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Stock Options: The Accounting Issue and Its Consequences

Bob Lyke, Domestic Social Policy Division; and Gary Shorter, Government and Finance Division

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Stock Options: The Accounting Issue and Its Consequences

Bob Lyke
Specialist in Social Legislation
Domestic Social Policy Division

Gary Shorter
Specialist in Business and Government Relations
Government and Finance Division

Summary

The Financial Accounting Standards Board (FASB) has issued a long-anticipated rule that stock options must be recognized as an expense on corporation income statements. The previous accounting rule permitted but did not require recognition; corporations that elected to omit the cost of options, as most did, have been able to report higher earnings. Supporters of the old rule argue it encouraged companies to issue options, helping to ensure that executives served the shareholders' interests. Options can be especially useful to cash-constrained start-up companies that cannot pay competitive salaries. Supporters also maintain that options cannot be valued accurately enough to be included on the income statement and that investors otherwise have sufficient information to make informed judgments about company value. Critics of the old rule argue that it encouraged excessive use of options and created incentives for executives to manipulate financial data in order to drive up stock prices. They note that exercised options are deducted in determining corporate income tax liability. FASB provided that the effective date for most companies would be the first fiscal quarter beginning after June 15, 2005, but the U.S. Securities and Exchange Commission (SEC) has given many companies a six-month deferral. H.R. 913 (Representative Dreier) would require enhanced disclosure of companies' stock options and a three-year study of its effects, during which time new accounting standards on options would not be recognized.

Compensatory Stock Options

Many corporations grant employees options to purchase company stock at a particular, advantageous price. Under *compensatory plans*, options are granted primarily in exchange for services; executives, other employees, and directors sometimes accept lower salaries, wages or benefits in order to receive the options. Normally compensatory

plans require employees to work for the company for an additional vesting period, such as two years, until the options can be exercised. Corporations also have *noncompensatory plans* that serve different objectives, such as promoting employee loyalty or raising capital without a public offering. One common noncompensatory plan, an employee stock purchase plan, normally offers stock for immediate purchase at a modest discount; it carries special tax incentives for employees.

Compensatory plans usually involve *fixed options*, for which the number of shares that can be obtained and the exercise price that must be paid are established when the options are granted. Generally the exercise price is set equal to the market price on the grant date; option holders hope that the market price will rise over the vesting period, allowing them to buy the stock at a substantial discount. Some plans instead have *performance options*, for which the number of shares of stock that can be obtained and the exercise price are not established; these depend on whether the company meets performance goals such as growth in sales. Of course, there is an implicit performance aspect to fixed options since they would be worthless (and not exercised) if the exercise price is greater than the market price when employees are able to purchase the stock.

Current Accounting Treatment

The accounting controversy involves compensatory fixed options.¹ While federal securities laws give the U.S. Securities and Exchange Commission (SEC) authority to set accounting standards for publicly-traded companies, the SEC generally defers to standards established by the Financial Accounting Standards Board (FASB), a private organization of accounting experts. See [<http://www.fasb.org>]. According to the standard that has been in place since 1995, companies can choose how they account for fixed options (Financial Accounting Statement (FAS) 123.) Under the *intrinsic value method*, companies must recognize compensation cost (usually as an expense) only to the extent the market price *exceeds* the exercise price on the grant date; any cost so recognized is apportioned over the vesting period (e.g., two years) before the options can be exercised. Thus, no cost is recognized under this method if the exercise price equals or exceeds the market price on the grant date. Under the *fair value method*, companies must recognize compensation cost (usually as an expense), similarly apportioned over the vesting period (e.g., the two years), if the options have value when granted; there can be value even if the exercise and the market price are the same on the grant date since there is opportunity to profit if the latter increases. Estimates of this value can be derived from option pricing models. FAS 123 requires companies that use the intrinsic value method to include a footnote in their annual financial statements showing what the pro forma effect on earnings and earnings per share would be if they instead used the fair value method.

Prior to FAS 123, issued in October 1995, accounting standards required use of the intrinsic value method for determining whether the cost of fixed options should be recognized. In the early 1990s, the FASB proposed requiring all companies to use the fair value method. The proposal aroused intense opposition from many businesses and was criticized by Members of Congress, who had rarely been involved with private sector

¹ For additional perspectives, see the CRS General Distribution Memorandum, *Stock Options: Overview of Financial Accounting*, by Bob Lyke (available from the author), and CRS Report RL31458, *Employee Stock Options: Tax Treatment and Tax Issues*, by James M. Bickley.

accounting issues. The Senate passed a Sense of the Senate statement against the proposal (S.Amdt. 1668 to S. 783). Fearing it might lose its independence, the FASB retreated tactically and gave companies a choice of using either the intrinsic value or fair value methods, with some exceptions. Until recently, nearly all companies chose to continue with the older practice. In the last year or so, however, a growing number of firms have adopted or announced intention to adopt the fair value method, either voluntarily or in anticipation of the new FASB standard. A July 2004 Bear, Stearns and Company report listed 753 such firms, including 120 in the S&P 500.

