

Accounting Treatment of Employee Stock Options

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Hassett/Wallison's Objections to Expensing Options

- No satisfactory method to estimate value of stock options
- Inconsistent with principles and objectives of accounting
- Considerable legal risks
- Consequently, fair-value analysis is inappropriate

Calomiris/Hubbard Objections to Expensing Options

- Information already disclosed to sophisticated investors (others should buy index funds)
- Although accounting is irrelevant for investment decisions, it might be misleading
- No uniformly satisfactory method to estimate value of stock options
- Cost of options is firm-specific – cannot be uniform method
- Consequently, only disclosure should be required

Criticism of Option Value Measurement

- Both papers strongly criticize use of Black/Scholes model
- HW cite other papers
- CH are more specific:
 - Underlying asset returns – data generating process
 - Negative autocorrelation – table (not clear to me)
 - Other statistical factors can make big differences – not shown
 - Exercise strategies of employees

CH also point out that the value of options compared to cash payments differs, because the cost of new stock issues varies considerably among companies

Reasons for not expensing not mentioned

- Options are valuable as incentives (true)
- Particularly for companies with growth options (true)
- And high cost of capital (true only if employees believe risk is lower)
- Expensing would discourage use of options (not true if accounting really doesn't matter)
- Options really are costless to shareholders
 - if stock price goes up, employees and shareholders benefit
 - if stock price goes down, shareholders benefit from not having paid employees in cash

Reasons not mentioned continued

- Therefore, expensing options will be harmful to the economy

- Alternatives:

Options give CEOs and CFOs incentives to:

- Take excessive risks (increase value of options)
- Produce misleading financial statements designed to increase share prices, at least until options can be exercised and stock sold

Options are a form of employee compensation and should be accounted for as such

Accounting for Employee Stock Options

- Accounting models:
 - Asset/liability (AL)
 - Revenue/expense (RE)

Asset/liability

option when granted establishes:

a liability equal to expected amount that will be transferred from shareholders to option holder

an asset equal to value to company of employee effort (equal to liability)

Accounting for Employee Stock Options Continued

- Revenue/Expense
 - Employee creates or will create revenue
 - Payment to employee in the form of option, cash, or whatever is matched to revenue
 - Conservatism
 - delay recognition of revenue until ownership is secure and value is measured reliably (trustworthy)
 - Recognize expense, even if amount is uncertain if liability or assets use has occurred

Essential Accounting Issue

- Employee stock options definitely is an expense, no different conceptually than cash payment or payment in goods, etc.
- Issues are:
 - Amount of total expense
 - Allocation (assignment) to revenue over time

Cost of Employee Options to Shareholders

- Expense is opportunity cost – at what price could the options have been sold?
- Expense is not (as per HS) the saving in cash payments to employee – what the option is worth to the employee
- Expense is not the saving from not having to issue stock if cash were paid to the employee (as per CH)

Opportunity Cost to Shareholders of Options

- Black/Scholes if adjusted to account for special properties of option (e.g., delay in exercising, probability of vesting)
- Investment banker opinion
- Offer options with similar features to shareholders and other investors

Bottom Line

- Zero is a number – it is not preferable to an estimate
- Accounting is not perfect, the best should not be the enemy of the good