intel can easily calculate the probability that this order will be filled and the goods accepted by Cisco. If that probability is, for example, 95%, Intel should record revenue of $950,000 on receipt of the order. (In order to match revenue with expense, it would be a simple matter to calculate cost of goods sold in order to arrive at gross profit as well.) Of course the revenue recognition rules under Generally Accepted Accounting Principles ("GAAP") do not allow revenue to be recorded until the order is actually shipped. Or consider the case of equipment delivered to a customer on a freely cancelable lease (what accountants call an operating lease). Under DPV accounting, it would be relatively straightforward to estimate the time the equipment would be on lease, discount the future revenue stream back to the present and take this amount into revenue at the installation date. GAAP does not allow this. The treatment of research and development expense is also instructive. Statistically, there is a high probability that a company's investment in R and D has a value greater than zero. Nonetheless, because this value is so difficult to ascertain (arguably no more difficult than the hypothetical value of a call premium on an ESO), GAAP requires that it be expensed as incurred. The point of these illustrations is that if FASB decides to change its accounting practices
to some kind of expected value concept, it must, in order to be consistent, do so for all transactions, not just ESOs.

The third and perhaps most important count on which the above argument fails is that it neglects to consider the fact that an actual "cost" of an ESO cannot be incurred unless there is a corresponding increase in the value of the enterprise in an amount substantially greater than the cost. To elucidate, consider the following analogy: A company is a plaintiff in a $100 million lawsuit which it reasonably estimates it has a 75% chance of winning. The expected value of an eventual award, therefore, is $75 million (not including a discount for the time value). Its legal counsel has the case on contingency for 30% of the eventual award. This means the expected value of the company's cost to prosecute this lawsuit is 30% of $75 million, or $22.5 million. Should the company take a charge to its income of $22.5 million? If so, shouldn't it also reflect the $75 million expected value of the award as well?

In the illustration on pages four and five, Acme Electronics issued one million ESOs at an exercise price of $10 per share. Subsequently the stock rose to $25, resulting in market value appreciation of $159 million of which $150 million was attributable to preexisting shareholders and $9 million was attributable to the ESO holders. In short, the ESOs cost to shareholders could only have occurred in the context of a gain in the value of their share of the enterprise, which in this case dwarfed the cost.

The point of these illustrations is that, it would be illogical to record the hypothetical cost of an ESO without also recording its more than offsetting hypothetical benefit. But how would this be done? If, in the case of Acme, the ESOs were valued at $3 per share (the DPV of the future gain in the stock), the charge to income would be $3 million. This would imply an expected-value gain of $30 million to preexisting shareholders ($3 times 10 million shares outstanding). Should this amount be recorded somewhere on the company's financial statement? While doing so would be logically consistent with the notion of expensing ESOs, it does not seem to be good accounting practice. This raises the question of whether either one of these entries are valid as applied to the company's financial statement, or whether both the cost and the gains should be reflected (implicitly) only on the statements of the preexisting shareholders. If
so, this objective is presently accomplished through use of the treasury stock method of calculating dilution.

**Employees pay for ESOs with their services; the value of this payment is equal to the value of the ESO grant, which determines the amount to be expensed.**

In FAS 123, paragraph 88, FASB stated: "...equity instruments, including employee stock options, are valuable financial instruments and thus are issued for valuable consideration, which often is cash or other financial instruments but for employee stock options is employee services. Using in the entity's operations the benefits embodied in the asset received results in an expense, regardless of whether the consideration is cash or other financial instruments, goods, or services."

This statement seems to exhibit a misestimation of the function of an ESO. ESOs are not granted for services, per se. An ESO, like a bonus, is a form of incentive compensation the purpose of which is to achieve a particular result, namely to increase shareholder value. The issuers of ESOs recognize that there is a dramatic difference between an employee performing routine tasks in an acceptable manner and doing the hundreds of things—large and small—that an owner might do to increase enterprise value. Moreover, as noted earlier, an ESO has no realizable cash value unless it vests and goes into the money. Otherwise, it will be worthless to the recipient regardless of whether he or she has provided "services".

Perhaps what FASB and other proponents of expensing are suggesting in paragraph 88 of FAS 123, is that employees accept lower cash compensation from their employers in return for ESOs, and that the differential between what they receive in cash and the cash they might have received in the absence of an ESO grant, is an expense.\(^{11}\) This notion, however, is not supported by the available facts, and even if it were it would not be relevant. With the exception of early stage companies, there is little evidence that employees are required to accept lower cash compensation in exchange for ESO grants. In fact, in a study of 490 public companies published in 2000 by Rutgers professors Blasi, Kruse, and Sesil and professor Kroumova of the New York...

\(^{11}\) Although, interestingly paragraph 82 of FAS 123 states: "The Board acknowledges that employee stock options, as well as other forms of stock-based compensation, usually are not direct substitutes for a stated amount of cash salaries."
Institute of Technology, the authors found "no systematic evidence of any kind that companies that adopted broad-based stock option plans reduced their fixed compensation in any significant way." Indeed, they found that on average the fixed wage compensation levels of this large sample of companies was 8% higher than comparable firms in the same industries that did not offer broad-based plans. This 8% differential was found to exist in the mid-eighties before the broad-based plans were adopted and the differential remained after the adoption of the plans and through the mid-nineties, the end of the study period.\textsuperscript{12}

But surely it is true that some employees accept less cash compensation in return for ESOs. This does not mean, however, that ESOs should be expensed. Many employees make tradeoffs when agreeing to salary compensation. An executive may either implicitly or explicitly accept a lower salary in return for the opportunity to earn a bonus based on his or her performance, or on the overall performance of the company. A salesperson may accept a lower salary (or no salary) in return for the opportunity to earn commissions on his or her completed sales transactions. The reason an employee would do this is that the potential for gain from the bonus or sales commission would always far exceed the amount the employee might forgo in salary. Like a bonus plan or a sales commission plan, an ESO's purpose is to stimulate the employee to achieve a particular result. If the employee is successful, substantial economic rewards will redound to him or her. And, in any rationally designed incentive compensation plan, the rewards to the employees will always be accompanied by increases in enterprise value that far exceed the cost of the plan.