FAS 123 made it clear that FASB would have preferred to require companies to use the fair value method. In its view, the options in question are granted in exchange for services; conceptually, they represent compensation just as do payments for other transactions involving employees. While recognizing there are questions about measurement, it argued that option pricing models are now widely used (unlike when the intrinsic value method became the standard) and that recognizing *no* expense whatsoever clearly would distort earnings. FASB discounted possible adverse economic effects of recognizing options as an expense and said they should not be given weight in any case.

Opponents of recognizing options as an expense on the income statement argue that the cost is borne directly by the shareholders (through reductions in their share of equity), not the corporation. They also argue that conceptually an expense occurs when assets are used up (for example, when supplies are used in production) and that no asset is created when options are granted. In addition, it is argued that attempts to change the current accounting rules stem from opposition to corporate financial abuses, not reasoned theory.

The New FASB Rule

On December 16, 2004, FASB formally amended FAS 123 in a statement entitled *Share-Based Payment* and referred to as FAS 123(R). In general, the revision precludes use of the intrinsic value method described above and requires recognition of stock option grants as an expense on the income statement. FASB provided that the new rule would be effective for most public companies the first interim or annual reporting period beginning after June 15, 2005; for small public companies and nonpublic companies the comparable effective date would be December 15, 2005. However, on April 15, the SEC determined that the effective date would be the first interim or annual reporting period of a company's *first fiscal year* beginning after June 15, 2005; for many companies, the SEC rule defers the effective date by six months. A similar change was made for small public companies and nonpublic companies. FASB and its staff have been issuing additional guidance on various technical issues, such as how the term "grant date" should be applied, as well as on transition matters.

FAS 123(R) does not require companies to use a particular stock option valuation model, in part because it anticipates that more sophisticated models will be developed in the future. It does indicate that so-called open-form models that can incorporate a number of valuation parameters may be more appropriate than closed-form models (including the Black-Scholes model) that have been widely used. FAS 123(R) also addresses the appropriate accounting treatment of various other instruments, such as appreciation rights and employee stock purchase plans.

On March 29, 2005, the SEC Office of the Chief Accountant released Staff Accounting Bulletin (SAB) 107 providing interpretative guidance related to the interaction of FAS 123(R) and SEC rules and regulations, as well as staff views of valuation of share-based payments. On September 9, 2005, the office also released informal progress reports on option valuation; among other things, the work noted that using a market mechanism to estimate value may have advantages over model-based approaches.

FASB's proposal is generally consistent with the approach taken by the International Accounting Standards Board (IASB) in its February 19, 2004 rule, International Financial Reporting Standards 2 Share-Based Payment (IFRS2). (The IASB is an independent, privately-funded entity based in London that is developing global accounting standards. It works closely with national standard-setters, including FASB.) Information about the IASB and IFRS can be obtained through its website [<http://www.iasb.org>]. On February 7, 2005, the European Commission required publicly traded companies registered in European Union countries to follow IFRS2.

Many accounting professionals support the FASB position on stock options, either on technical or procedural grounds. An organization opposing treating options as an expense is the International Employee Stock Options Coalition (IESOC), whose members include business associations and some high-tech corporations. See IESOC's website at [<http://www.savestockoptions.org>].

Financial Market Consequences

High-tech firms are more likely to issue stock options to their workers than firms in other economic sectors. Since requiring the cost of options to be recognized as an expense may have a disproportionately negative effect on their reported earnings and stock prices, which are proxies for the market's faith in future earnings, their ability to raise capital may be impeded. Traditionally, a company's earnings history been a key factor used by investment banks to determine whether capital should be raised through an initial public offering (IPO). Investment banks also look to stock price/earnings ratios of related firms to help them determine proper IPO pricing. In addition, a firm's stock price can significantly influence the prospect and cost of secondary stock offerings as well as the cost of debt financing.

At issue, however, is whether the stock market already incorporates the cost of options. Based on the view that capital markets tend toward informational efficiency, (i.e., that market prices tend to reflect relevant information and thus the true value of underlying assets), some financial observers argue that the cost of options is implicitly recognized notwithstanding use of the intrinsic value method and that a requirement to use the fair value method may not materially affect stock prices. Behind this view is a belief that the sophisticated investors who tend to move stock markets (institutional investors, among others) are already taking into consideration the footnoted pro forma data on earnings that are required under the intrinsic value method.

