Mandatory Expensing of Stock Options:
A Bad Idea Whose Time Has Come

James K. Glassman
Resident Fellow, American Enterprise Institute
And
Host, www.TechCentralStation.com

Testimony before a hearing entitled,
“The Accounting Treatment of Employee Stock Options”
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

June 3, 2003

American Enterprise Institute
1150 17th Street, N.W.
Washington, D.C. 20036
202/862-7198
jglassman@aei.org
Mandatory Expensing of Stock Options: A Bad Idea Whose Time Has Come

Mr. Chairman and members of the subcommittee:

At a time when roughly half of Americans own stocks – either in the form of individual shares or in mutual funds – the Congress has become appropriately concerned about scandals that have shaken the faith of investors.

Today’s hearing focuses on stock options, issued as incentive compensation to chief executives and other managers and employees of publicly traded companies. The hearing is especially timely because the Financial Accounting Standards Board (FASB) is moving quickly toward a new rule that will require that companies expense such options when they are granted. The corporate scandals, which began with massive restatements of earnings in the fall of 2001 by Enron Corp., have put new life into the FASB’s long-term crusade to enact an options expensing rule.

There is concern, however, that FASB is acting in a precipitous fashion and that it is ignoring serious critics of expensing – among them, not only successful corporate leaders but also respected economists and a large number of financial and accounting professionals. Today’s hearing focuses on H.R. 1372, “The Broad-Based Stock Option Transparency Act of 2003,” which would obviate the need for mandatory expensing of options by directing the Securities and Exchange Commission to set new rules for broader disclosure of the effects of options on shareholders and to study the effects of those rules over three years.

I strongly favor the approach in H.R. 1372. In my view, requiring the expensing of stock options would be a serious, even disastrous, mistake, for three reasons:

1. By severely discouraging the use of a powerful incentive for employees at all levels, mandatory expensing is likely to have a dangerously adverse impact on innovation, economic growth and national competitiveness. Options work. They align the interests of managers and shareholders, and they provide a powerful encouragement to innovation and hard work.

---


2 For example, in FASB Comment Letter No. 239, the Association of Financial Professionals, an organization of 14,000 individual members in the financial management profession, wrote: “AFP continues to oppose any requirement that companies record as an expense the fair value of stock options issued by employees. Employee stock options have value to employees and are a cost borne by shareholders, not the company. The cost of stock options is reflected in fully diluted earnings per share, under current accounting rules.”
2. Mandatory expensing of options is likely to confuse and mislead, rather than further enlighten, investors. As Howard Gleckman of Business Week writes, instead of shining a light on a company’s financial health, expensing “may leave hapless investors blinded by a fog of incomprehensible calculations.”

3. As a long-term strategy, mandatory expensing leads accounting policy in precisely the wrong direction. The expensing of stock options has become the prime example of an accounting fetish – a kind of obsession to reduce contingent liabilities and other information about a company to a single number that can be included in earnings statements under GAAP, Generally Accepted Accounting Principles. GAAP earnings statements, in truth, comprise only one view of a company’s health and prospects – and often a distorted one. Investors need many views, and they are being poorly served when policymakers elevate GAAP to a kind of holy status.

I will address each of these issues shortly, but, first, some brief background.

**Background**

An option is literally a choice. The owner of a fixed stock option has the choice of purchasing shares at a fixed time in the future at a price that was fixed at the date it was granted. Often, that price is the market price at the date of the option grant. Therefore, if, by the time of the exercise date, the stock rises above the price at which it was granted, the owner of the option will exercise the option, purchase the stock, then either sell the stock at a profit or hold it for a longer period. It is easy to see how such options help align the interests of managers with those of shareholders, whose main concern is that the value of their stock increase.

Encouraging management to adopt a shareholder-orientation became a major concern in the 1970s when managers, who typically owned little stock, were criticized for using corporate assets for their own benefit and paying scant attention to the interests of institutions and individuals who were the actual owners of their companies. Today, roughly one-third of the compensation of CEOs comes in the form of stock options, up from one-fifth in the 1980s. “Options, as two distinguished economists, William Baumol and Burton Malkiel, recently wrote, “are needed to ensure compatibility of the interests

---


of stockholders and management, whose divergence has recently been so dramatically demonstrated.”