There appears to a substantial disconnect between how FASB proposes to account for ESOs and how it currently accounts for other forms of incentive compensation. For example, consider the case of an employee bonus plan based on the employer meeting a certain profitability objective. The accounting treatment of such a plan is to accrue and expense the bonus only if it is determined that the profitability target has been met or, in an interim reporting period, is on target to be met. As

contrasted with the proposal for ESOs, FASB does not calculate the discounted-present-value of a bonus and expense it over the period in which the bonus plan is in effect. Under FAS 123, however the DPV of an ESO could be expensed even if there is never an actual cost to the issuing company.\textsuperscript{13} In this event, the issuer would have made a very bad bargain, having paid for "services" and received nothing in return.

If a company were to go to a third party to underwrite an issuance of ESOs, the underwriter would charge to compensate for its risk. If there is a cost to a third party, there must be an equivalent cost to the company that writes its own options.

The position of a third party underwriter and a company that grants ESOs to its employees is not even remotely comparable. When an underwriter issues options it is betting that the stock underlying the option will not appreciate more than the amount of the call premium it charges. If the underwriter is wrong, it loses money on the transaction (assuming it is not hedged). The position of the company when it acts as the writer of the option is completely different. Because the cost if any of ESOs is always accompanied by a corresponding benefit substantially in excess of the cost, on a net basis, the shareholders cannot lose; they can only gain. Said another way, in the case of the third party underwriter, the higher the stock price goes, the worse it is for the underwriter; whereas, in the case of the company writing its own options, the higher the stock price goes, the greater is the absolute economic benefit to its shareholders.\textsuperscript{14}

The question of whether a company should write its own ESOs or contract with a third party underwriter (assuming there is one that would undertake such a contract at a reasonable price—see footnote 10) is the equivalent of a "make or buy" decision, and must be based on what is in the company's and its shareholders' economic best interests. If the company buys ESOs from a third party, it is certain to incur an expense (on the company's financial statement) in the amount of the cash it lays out. If it writes the options itself, its shareholders may incur a cost (in the form of dilution), or they may

\textsuperscript{13} Under FAS 123, once an ESO vests, the original charge cannot be subsequently reversed, even if the ESO expires worthless.

\textsuperscript{14} Of course this may not be true on a relative basis. If too many ESOs are issued, the shareholders' net value in the enterprise might be less than it would have been if there had been less dilution. The percentage of the company to be shared with employees is a judgment call made by shareholders. But this doesn't change the fact that the cost of ESOs can only be incurred if there is a gain to shareholders.
not, depending largely upon the productivity of the ESO recipients. There is no accounting precedent for requiring a company to record an expense based on what a third party might charge for a good or service.

If ESOs aren’t expensed at grant date the financial statements of the users of ESOs will not be comparable to the statements of non-users.

FASB raises this concern in paragraphs 97 and 98 of FAS 123. In paragraph 97, FASB states: “Some entities use fixed stock options more extensively than other entities do, and reported operating expenses thus are understated to differing degrees. Comparisons between entities of profit margins, rates of return, income from operations, and the like are impaired to the extent that entities continue to account for their stock-base employee compensation according to the provisions of Opinion 25” (the intrinsic value method). The presumption in this statement, is that if one company pays only cash income to its employees and another compensates its employees with a combination of cash and ESOs, investors will be misled as to the true performance of the company that uses ESOs.

In paragraph 98, FASB provides an illustration of the lack of comparability: “...assume that Companies A, B and C each report $6 million of total compensation cost. Company A does not grant fixed stock options to its employees, but Companies B and C do. The value of fixed stock options as a percentage of the total compensation package for employees of Companies B and C are 20 percent and 40 percent, respectively. Total compensation cost for Company A is $6 million, as reported in its financial statements. Although Companies B and C report the same amount of compensation cost as Company A, actual compensation is $7.5 million for Company B and $10 million for Company C. The three companies are not competing for capital on a level playing field because their financial statements are not comparable.”

Of course, the relevance of this illustration is totally predicated upon FASB’s premise that ESOs should be expensed, which is the issue in dispute. If ESOs truly had a realizable call premium (one that could be sold on the open market or in a negotiated transaction), Companies B and C would in fact, be understating their expenses and
overstating their income. But this is not the case. If ESOs are deemed not to be expenses, the comparability issue described by FASB is moot.

But should there be a concern about comparability as between two competing companies, if one issues ESOs and the other does not? After all, the existence of ESOs in a company's capitalization represents the potential for dilution at some point in the future. While this is a fact that investors should consider in their analysis of a company, it is not an issue that should concern accountants. It is common for companies competing in the same markets to use different business models and different compensation models. For example, some companies sell their products direct to consumers and others sell through distributors. The income statements of two such companies will look markedly different, particularly with respect to gross margin and selling cost. Or, more on point, consider the case of two commercial brokerage firms, one of which compensates its sales force with salary only, while the other pays no salary, choosing instead to pay commissions based on completed transactions. In neither of these examples is it the accountants' job to reconcile the statements of the competing companies.

**Searching for a Debit (and a Credit)**

The original Exposure Draft of FAS 123 proposed that an asset account, "prepaid compensation", be created at the date an ESO is granted; this asset would then be amortized (expensed) during the vesting period. FASB abandoned this approach after a large number of respondents to the Exposure Draft objected to the recognition of prepaid compensation as an asset at grant date (arguing convincingly that a non-vested ESO did not meet the definition of an asset in paragraph 25 of Concept Statement 6). FASB had to find another debit.

In the final version of FAS 123, FASB reasserted that ESOs are granted in return for services and that the requisite accounting treatment for such transactions should be as follows: "The compensation cost for an award of equity instruments to employees shall be recognized over the period(s) in which the related employee services are rendered by a charge (debit) to compensation cost and a corresponding credit to equity
(paid-in capital)...the service period shall be presumed to be the period from the grant date to the date that the award is vested and its exercisability does not depend on continued employee service.” While this new position appeared to be a distinction without a difference, it nonetheless was approved. Under this pronouncement, the equity account of a company granting ESOs would be reduced by a debit to retained earnings, and simultaneously increased an equal amount by a credit to paid-in capital.

