

**The Economic and Legal Consequences of
Requiring the Expensing of Employee Stock Options
Without
Specifying the Valuation Method**

by

Kevin A. Hassett

Director of Economic Policy Studies

AEI

and

Peter J. Wallison

Resident Fellow

AEI

Draft of 12-31-03

Key question:

- Does it make sense to require the expensing of employee stock options when no one knows how to do it?

Among the errors of Sarbanes-Oxley:

- Unblinking acceptance of GAAP as key financial disclosure
- Congress not aware that GAAP is becoming increasingly useless

Many reasons not to expense stock options:

- Differential effect on small companies
- Reduces management incentives
- Discourages companies from going public
- But even on its accounting merits, expensing stock options is not good policy

The principal problem:

- No way to place a consistent or trustworthy value on Employee Stock Options
- Many different outcomes, depending on inputs and assumptions
- No one outcome is correct or reliable

Does Fair Value accounting make sense in this context?

- Fair value accounting—an attempt to avoid using misleading “cost” valuations
- One of the sins of Enron was using fair value accounting to mislead

Fair value accounting is the underlying idea of expensing stock options

- Proponents probably thought Black-Scholes would work
- B-S does not work for long term options

No Guidance from FASB

- FASB has recognized deficiency of Black-Scholes: “no model precluded”
- Companies are on their own—the FASB will not prescribe a model

Key question:

Does it make sense to require a fair value estimate of stock option expense when no one knows how to do it?

Accounting has always rested on certain key concepts:

- Reliability
- Consistency
- Comparability

Arguments in favor:

- Employee stock options have some value—value not zero
- If left out of earnings per share, earnings will not reflect all costs
- Accounting concept of conservatism—better to reduce EPS by some number (even if subject to doubt) than to leave it blank

Arguments against:

- Damage to credibility of GAAP financial statements
- Reliability
- Consistency
- Comparability
- Encouraging use of speculative fair value
- Litigation—with no agreed pricing model, companies will be sitting ducks for the plaintiffs bar

Recommendation:

- FASB should defer expensing of employee stock options until it or others develop a reliable options-pricing model