The controversy over the accounting treatment for stock options goes back more than 30 years. In 1972, the Accounting Principles Board issued Opinion No. 25, which stated that no compensation expense need be recognized for fixed stock options granted to employees “because of the concern that stock options could not be reliably valued at the exercise date.”\(^5\) As the use of such options increased, the FASB in 1984 began to reconsider the earlier ruling by its predecessor.\(^6\)

As a result, companies today have two choices. They can adopt the “fair-value” method of treating options and record them as an expense against earnings in the year in which the grant is made, or they can use the “intrinsic-value” method, which discloses the impact on net income in footnotes but not as a charge against reported earnings; if shares are issued to accommodate the exercise of options, then a dilution will occur on that date. Most public companies use the second method.

On March 12, however, the FASB announced it was opening a formal inquiry into requiring the expensing of stock options, making the fair-value method mandatory. The FASB favors such expensing, as does the International Accounting Standards Board (IASB). The FASB and the IASB are eager to bring their standards into convergence within a short time.

**Expensing of Options Imperils Innovation, Growth and Competitiveness**

The FASB has a single mission, which it states this way:

“... to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.”\(^8\)

Federal policymakers have a far broader mission.

For example, they are responsible for encouraging – or at least not discouraging – economic growth, for preserving and increasing jobs, innovation and U.S. competitiveness. Even if the FASB expensing proposal were cogent from an accounting viewpoint (and it is not), it would be the duty of Congress and the executive branch to consider its economic impact. I do not have to remind you. That is your job. You can’t abdicate it. You can’t farm it out to a group of accountants, however well-meaning.

---


\(^7\) Ibid, p. 3.

\(^8\) On the home page of the FASB website: [www.fasb.org](http://www.fasb.org).
As a result of expensing options, many firms – among them America’s most successful and innovative -- will be forced to take massive charges against earnings. “Accounting for [options’] cost by the usual method (the Black-Scholes options-pricing model) would cut tech firms’ reported profits by 70 percent, on some estimates.”

Although they will not alter the firms’ cash flow or actual business prospects from what they are today without mandatory expensing of options, the reduced reported earnings are almost certain to lead to lower stock prices and a higher cost of capital for the firms. Companies, in addition, will be discouraged from issuing options in the future and, in some cases, from listing their shares on the public market. The effect will be to reduce economic growth, U.S. competitiveness and job creation.

While some critics have made wild claims about the uselessness of stock options, the truth is that firms issue options because they work. They represent an efficient method, especially for companies that have limited cash and depend on innovation to prosper, to spur employees at all levels to work harder and accomplish more – and thus to increase the value of the corporation and ultimately its stock price.

Are other incentives, such as cash or perks or the awarding of restricted stock, better incentives than options? Perhaps for some companies, and nearly all firms diversify their incentives beyond cash. But academic research shows that “incentive-intensive” firms favor the use of stock options. No one knows more about incentives at an individual company than the shareholders, the board and the top managers of that firm. When they choose stock options, it is hubristic and foolish for outsiders to second-guess them. Discourage stock options and you discourage a management tool that works for vast numbers of the best American companies. And not just for the CEOs of those companies.

In their book, In the Company of Owners (Basic 2003), Joseph Blasi, Douglas Kruse and Aaron Bernstein construct an index of the 100 largest firms that focus on the Internet. They find that “employees and executives at these firms hold fully a third of their company’s stock. Break that down, and the top five officers hold only 14 percentage points. The other 19 points belong to average employees, 17 of them through options.” The authors argue that “investors and employees alike would gain if companies turned employees into corporate partners by granting stock options to most of the workforce. Most U.S. corporations would be better run, and in the long run most profitable, if America pursued this approach.”

The power of stock options is undeniable. As one of America’s best-known and most successful venture capitalists said recently in Congressional testimony:

10 Typical is Charles Munger, vice chairman of Berkshire Hathaway, Inc., who has said, “In 90 percent of the cases, the handing out of options is excessive.” Quoted in “Options Vigilantes,” by Robert Lenzner, Forbes, Dec. 23, 2002, p. 67.
11 Bryan, S., op. cit.
12 In the Company of Owners: The Truth About Stock Options and Why Every Employee Should Have Them (Basic, 2003), Joseph Biasi, Douglas Kruse and Aaron Bernstein, p. xii.
13 Ibid. p. xi.
“This is a big competitiveness issue…. The innovation economy is where we’re going to get the growth in jobs and the economic security for Americans…. The use of broad-based employee stock ownership, which I contend will disappear if expensing is mandated, …delivers higher returns to the shareowners of the companies who use them, produces higher productivity, higher returns on equity, higher returns on assets, counting the effect of dilution.”