FASB’s rationale for debiting compensation cost is perplexing. Since on the date of grant an ESO (typically) has no intrinsic value, the only basis for the debit is that the option has a call premium that is compensation for future “services”. But as we have seen, no such call premium exists in realizable form. And any hypothetical call premium that might exist, can only exist in the presence of a far greater hypothetical increase in shareholder value. Moreover, the assertion that ESOs are issued for services is arguably inaccurate. ESOs are not issued for services; they are issued for the purpose of achieving a desired result. In that sense their cost is contingent not current. In any event, since the only benefit that an ESO recipient can ever realize is from the intrinsic value (and then only if the ESO is vested), the debit would appear to be invalid.

As noted above, extending FASB’s logic with respect to ESOs, would mean that the DPV of a bonus should also be calculated and debited to expense regardless of whether it is ever earned.

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15 FASB’s theory is difficult to understand. The Board seems to be saying that a hypothetical call premium is created at the date of grant (and valued on that date), and then transferred to the employee over the vesting period in return for services. But this premium is not an asset that is used up during the period. If it is not an asset that is used up it must be an “outlay” of some kind that is simultaneously created and transferred as services are provided. This seems inconsistent with the notion of valuing the call premium at the date of grant.

16 Under FAS 123, an expense is only charged if the ESO vests. It follows, therefore, that the “services” provided by employees are only considered rendered if the ESO vests. This means that if an ESO doesn’t vest until the end of four years, and the employee terminates employment after three years and 11 months, no service is deemed to have been provided. This seems clearly to contradict FASB’s position that ESOs are issued for services. Wasn’t the employee providing services during his almost four year tenure?
**Pandora's Accounting Box**

FASB's proposed accounting entries will result in some rather perverse accounting outcomes in financial statements that may impair these statements' usefulness. Here are just four examples.

**Where did the cash come from?**

Like most public companies, "Expenser Corp." (a fictitious name for a real company) has been reporting to its shareholders using the treasury stock method of accounting for ESOs, which measures dilution to shareholder ownership. In the company’s footnotes, it has been disclosing what its net income would have been if ESOs were expensed. The ESO expense has been calculated using Black-Scholes. During the last five fiscal years, Expenser Corp.'s cumulative reported net income was $1.4 billion while its pro forma cumulative net income after expensing ESOs was about $800 million (43% less). During this same period, Expenser generated almost $2 billion in cumulative cash flow from operations (after capital expenditures but excluding cash generated from option exercises). Cash flow, therefore, was almost $1.2 billion greater than the net income that would have been reported under option expensing rules using Black-Scholes. (While it is likely that some other pricing model will be used to value ESOs that will be less punitive than Black-Scholes, there will still be a significant difference between net income and cash). About $600 million of the cash differential was from tax savings resulting from the deduction of the intrinsic value of the ESOs when they were exercised. The balance of $600 million was, according to FASB's proposed accounting entries, a "sale" of equity (resulting in a credit to paid-in capital) to its employees in exchange for their services.

On its face, this seems like an odd outcome. Under FAS 123 expensing rules, paid-in capital would show a $600 million increase without any cash changing hands. In addition, even if the ESOs expire worthless (or turn out to have an intrinsic value at exercise that is less than the amount of the charge), as long they have vested, the expense and the credit to paid-in capital will go unchanged. In this scenario, the
company will show paid-in capital that has not been paid in. Does this accurately present the company's financial performance and condition?

What a difference a day makes.

Assume two employees receive ESOs on the same day that vest at the end of four years (this is common for preexisting employees). The ESOs are expensed monthly during the vesting period. On the day before the ESOs vest, employee A leaves the company, while employee B stays the extra day. Both employees have rendered virtually the same amount of “services”. Under FAS 123, however, in the case of employee A, the expense will be reversed while in the case of employee B, the full expense will be charged. Is this accounting treatment helpful to investors?

Does this seem right?

At one point in the recent past (this is an actual case), Expenser Corp. had vested ESOs outstanding with per share exercise prices as low as $7.50 and as high as $87. Its stock was then trading at $40 per share. As required under FAS 123, in its footnotes, Expenser recorded the expense of these ESOs using Black-Scholes. In one instance, for every four thousand ESOs, the expense was $53,000 per year during its vesting; in another, the expense was $5,000. If you guessed that the $53,000 charge was for the $7.50 option you would be wrong. Even though the $87 option was way out of the money (and therefore would most likely expire worthless), it was costing the company, pro forma, $53,000 per year. Does this sort of outcome improve the usefulness of financial statements?

Unintended Consequences

Requiring the expensing of ESOs may have substantial repercussions with respect to other financial transactions. FASB has posited that an ESO has tangible value to the recipient and has, therefore, a corresponding cost to the grantor. If this logic were applied to a transaction between two companies (rather than an employer and an employee), it would appear that FASB will have to modify its revenue recognition
rules and petition the SEC to do the same. Consider the following hypothetical situation.

Seagate Technology, a large supplier of hard disk drives, goes to one of its customers, Dell Computer, and makes a proposal. If Dell agrees to use Seagate as one of its suppliers of drives, Seagate will grant Dell a ten year option on $600 million worth of Seagate stock vesting over four years. Vesting would be predicated on Seagate remaining as a supplier to Dell. The option would be exercisable at the fair market value on the date of grant and be non-transferable. Seagate would be free to stop supplying Dell at any time, in which case the unvested portion of the option would terminate. Likewise, Dell would be free to terminate Seagate as a supplier at any time. If it did so, however, the unvested portion of the stock option would be forfeited and the vested portion of the option would then expire in 30 days. It should be obvious that this option has precisely the same characteristics as an ESO, except that it is issued to a customer rather than an employee. In both cases the recipient of the option is being given an incentive to increase the enterprise value of the issuer (in Dell's case, Dell knows that, all other things being equal, the more drives it buys from Seagate, the higher the stock price will go and the more profit Dell will make on the option). Assume now that an options pricing model has been adopted that values the Seagate option at $200 million. Applying FASB's logic on ESO expensing to this transaction would result in Seagate expensing $50 million per year ($200 million divided by the four year vesting period) and Dell recognizing $50 million per year in revenue, all of which would drop to its net income line, but none of which would be in cash.