A number of empirical studies support this position: A study conducted by Towers Perrin, a respected business consulting firm, examined 335 companies that elected to reflect option expense on their income statements during 2003. Tracking share prices on the day of the company's declarations, and during the 150 trading days before and 150

trading days after, Towers Perrin found that on average their share performance was about the same as the 900 companies that made up the S&P's 500 and mid-cap 400 indexes. It concluded that generally speaking, a company's decision to expense stock options has no impact on its share price, similar to its findings in a 2002 study.

The view that the stock market does not already incorporate the cost of options is held by some observers (among them Alan Greenspan, Chairman of the Federal Reserve Board, and various shareholder advocates) who draw a different policy conclusion than those who stress the potentially harmful outcomes for high-tech companies. In their perspective, to the extent that the market does not reflect the cost of options, there is informational inefficiency that may result in the misallocation of capital. If recognizing the cost of options results in lower reported earnings and difficulty raising capital, that may indicate that investors were previously inadequately informed. If investments then flow to other economic sectors, there may then be a gain in overall economic efficiency.

A report released by Bear Stearns & Co. in the spring of 2004 found that net income for firms listed on the high tech laden Nasdaq 100 index would have fallen by 44% in 2003 if the firms had expensed their stock options. An April 2004 Congressional Budget Office (CBO) report, *Accounting for Employee Stock Options*, concluded among other things that expensing options does not mislead investors in startup companies by distorting their financial reports; in its view, firms in the startup phase tend to turn to venture capitalists and private equity firms for fund-raising, entities with sophisticated investors who look beyond the firm's stock option expenses to see their true potential. CBO also found little evidence that recognizing the fair value of stock options would do harm to the national economy.

Some would argue that accounting standard setters should not take into consideration possible capital market effects, particularly adverse effects that are largely concentrated in one economic sector. In their view, accounting standards should be based on conceptually sound principles, such as the proper measurement of income and expenses, and that investors should be left to make informed decisions on their own. They would say that stock options should be encouraged or discouraged by market forces, not by how they are recognized. However, others might argue that accounting standard setters have often taken economic consequences into consideration and that it is not inappropriate to further what is a legitimate way to compensate executives and other employees. They might note that criticism of the current accounting standard stems in part from a desire to reign in executive compensation, an objective that might be accomplished by other means.

Compensation Consequences

If companies are forced to recognize the cost of options as an expense, observers in the field predict that firms may

- reduce the total number of options they grant;
- eliminate stock options for rank-and-file workers, while generally retaining them for executives;
- eliminate employee stock purchase plans that permit workers to acquire company stock at substantial discounts; and

- be more inclined to switch to variable options, which FAS 123 already requires to be recognized as an expense. (These plans may not pay off for employees if the stock price rises after the grant date.)

By early 2005, when required expensing was starting to seem inevitable, surveys conducted by the National Center for Employee Ownership (NCEO) found that at least 40% of publicly traded companies with stock options were reconsidering them. They also found that as many as a third of the companies might discontinue them over the next few years. But NCEO officials believe that most companies with broad-based stock option plans (about 17% of publicly traded companies) will probably keep them. Other observers, however, are not as optimistic about the future of broad-based stock options. The 2005 Deloitte Stock Compensation Survey (July 2005) found that 75% of senior executives indicated they were reducing or had already reduced the number of options granted; rank-and-file employees were the ones most affected. A Watson Wyatt survey released in October 2005 found that the economic value of stock options had already declined by nearly 60% between 2001 and 2004; fewer options were granted and the average size was smaller.

Congressional Action

Congressional concerns over the new FASB rule were evident in the 108th Congress. The most significant example of this was H.R. 3574 (Representative Baker), an amended version of which the House Committee on Financial Services reported on July 15, 2004 (H.Rept. 108-609) and which the House passed on July 20, 2004, after further amendment. This bill would have required recognition of option expense only with respect to highly compensated executives, set conditions for measurement and recognition, exempted small businesses among others, and delayed implementation pending completion of a study.

Concerns over the new rule persist in the 109th Congress. H.R. 913 (Representative Dreier) would require enhanced disclosure of companies' stock options and a three-year study of its effects, during which time new accounting standards on options would not be recognized. The bill would also direct the Secretary of Commerce to study the economic impact of broad-based employee stock option plans, particularly in technology and high-growth industries. However, Senator Shelby, chairman of the Senate Committee on Banking, Housing, and Urban Affairs, has stated that restated he would fight any legislative efforts to block the new rules requiring options to be recognized as an expense.

Christopher Cox, the Chairman of the SEC, had been a cosponsor of H.R. 913 when he was a congressman, but he expressed support for the FASB rule during his confirmation hearing in July 2005. However, how the rule will be implemented during his chairmanship remains to be seen. On November 14, 2005, Mr. Cox named Scott Taub as the Acting Chief Accountant, a critical position with respect to implementation issues.