Very simply, if an expensing rule is enacted, it will damage the most dynamic companies in America. Many of them will end their stock-option plans or reduce them significantly. Typical is Advanced Fiber Communications, which stated in a letter to the FASB: “The expensing of options would likely require AFC to discontinue its broad-based stock option plan that helps us to retain and motivate our employees.”

It is the responsibility of elected public officials to weigh these economic costs – and to act.

Expensing of Options Will Confuse and Mislead Investors

Stocks options issued by companies to their employees cannot be accurately valued at the time they are issued. They do not comprise a cash cost, and they have no market price since they cannot be sold. The Black-Scholes method of valuation, the “gold standard” for determining the value today of options subject to future contingencies, applies to options that are tradable – not to options whose ownership is restricted to specific individuals. Consider just one contingency: Many employees will quit before they options can be exercised and lose all their rights to the value of the options. That can’t happen with conventional options purchased in open markets.

“Mark Rubenstein, a finance professor at the University of California at Berkeley, found that some models used to value options require as many as 16 separate variables.” Adjusting only a few of those variables, he found, could produce “huge differences in costs.” For example, in one test, Rubenstein discovered that the value an option for a theoretical $100 stock could range from under $20 to over $300. How valuable is such information to investors? Not very. Can such information be easily manipulated by firms to meet earnings targets? Of course.

Think about how an employee stock option works. If a company issues an option today, when the price of its stock is $50 per share, allowing an employee to buy stock at

---

14 Testimony of John Doerr at hearing of the Committee on Banking, Housing and Urban Affairs, U.S. Senate, May 8, 2003; transcript, at p. 55. Mr. Doerr has been a partner in the venture-capital firm Kleiner Perkins Caufield & Byers since 1980. The firm has sponsored investments in such companies as Compaq, Cypress, Intuit, Macromedia, Lotus, Netscape, Sun Microsystems, and Symantec, which have led to the creation of over 30,000 jobs.

15 FASB Comment Letter No. 185. See also many others (Staples, Altera, Genentech, etc.), including, poignantly, FASB Comment Letter No. 29 from Vermont Teddy Bear Company: “If options are expensed, I can tell you that a small company like the Vermont Teddy Bear Company will no longer grant them.”

16 Quoted in “The Imperfect Science of Valuing Options,” op. cit.
the same $50 in five years time, how can the firm accurately value the option today if it
does not know the price five years from today? It can’t, so it has to guess the value, using
those multiple variables, including interest rates, volatility, earnings, likelihood of job
retention and on and on.

For that guess to have any usefulness to investors, it needs to be updated
frequently. Imagine that the firm originally estimates its stock price at $120 five years
from now and that, after one year, the stock drops to $15. Is it reasonable to believe that
in four years, the price will rise to $120? Probably not. So the company should then
reduce its estimate for the value of the options issued the previous year. Such a reduction
would create increased earnings! So as the firm’s stock price drops, its earnings increase.

Such a perversion reminds us of the purpose of accounting conventions in the first
place – to convey information about the health and prospects of a company for investors
and potential investors. But some information cannot be reduced to a single number. Nor
should it be. The expensing proposal, nevertheless, “serves to satisfy an unquenchable
fetish to see a contingent liability converted, however clumsily and unconvincingly, into
a dollar amount that can be charged against earnings – without (and here’s the fetish
element) caring in the slightest whether it’s helpful or meaningful to do so.”17

In this case, it is not helpful or meaningful to reduce all the information about
options to one number. It is confusing and misleading – and utterly unnecessary.

The current regime gives firms a choice: expense options at the time they are
granted or provide information about the options in the footnotes and record a dilution
when the options are exercised. The information provided today by companies is highly
detailed. Consider, for example, the Form 10-K of Gilead Sciences, Inc., a
biopharmaceutical company based in Foster City, California. The footnote on stock
options extends for four pages. It shows the number of options outstanding, forfeited,
exercised and outstanding for the preceding three years, the weighted average exercise
price of those options and the weighted average fair value of options granted. It then
breaks down, by four price categories, the number of options and their average price and
contractual life. And it presents a table that shows what net income would be if the
company had chosen the alternative method, “fair value” accounting, under FAS 123.
There is more information as well.18 In fact, for typical companies, the information
provided on stock options exceeds information provided for far more important aspects of
the business, including intellectual-property assets, cash compensation expenses, leases,
and investments.