The problem is that this transaction does not comport with either FASB's or the SEC's current standards for recognition of revenues and gains, which require that revenue or gains be “realized or realizable, and earned”.17

It is highly unlikely that either FASB or the SEC will change their revenue recognition rules to sanction a non-cash $200 million increment to Dell's net income arising from the transaction described. And if Dell's receipt of an option grant is not recognized as net income, how can the grant of a conceptually identical option be charged as an expense to the grantor?

17 See page 12, herein, for an excerpt of FASB's pronouncement on recognition of revenue and gains.
One of the most hotly contested issues in the expensing debate has been over the question of how to value an ESO. Some opponents of expensing have made this the centerpiece of their case. They argue that there is no acceptable method extant to value an ESO. FASB and other proponents of expensing disagree. In paragraph 111 of FAS 123, the contrary view is stated clearly: "...financial statement recognition of estimated amounts that are approximately right is preferable to the alternative—recognizing nothing...." FASB believes that the value of an ESO can be approximated using a to-be-developed pricing model or a modified version of an existing model.

To date, however, FASB has not found an ESO valuation approach that it deems acceptable. One of FASB's biggest challenges will be to find a model that is not susceptible to wide variation induced by inputs that are highly subjective. A model that allows for too much subjectivity could significantly impair the comparability of financial statements, and open the door to managerial abuse.

Perhaps the greatest difficulty in finding a valid model for ESOs is confirming its accuracy. In the case of a publicly traded option, the marketplace is the ultimate determinant of the accuracy of any pricing model. Black-Scholes is considered reliable because the public marketplace has been shown to confirm its findings. Because of the non-transferability of ESOs, they cannot be traded and a public market price confirmation cannot be obtained. As a result, FASB can never be assured that the pricing model it chooses will be valid. More importantly, neither can the investors who base their investment decisions in large part on the accuracy of financial statements.

To be truly useful, FASB's pricing model should function as effectively for private companies as it does for public companies. This will also be a challenge, since the most popular models in use, have as their most important variable, stock price volatility, which, is virtually incalculable in a private company. FASB has no solution for this problem at this time and is proposing using a valuation methodology for private companies that essentially excludes volatility as a variable (what FASB calls the "minimum value" approach). This "solution" to the problem of valuing private company ESOs is arbitrary, and will result in public companies reporting higher expenses for
ESOs than private companies, when in fact the opposite might be more accurate. Clearly, this will create financial statement comparability problems that could result in an "unlevel playing field" for private companies in “competing for capital” (these are FASB’s words in asserting that not expensing ESOs will cause an unlevel playing field as between the users of ESOs and the non users). It is curious that FASB has decided to accept non-comparability as between public and private companies but not as between users and non-users of ESOs.

It should be instructive that there is no reliable way to value an ESO of a private company. What it suggests is that it is the existence of a realizable market value (either negotiated or priced on the public market) for an ESO that determines whether it should be expensed or not. The inability to accurately value private company ESOs casts further doubt on the wisdom of FASB’s approach.

When something is difficult to value, it is common accounting practice to wait until it can be valued with confidence before recording it as a transaction. It is odd, therefore, that FASB has decided to make an exception in the case of ESOs. Paragraph 114, of FAS 123, says: “...deferring final measurement of a transaction until enough of the related uncertainties have been resolved to make reasonably reliable measurement possible is the usual accounting response to measurement difficulties for virtually all other transactions except an award to an employee of fixed stock options (emphasis added).”

ESO valuation problems appear to be much greater than expensing proponents are willing to admit and should weigh heavily in the final decision to impose expensing rules.

**A Very Unusual Accounting Concept**

The expensing of ESOs, if required by FASB, will become one of the most unusual accounting practices in existence. There are least five ways in which ESO

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18 The preponderance of private companies that are large users of ESOs, are start-up or early stage companies. Because of the high risk inherent in such companies, their stock prices are almost certain to be more volatile than companies that have matured enough to go public.
expensing, as proposed in FAS 123, will deviate from normal accounting rules:

- It will be one of the few expenses that are required for financial reporting purposes, but are not allowed for tax purposes.
- It will be one of the only non-cash expenses that does not tie directly to either an asset or a liability on the balance sheet.
- It will be one of the few transactions in which the DPV of a future event is used instead of the recording of a historical event.
- It will be virtually the only transaction that will be recorded before "....enough of the related uncertainties have been resolved to make reasonably reliable measurement possible...." (FASB's words)
- It will be one of the only expenses that may not be reversed even if it is subsequently nullified by virtue of the option's forfeiture or expiration.

The existence of any one of these accounting rarities should give one pause; the existence of all five in the same rule, should cast serious doubt on the validity of the entire concept.

**Why is This Issue Important?**

Some who advocate expensing have asked what all the fuss is about. They assert that investors will not revise their assessment of the investment merits of a company simply because of an accounting change. In short, they believe that investors will ascribe the same value to a company whether it expenses ESOs or not. While this is possible, it is unlikely. Since 1995, when FAS 123 was published, companies that have not expensed ESOs have been required to show in their footnotes their pro forma earnings as if the ESOs were expensed. Most companies have used Black-Scholes to calculate the amount of this putative expense. This has provided an additional level of disclosure that could be used by investors to evaluate their investments. The SEC, however, has recently mandated a substantial curtailment of pro forma reporting of net income. As a result, it appears that public companies may not be allowed to report their net income both ways, with and without ESO expensing. If this were to eventuate, company financial statements would more likely than not be accepted as presented.
Other proponents of expensing believe that as long as every company accounts for ESOs in the same way, there will be no material effect on relative stock market valuations or anything else of importance. This premise is almost certainly incorrect. If ESO expensing is required, there will be a huge variation among industries in the extent to which these new “expenses” will impact earnings and, potentially, market values.

There are three primary factors that will determine the impact ESO expensing will have on a company’s earnings: (1) Annual ESO grants as a percentage of a company’s capitalization; (2) The price of the company’s stock relative to earnings (the PE ratio); and (3) The volatility of the company’s stock price. The degree to which companies rely on ESOs for employee compensation varies greatly. Obviously, the biggest users of ESOs will report the highest ESO expenses (all other things being equal). By and large, these large users of ESOs are also the highest growth companies in the world. Because of their high growth, these companies typically have the highest PE ratios. Finally, the stocks of these high-growth, high-PE companies are almost always the most volatile, and high volatility translates into high ESO valuations in the most commonly used option pricing models. The combination of the three variables—large annual grants of ESOs, high stock price and high volatility—can result in aggregate ESO expenses, as a percentage of net income, that are 20 times greater than those of companies without these characteristics. As a result, these companies will have to report dramatically higher charges to net income.\(^\text{19}\)

The consequence of FASB’s or the SEC’s two proposed actions (imposition of expensing rules and the curtailment of pro forma reporting of net income), may be that the greatest contributors to America’s economic growth and productivity will be significantly devalued. The impact of such a devaluation could be a material decline in the flow of capital into this vital sector of our economy.

**Conclusion**

FASB’s stated mission is to “establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers,

\[^{19}\text{In high growth companies, the non-cash "expense" attributed to ESOs, could be a very substantial percentage of a company’s net income—as much as 50% or more.}\]
auditors, and users of financial information". All of these constituent groups should support this mission. But FASB is considering making one of the most substantive changes in accounting policy in its history, and one that could have a deleterious effect on some of the most productive companies in the US economy.

In light of the radical departure from past practices, and the as yet unknown but potentially negative consequences, it is vital that FASB gets this right. FASB has, to date, made a diligent, intensive and well-intentioned effort to do so. And if expensing is, in fact, the most appropriate way to account for ESOs then that is how it should be. But the case against expensing is sufficiently compelling, that it is incumbent upon FASB to reconsider its position.

Kip Hagopian
Acknowledgements

The objective of this paper is to make a meaningful contribution to the debate on the accounting merits of the expensing of employee stock options. To the extent this objective has been achieved, substantial credit is due to several people and organizations.

The underpinning of the paper was a letter of comment on FASB's proposals on stock-based compensation submitted by Maxim Integrated Products, Inc. The lead writer of that comment letter was Tony Gilbert, formerly a senior partner of Cooley Godward LLP and, at that time, Maxim's chief legal counsel. Mr. Gilbert did an outstanding job of summarizing and presenting the case against expensing ESOs. The CEO of Maxim, Jack Gifford, together with Maxim CFO, Carl Jasper and Managing Director, Tim Ruehle were major contributors to the letter (both Mr. Jasper and Mr. Ruehle are CPAs), as was the author of this paper. Parts of that letter have been used in this paper.

During the drafting process, several people provided invaluable insights and commentary on the paper. Chief among them was Tim Ruehle, who supplied volumes of accounting literature and FASB pronouncements and provided ongoing assistance in the interpretation of the many accounting concepts and rules pertaining to this issue. Carl Jasper also made very important contributions in this respect, as did the office of the CFO at Intel Corporation.

One of the most vital contributions to the paper was made by Professor John Buckley, Professor Emeritus at the Anderson School of Management at UCLA, and formerly Chairman of the Department of Accounting and Director of Research in Accounting and Information Systems at Anderson. Currently Professor Buckley is founder and partner of Buckley & Associates, specializing in theoretical and applied accounting and economic analyses. Professor Buckley's comments were particularly useful because of his extraordinary expertise in accounting theory and his impartial viewpoint. Professor Buckley concurs with virtually all of the arguments and conclusions in the paper and is against expensing.
Since much of this debate revolves around some basic concepts of economics, it was quite helpful to have the insights of Anderson Professor Edward Leamer, Professor of Global Economics and Management and Director of the UCLA Anderson Economic Forecast, and Professor Charles Wolf, Jr., Senior Economic Advisor and Corporate Fellow in International Economics at RAND Corp., Professor of Public Policy in the Pardee RAND Graduate School, Founding Dean of the RAND Graduate School of Public Policy (1970 to 1997), and Senior Research Fellow at the Hoover Institution. Both professors Leamer and Wolf were excellent sounding boards for the economic theories espoused in the paper and generally provided confirmation of the validity of those theories. Professors Leamer and Wolf favor the position that ESOs should not be expensed.

Very helpful information and comments were provided by Rutgers Professor of Human Resource Management Joseph Blasi, co-author of a comprehensive study on the impact of broad-based option plans on company productivity. Professor Blasi is opposed to expensing.

Perhaps the most diligent contributor to the paper was Professor Ed Zschau, currently a Visiting Lecturer at Princeton University and formerly Assistant Professor of Business at the Stanford Graduate School of Business and Professor of Management at the Harvard Business School. Professor Zschau was also a U.S. Congressman and has been a very successful business executive, having run profitable businesses as large as $6 billion in revenue. Professor Zschau read virtually every draft of the paper and supplied consistently insightful comments and suggestions for improvement that greatly influenced the final product. Professor Zschau is against expensing.

Lastly, FASB itself is deserving of considerable credit. While the paper comes to a different conclusion on expensing, and in some places questions FASB's pronouncements and proposals, it is clear that FASB has made an enormous contribution to the understanding of this issue and has provided ample opportunities for opponents to present their case. This issue is exceptionally complex and FASB has made many persuasive arguments for its position. FASB's presentation of these arguments in FAS 123 and elsewhere was one of the most important sources for this paper.
About the Author

Kip Hagopian was active in venture capital investing for approximately 30 years. He was a founding partner of Brentwood Associates. Brentwood has since split into three companies: Brentwood Associates Private Equity, Redpoint Ventures and Versant Ventures, which are three of the largest and best known private equity firms in the United States. Mr. Hagopian has served on several high-technology company boards of directors. He holds a BA and MBA from the University of California at Los Angeles.
B. KIPLING HAGOPIAN

B. Kipling ("Kip") Hagopian co-founded Brentwood Associates, a high-technology venture capital and private equities firm in 1972, and for several years headed its high technology investment group. Brentwood and its successor firms, Brentwood Associates Private Equity, Redpoint Ventures and Versant Ventures, are some of the largest private equity firms in their respective fields. Since 1990, Mr. Hagopian has gradually reduced his commitment to venture capital in order to pursue other interests. Presently, he is affiliated with Brentwood Venture Capital in the capacity of Special Limited Partner of several Brentwood funds, and with Redpoint Ventures I as a Special Advisory Partner.