Under the current regime, investors who require information on stock options can
get it – and get it in spades. They can use it – not as a single number – but as a mass of
detail more important than a single number – to make their decisions. Perhaps there could
be even more transparency. Perhaps the disclosures could be made in a more uniform
way. H.R. 1372 addresses such improvements.

Since 1993, I have written a regular financial column for the Washington Post, which is syndicated into many other newspapers, including the International Herald Tribune and the New York Daily News. I have written about investing for many other publications as well, including the Wall Street Journal, Los Angeles Times, The New Republic, The Weekly Standard, Forbes and Worth magazine. I have devoted much of my professional life to educating small investors, so I have a keen interest in ensuring that investors get all the information they need to make good decisions.

Do current accounting rules give them such information? Absolutely. Will expensing help them make better choices? Not at all. Will it confuse them and actually increase the fog surrounding investment decisions? That is highly likely.

Let’s go back to first principles. William A. Sahlman writes, “What an investor cares about most is her percentage claim on the after-tax free cash flow generating capacity of a company. Accounting machinations often affect reported income but not cash flow.” Stock options “affect the percentage claim someone has on a company’s cash flows – the more options outstanding, the lower the potential ownership percentage of the outside investor.” And that effect, of course, is duly noted under the current regime, which both discloses the potential shares that would have to be issued to satisfy the exercise of options and, when the exercise occurs, the actual shares and their dilutive results. In other words, stock options are a cost, not to the company, but to its shareholders.

But wherever the cost is assigned, there is another side to options that is missing in the accounting debate. “Granting stock options,” writes Mr. Sahlman, “will also affect the level of…prospective cash flows.” And this is what investors should care about. “The CEO will have strong incentives to increase value per share because of the stock option grant.”

In other words, whatever cost is assigned to options, it should – in the case of well-run companies – at least be balanced by the likelihood of higher cash flow. “A number of academic studies,” write Baumol and Malkiel, “support the observation that employee stock options have an incentive effect sufficient, or more than sufficient to cover their market value.”

---

20 Ibid.
21 This point was made forcefully by Dennis Powell, chief financial officer of Cisco Systems, at a recent hearing: “In the last six months, I have surveyed in face-to-face meetings over 50 of our largest investors, and I’ve asked them that specific question: Who bears the cost of the options that are outstanding? Is it the company or is it the shareholders? One hundred percent of them recognized that this is a cost that is borne by the shareholders. It’s not an expense of the company. No assets of the company are being used. And that cost comes in the form of dilution.” Committee on Banking, U.S. Senate, May 8, 2003, op. cit., p. 25.
22 Sahlman, op. cit., p. 3.
23 Ibid.
24 Baumol and Malkiel, op. cit.
In short, to force all companies to take an immediate hit against earnings when they grant options would be to misrepresent the firm’s potential for generating future cash flow – and that potential is what investors should care about.

Imagine an expensing requirement going into effect in 2004. As a result, Company A’s reported earnings drop from $2 a share to $1 a share. Is the investor being provided with appropriate information about the health and prospects of this company? But the firm’s profit-generating power has not really been cut in half. Certainly, there will be explanations ensuing from the company and from regulators to assure investors that this earnings reduction shouldn’t be construed as dire. But such assurances will only add to the confusion. Mandatory expensing will have another unintended consequence: it will reduce the opportunities of investors by discouraging firms from risking their shares on the public markets. A major reason companies go public is to create a market for options issued as incentives for employees. If mandatory expensing is enacted, companies that had planned to list will not do so and many companies will stay private, issuing options but using non-market means to value them.