Mr. Hagopian is currently a Managing Partner of Apple Oaks Partners, LLC a private investment company he co-founded to manage his family's assets as well as the family assets of his co-founder.

During his venture capital career, Mr. Hagopian served in several industry leadership positions. For several years, he was a member of the Board of Directors of the National Venture Capital Association ("NVCA"), ultimately serving as President and Board Chairman. Mr. Hagopian also served several years on the Board of the Western Association of Venture Capitalists ("WAVC").

Mr. Hagopian has been involved in a variety of civic activities. In 1980, he was a member of presidential-candidate Ronald Reagan's "Business Advisory Panel" serving as Chairman of the Panel's Committee on "Capital Formation, Innovation and Productivity." In this capacity, he wrote the Committee's final position paper and recommendations which were submitted to President Reagan upon his election. In 1983 and 1984, Mr. Hagopian served on President Reagan's Commission on Industrial Competitiveness, which was comprised of 30 persons from business, labor, government and academia.

Mr. Hagopian currently serves on the Board of Directors of Maxim Integrated Products, a large publicly held semiconductor company, and is on the Board of Advisors of Thomas Weisel Partners, an investment banking firm. Mr. Hagopian's not-for-profit affiliations include memberships on the Board of Governors of the Pardee RAND Graduate School of Public Policy and the Board of Visitors and Executive Committee of the John Anderson Graduate School of Management at the University of California, Los Angeles. Past affiliations include several corporate board memberships as well as participation on the Executive Committee for Los Angeles Mayor Richard Riordan (1993-2001).

Mr. Hagopian has been a witness at several Congressional and executive branch hearings on tax policy, venture capital and securities law, and is an occasional lecturer at the UCLA business and law schools.

Mr. Hagopian holds a Bachelor of Arts degree in Industrial Design and a Master of Business Administration, both from the University of California, Los Angeles.
Stock Option Expensing Opponents

The following individuals oppose the FASB’s Employee Stock Option Expensing Proposal on the grounds that it would improperly account for options, resulting in the impairment of the usefulness of financial statements.

Prof. Joseph Blasi, Ph.D.
Rutgers Professor of Human Resource Management, co-author of a comprehensive study on the impact of broad-based option plans on company productivity

Prof. Emeritus John Buckley, Ph.D.
Professor Emeritus at the Anderson School of Management at UCLA, and formerly Chairman of the Department of Accounting and Director of Research in Accounting and Information Systems at Anderson. Currently founder and partner of Buckley & Associates, specializing in theoretical and applied accounting and economic analyses.

Prof. Tom Campbell, Ph.D., J.D.
Dean of the Haas School of Business, University of California at Berkeley, former professor of law at Stanford University, and former Congressman representing the Silicon Valley area of California in Congress. Prof. Campbell holds his bachelor’s, master’s and Ph.D. degrees in economics at the University of Chicago, and his law degree from Harvard.

Prof. Bud Fennema, Ph.D.
Chairman, Department of Accounting, Florida State University

James K. Glassman
Resident fellow at the American Enterprise Institute where he specializes in issues involving economics and financial markets.

Kevin A. Hassett, Ph.D.
Director of Economic Policy Studies at the American Enterprise Institute

Prof. R. Glenn Hubbard, Ph.D.
Dean, Columbia University's Graduate School of Business, Business School. Russell L. Carson Professor of Finance and Economics, and Former Chairman Council of Economic Advisors under President George W. Bush.

Prof. Edward Leamer, Ph.D.
Professor of Global Economics and Management and Director of the UCLA Anderson Economic Forecast.

Lawrence B. Lindsey, Ph.D.
Dr. Lindsey is President and Chief Executive Officer of The Lindsey Group; from Jan. 2001 to Jan. 2002 he was Assistant to the President and Director of the National Economic Council at the White House; served as a Governor of the Federal Reserve System from 1991 to 1997; Special Assistant to the President for Domestic Economic Policy during the first Bush Administration, and as Senior Staff Economist for Tax Policy at the Council of Economic Advisers during President Reagan's first term.
Francis J. O'Brien
Former Senior Partner and West Region Director of Accounting and Auditing of Ernst & Young.

Paul H. O'Neill
Former Secretary of the Treasury, former Chief Executive Officer of Alcoa Inc.

Alan Reynolds
Economist and senior fellow at the Cato Institute.

Prof. Emeritus George Shultz, Ph.D.
Jack Steele Parker Professor of International Economics at the Graduate School of Business, Stanford University; Former Secretary of Treasury and former Secretary of State.

Peter J. Wallison
Resident Fellow at the American Enterprise Institute for Public Policy Research and co-director of AEI's program on Financial Market Deregulation.

Prof. Charles Wolf, Jr., Ph.D.
Senior Economic Advisor and Corporate Fellow in International Economics at RAND Corp., Professor of Public Policy in the Pardee RAND Graduate School, Founding Dean of the RAND Graduate School of Public Policy (1970 to 1997), and Senior Research Fellow at the Hoover Institution.

Prof. Ed Zschau, Ph.D.
Currently a Visiting Lecturer at Princeton University and formerly Assistant Professor of Business at the Stanford Graduate School of Business and Professor of Management at the Harvard Business School. Professor Zschau was also a U.S. Congressman.
Why Expensing Employee Stock Options Would Be Improper Accounting

In 1993 all of the six major accounting firms were vigorously opposed to expensing employee stock options ("ESOs"). They made their respective positions quite clear in letters of comment to the FASB on its Exposure Draft of FAS 123 ("Accounting for Stock Based Compensation"). Each firm based its opposition on two issues: first, they argued quite persuasively that expensing ESOs was simply bad accounting; and second, they argued that the Fair Value of ESOs could not be measured reliably and accurately.

The following are excerpts from the comment letters of the five major firms that are still extant either independently or as part of a merger. (Arthur Andersen’s comments are not included.) These comments are organized into two categories: accounting merits and value measurement. All of the very same accounting firms that opposed expensing in 1993, are now on the record as supporting the FASB’s expensing proposal. (This includes Price Waterhouse and Coopers & Lybrand, which have merged to become Price Waterhouse Coopers.) This raises the obvious question: What has changed? Clearly, there has been no change in the basic concepts or theory of accounting in this 10-year period.