**Expensing Options Is Bad Strategic Accounting Policy**

The worst of the corporate scandals of 2001-02 involved WorldCom, the telecommunications company. At this point, it appears that the firm exaggerated its earnings by about $11 billion, mainly by recording current expenses as capital investments (which are depreciated over time). The WorldCom scandal was disclosed in June 25, 2002, when the firm announced a $3.9 billion restatement of earnings.25 In January 1999, WorldCom stock traded at $75 per share. But, on the day before the restatement, the stock was trading at 83 cents. In other words, the stock had already dropped by nearly 99 percent before the revelations. “While [the] announcement dramatically altered WorldCom’s reported earnings and EBITDA, the accounting restatement did not change its cash flows by a single dollar. Investors had been anticipating and reacting to the value destruction in WorldCom’s operating strategy for years before the accounting restatement.”26

The WorldCom experience is a vivid illustration of how reported earnings – that is, the earnings which would be affected by the change that the FASB proposes – do not comprise the only, or even necessarily the best, set of data used by investors in pricing corporations. The financial definition of the value of a business or investment is “the present value of a stream of future cash flows discounted at an appropriate rate.”27 Again, cash flows, not earnings. At the 2002 annual meeting of his company, Warren Buffett, chairman of Berkshire Hathaway, Inc., and probably the most successful investor of the

25 See WorldCom website. (The company has since been renamed MCI.)
27 Ibid.
20th Century, explained the way to value a company: “You just want to estimate a company’s cash flows over time, discount them back, and buy for less than that.”

As we have seen above, options policy can affect cash flows – and most likely in positive ways, though the effect cannot be precisely determined. What this committee needs to recognize is that, in the investor’s quest to estimate future cash flows, a wide range of information – not merely GAAP earnings – must play a role. Some of that information is contained in the footnotes of 10-K statements and annual reports. Some of it is in cash flow statements. It is my hope that other information, not included in any official reports, will be made available regularly, clearly and promptly by corporations in the future.

My American Enterprise Institute colleague Peter Wallison, with Robert Litan of the Brookings Institution, have argued forcefully that GAAP earnings do not by themselves reflect corporate health and prospects. “GAAP and all other methods of financial reporting, including International Accounting Standards, are inherently malleable, and results can be easily adjusted by corporate managements to meet predetermined targets.” GAAP earnings are also incomplete and often misleading. These facts will not change with mandatory expensing of options.

The response of public officials to the corporate scandals involving Enron, WorldCom and other large companies, has been “to enshrine the audited financial statement…as the principal disclosure of companies whose shares are traded in the public securities markets.” But, in fact, “there is strong evidence that investors are relying on many factors other than audited earnings in making judgments about the value of companies, particularly free cash flow.”

Rather than trying to quantify the unquantifiable, as mandatory expensing attempts to do, accounting policy should follow a different strategic path, in this age when the value of many corporations resides not in buildings and machines but in patents, reputation and the training of employees. Policy needs to move instead toward other, non-GAAP metrics, which can tell investors more.

For example, in 1991, Skandia International Insurance Corporation began “developing ways to measure its largely intangible assets as a supplement to its conventional accounting statements.” Skandia, in 1994, asked, for example, “What price does one assign to creativity, service standards or unique computer systems? Auditors, analysts and accounting people have long lacked instruments and generally accepted norms for accurately valuing service companies and their ‘intellectual
capital.”

In a subsequent report, Skandia cited “hidden assets, consisting of the employees’ competence, computer systems, work processes, trademarks, customer lists, and so on” as particularly valuable to investors’ understanding of the company’s worth and prospects.

Exactly how these metrics will be determined is no easy matter, but it is the direction in which accounting policy must now proceed. And the best way to find the metrics is not through strict rules promulgated by the FASB but by the promotion of competition and innovation in presenting information by corporations. The SEC and Congress need to state clearly that GAAP is not everything, that policymakers want businesses to develop their own best methods for presenting information clearly – and quickly. The FASB proposal is not only economically dangerous and misleading to investors, it is also a relic and an irrelevance in the continuing quest to represent the truth, on paper, about corporations.

But, finally, what of the corporate scandals, which are the reason we are here today?

Those who perpetrated fraud at Enron and WorldCom would not have been in the least deterred by a rule requiring the mandatory expensing of options. They were far too clever. They could easily have manipulated such a rule to serve their own ends. No single accounting rule will ever be able to stop the worst of crooks, just as a law against murder does not prevent murder.

I do not question the desire of the FASB and its supporters, including many in Congress, to restore investor confidence through mandatory expensing. But, in fact, investor confidence will probably be affected negatively, if at all, and the economy will be placed seriously at risk. This subcommittee, under such circumstances, cannot sit idly by and watch the consequences of this misguided accounting policy unfold.

Thank you.

---

34 Ibid.
35 Ibid.