Were they wrong then or are they wrong now? Which of their arguments in opposition to expensing do they no longer believe are valid and why? Surely their radical change in position cannot be based on a shift in the political winds. This would suggest that these firms have abdicated their fiduciary responsibility to produce accurate financial statements. These are questions each of these firms should be asked by both the FASB and by the SEC, which has the ultimate authority and responsibility to establish accounting rules for public companies.
ON THE ISSUE OF THE ACCOUNTING MERITS

"...the proposed changes in current accounting rules for stock options should not be adopted because they will not result in sufficiently reliable information; would not be a meaningful improvement over present practices; and, as you might expect, can severely impact the earnings and net worth of certain (especially high growth) companies."

Eugene M. Freedman
Chairman
Coopers & Lybrand
December 14, 1993

"In our November 5, 1993 letter, we once again expressed our concerns about the direction of this project and strongly recommended that the Board adopt a disclosure-based approach that retains current accounting standards. Everything we have learned since has only strengthened our conviction that the Board should not go forward with the current proposal."

J. Michael Cook
Chairman and
Chief Executive Officer
Deloitte & Touche
January 12, 1994

"...we have studied the Exposure Draft, analyzed the proposed accounting, and weighed its perceived benefits against the costs of compliance. Based on these procedures, we strongly oppose the proposal and believe that it would not enhance the overall usefulness or reliability of financial statements."

Ernst & Young
December 6, 1993

"Many in the business community have expressed a concern about the potential adverse economic effects on the competitiveness of U.S. business that could result from adoption of the ED. While that concern should not be a principal factor driving the accounting standard, it is entirely legitimate to expect that those who would change present practice, possible adverse economic consequences notwithstanding, would do so only with great conviction that the new standard is the right one. If there is any doubt, the Board should not proceed."

Price Waterhouse
December 17, 1993
"There is no disagreement that stock options provide the employee with a benefit that is valuable. However, there is considerable disagreement as to whether any cost that might be associated with that benefit should be recorded in financial statements and, if so, whether there is any reliable means of measurement. APB Opinion No. 25 concluded that for fixed stock options, such cost is simply the options' intrinsic value at the grant date. We are not persuaded that a better and more reliable measure of the employer's cost is available at this time."

Coopers & Lybrand
December 29, 1993

"We do not believe accounting for stock-based compensation arrangements represents a major financial statement reporting concern. We do acknowledge that disclosure of such arrangements is an important component of a company's corporate governance and stewardship responsibilities. We believe that the executive compensation disclosures currently required by the SEC in proxy statements fundamentally satisfy those responsibilities."

KPMG Peat Marwick
December 28, 1993

"We believe it is in the best interests of the public, the financial community, and the FASB itself for the Board to address those issues that would have a significant impact on improving the relevance and usefulness of financial reporting. Accounting for stock-based compensation does not meet the test."

Arthur Andersen
December 23, 1993

"The Present Accounting Model Should Not be Changed"

We remain unconvinced that the proposal is an improvement over present practice."

Ernst & Young
December 6, 1993

"We have given careful consideration to the many issues bearing on this project and have reached a conclusion that the road traveled by the Board has not borne fruit and is not likely to do so in the near term. We, therefore, urge the Board to withdraw the Exposure Draft."

Price Waterhouse
December 17, 1993

"The interests of all parties would be well served if the FASB does not
change its current standards regarding employee stock options. The FASB should shift its focus to issues where the need for improved standards is greater and the opportunities for developing those standards are more clear-cut."

Eugene M. Freedman
Chairman
Coopers & Lybrand
February 5, 1993

"For reasons outlined above, we strongly urge the Board not to proceed with the proposal, and instead withdraw it in favor of a new project to develop improved disclosures of stock-based compensation plans."

Ernst & Young
December 6, 1993

"The intrinsic measurement method that is used in APB Opinion No. 25 (APB No. 25) should be retained."

KPMG Peat Marwick
December 28, 1993

"We trust it is clear that we oppose fundamental change in this area at this time, for the reasons previously stated."

Price Waterhouse
December 17, 1993

"The issue of executive compensation has become something of a political football in recent months, and I am troubled that the FASB may be letting political rather than accounting considerations set its agenda. The little concern about employee stock options that has been expressed by users of financial statements has largely been assuaged by recent SEC actions. The SEC's new proxy rules require very full disclosure of executive compensation, enabling interested parties to make their own determinations regarding the costs and values of any stock options that have been granted. Options are "common share equivalents", when they become likely to be exercised (because of the rise in stock price) and thus reduce earnings per share. In this way, they become reflected in a business' cost of capital. The FASB proposal would reflect, in effect, a double dip or double cost of capital."

Eugene M. Freedman
Chairman
Coopers & Lybrand
February 5, 1993

"Any compensation for stock-based compensation arrangements, as for other noncash compensation such as health care benefits, company
cafeterias, and company athletic facilities, should be measured based on the cost to the employer, not the value received by the employee.”

Arthur Andersen
December 23, 1993

“Thus, notwithstanding the Board’s considerable efforts to develop a workable approach, we are convinced that in comparing the costs of compliance with the results attained, the proposed accounting provides a less satisfactory answer than current practice. Accordingly, we urge the Board not to proceed with a final standard.”

Ernst & Young
December 6, 1993

“In summary, we believe the ED is predicated on a valuation methodology that is not sufficiently developed and on a largely imagined user demand for fundamental change. In light of this, and considering economic consequences, we believe the ED does not provide a platform from which the Board should proceed to a final standard.

Price Waterhouse
December 17, 1993

“Awards that call for settlement by issuing equity instruments are equity instruments and measurement of such awards should be made at grant date to the extent possible. Thus, the approach used in APB No. 25 for “fixed” plans should be continued.”

KPMG Peat Marwick
December 28, 1993

“It has been a general tenet of accounting that standards should be altered only when there is clear evidence that a proposed change would improve financial reporting. There is no convincing proof that any financial statement user would benefit from the changes being discussed regarding accounting for stock options. Current standards would be supplanted by new ones which introduce hypothetical, arbitrary and capricious measurement systems, providing little benefit to users of financial statements, providing little benefit to users of financial statements and exerting an adverse impact on the U.S. economy, particularly a vital segment.”

Eugene M. Freedman
Chairman
Coopers & Lybrand
February 5, 1993
"After carefully reviewing the Exposure Draft, we do not support the issuance of a final statement based on its approach."

KPMG Peat Marwick
December 28, 1993

"We continue to believe that in view of our concerns with the Board’s proposal, present practice supplemented with additional disclosures is a superior approach. The potential effect of options is already reflected in the earnings per share calculation."

Ernst & Young
December 6, 1993

"...we urge the Board to retain current accounting for ESOs and not to proceed with a standard requiring hypothetical and arbitrary recognition in financial statements."

Coopers & Lybrand
December 29, 1993

**ON THE ISSUE OF MEASURING OF FAIR VALUE**

"Consequently, any requirement to use an option-pricing model must comprehend an awareness that the model produces a theoretical estimate, which is no more than a surrogate for an indeterminable fair value. And, given that fair value cannot be determined, the level of measurement precision required by the Exposure Draft is unwarranted. It not only increases the complexity and cost of complying with the proposal, but also increases the potential for noncomparability among enterprises.

There are six variables used in the Black-Scholes and binomial option-pricing models. Three of these variables (current price of the underlying stock, exercise price, and risk-free interest rate) can be determined somewhat objectively. Three of the variables (expected volatility, expected dividend yield, and expected term of the option), however, require a subjective assessment of the future. Illustration 1 of the Exposure Draft presents an example of an option with a Black-Scholes price of $18.02. Adjusting all three of the subjective variables by 50% up and down together produces Black-Scholes prices ranging from a low of $7.73 to a high of $29.05. This analysis demonstrates that by changing these variables, the price of an option can be increased or decreased dramatically."

Deloitte & Touche
November 5, 1993
“Our study found that the key assumptions used in valuing stock options -- stock price volatility and expected option term -- are subject to considerable judgment and significantly affect option values. Because of the sensitivity of option values to changes in underlying assumptions, there is a wide variation in values among companies which will adversely affect the comparability and usefulness of financial reporting.”

Eugene M. Freedman
Chairman
Coopers & Lybrand
February 5, 1993

“The Board’s proposal will not result in meaningful improvements in financial reporting, and the benefits of changes to the present accounting standards will not outweigh the very significant costs.”

J. Michael Cook
Chairman and Chief Executive Officer
Deloitte & Touche
January 12, 1994

“The key findings of our study that support this view are as follows:

• Key valuation assumptions are subject to considerable judgment and significantly affect option values. For example, a five-percentage-point change in volatility (which can often be justified solely by alternative ways of looking at historical volatility) produced, on average, a 15 percent change in option value. A change in expected term from three years to five years (again easily justifiable) produced, on average, nearly a 40 percent increase in option value. The key assumptions are subject to so much judgment and guesswork that selections among a wide range could be justified as the best estimates. The end result would adversely affect the comparability of financial statements of companies in the same industry and at the same state of development.”

Coopers & Lybrand
December 29, 1993

“The output of an option-pricing model is only a mathematically-derived “theoretical” value, which may or may not be indicative of fair value. Since a market for employee stock options generally does not exist, there is no objective way to assess whether the theoretical value approximates the
price at which the option could be sold in an active market."

Deloitte & Touche
November 5, 1993

“We continue to believe that existing option pricing models do not produce a reasonable or relevant value of employee stock options.”

Ernest & Young
December 5, 1993

“Our conclusion is that the methodology in the ED for calculating the fair value of employee stock options significantly overstates their fair value, but by how much is pure conjecture. Furthermore, there is no future event that ultimately will verify the accuracy or inaccuracy of the estimate of grant date fair value.”

Price Waterhouse
December 17, 1993

“We believe that using option-pricing models for ESOs does not result in sufficiently reliable information because of the wide variation in values among companies and the sensitivity of such values to changes in the underlying assumptions. Accordingly, the proposed changes in accounting would have an adverse impact on the comparability and usefulness of financial statements.”

Coopers & Lybrand
December 29, 1993

“As acknowledged in the Exposure Draft, the Black-Scholes and binomial option-pricing models were not designed to deal with long-term, forfeitable and nontransferable employee stock options.”

KPMG Peat Marwick
December 28, 1993

“The following discussion supports our continuing recommendation for a fundamental change in the direction of the stock compensation project.”

KPMG Peat Marwick
December 28, 1993

“....we urge the Board to retain current accounting for ESOs and not to proceed with a standard requiring hypothetical and arbitrary recognition in financial statements.”

Coopers & Lybrand
December 29, 1993
“Finally, we are concerned with the auditability of the “expected volatility” and “expected dividend yield” during the expected term of the option. Although these assumptions are necessary to calculate a theoretical fair value amount using option-pricing models, it is difficult for companies to provide sufficiently reliable audit evidence to support these assumptions after considering the benefit of hind-sight.”

KPMG Peat Marwick
December 28, 1993

“If the FASB remains determined to address accounting for employee stock options, I am also distressed by the imposition of valuation techniques commonly associated with tradable options as the primary mechanism for determining the cost of restricted stock options granted to employees. This approach would require businesses to make difficult and arbitrary determinations in order to put a price tag on their options programs and provide hypothetical information which will confuse readers.

To be sure, there are a number of option valuation models available, but they are designed for publicly traded options. Employee stock options are typically long term, non-transferrable, and subject to a number of conditions, including continued employment. There is no market mechanism to establish a value for these options. Thus, it is very difficult to identify a procedure for valuing them that would provide a meaningful improvement over present practices.”

Eugene M. Freedman
Chairman
Coopers & Lybrand
February 5, 1993

“We are not comfortable with an approach that uses a “black box” to generate an accounting value when we are not able to articulate what is happening in the “black box” or explain why it is appropriate to accept different answers for valuing options.....”

KPMG Peat Marwick
December 28, 1993

“At this time, we are aware of no reliable way to measure the effect of differences between ESOs and publicly traded options or to modify present models to account for these differences.”

Coopers & Lybrand
December 29, 1993