

8-23-2005

Expensing Stock Options

Vipul Dhadda
Pace University

Follow this and additional works at: http://digitalcommons.pace.edu/honorscollege_theses

Recommended Citation

Dhadda, Vipul, "Expensing Stock Options" (2005). *Honors College Theses*. Paper 11.
http://digitalcommons.pace.edu/honorscollege_theses/11

This Article is brought to you for free and open access by the Pforzheimer Honors College at DigitalCommons@Pace. It has been accepted for inclusion in Honors College Theses by an authorized administrator of DigitalCommons@Pace. For more information, please contact rracelis@pace.edu.

FIN 495 Thesis:

Expensing Stock Options

Prepared by: Vipul Dhadha

Mentor: Dr. Jouahn Nam

**Submitted to: Honors and LLSP
Department,
Pace University**

Date: May 17, 2005

Table of Contents

Chapter 1	Expensing Stock Options: An Overview		3
	The Thesis Prupose	6	
Chapter 2	Putting Stock Options Under a Microscope		7
	A. Definition	7	
	B. Types of Stock Options	10	
	C. History of Stock Options	12	
	D. SFAS 123 and SFAS 123(R)	15	
Chapter 3	Expensing Stock Options: The Merits		18
Chapter 4	Expensing Stock Options: The Demerits		23
Chapter 5	Expensing and Investors' Reactions		27
	A. EPS Effect on Specific Industries	28	
	B. Notable Mentions	29	
	Appendix A	32	
Chapter 6	Expensing and Companies' Reaction		34
	A. Stock Options to Remain Primary Long-Term Incentive Vehicle?	35	
	B. Plan to Place More Emphasis on Other Forms of Long-Term Compensation?	36	
	C. Plan to Reduce Eligibility for Long-Term Compensation?	37	
Chapter 7	Conclusion		39
	<i>Works Cited</i>		41

Chapter 1

Expensing Stock Options: An Overview

On April 15, 2005, when many people were pushing themselves to comply with the Uncle Sam's tax-filing deadline, Securities and Exchange Commission (SEC) gave some sigh of relief to the US companies by announcing a new deadline for expensing stock options in financial statements as the next fiscal year after June 15, 2005, for large companies and December 15, 2005, for small companies. The Connecticut based Financial Accounting Standards Board (FASB) had earlier announced the deadline as the next fiscal quarter following June 15, 2005, for all the large companies and by Dec 15, 2005, for all the small companies to expense stock options in their financial statements. However, this relief is short lived for all the corporations.

Before talking much about the implications of the deadlines, it is important to put forward what exactly is expensing stock options and what is the fuss surrounding it? During the 1990's economic boom, many companies compensated their employees' performances by issuing stock options to appreciate their laudable performances and, more significantly, to link them to the company's stock prices. FASB gave these companies a choice of **either** expensing stock options **or** recognizing them in footnotes to the financial statements. For profitable reasons, many companies rationally chose only to recognize stock options in the footnotes. Nevertheless, the massive corrective measures being implemented in wake of the colossal debacles of companies like Enron and WorldCom, which were largely triggered by manipulative accounting and some cracks in the system, FASB has now set a mandatory deadline for companies to show stock options as an expense in their financial statements. This mandatory requirement is an amendment to **either/or** provision of Statement of Financial Accounting Standards (SFAS) 123,

Accounting for Stock Based Compensation, and has been embodied as SFAS 123(R), Share-Based Payment. SFAS 123(R) now requires all share-based compensation awards granted, modified or settled after December 15, 1994, to be accounted for using the fair value method of accounting effective of the set deadlines.

FASB's decision has been widely appreciated and, simultaneously, contested by many people in the business world. Like any coin with two sides, there is head and tail to expensing stock options, too. Long before FASB's decision, proponents and opponents have head-to-head argued over the issue of expensing. Many companies have been lobbying against the proposed amendment, disputing that its implementation will hurt the competitiveness of American industry. Some major points that lobbyists have raised against the expensing requirements are:

- Companies in technology industry rely heavily on stock options to attract and retain key employees and will get hit the hardest by expensing.
- FASB's stock options valuation methods, including the omnipresent Black-Scholes and Binomial-distribution models, overstate the cost of options and are expensively complex to use.
- FASB's decision lacks *field testing*, hence, not backed with material benefits and facts.
- Expensing may cause the domestic job loss and expedite the outsourcing wave.
- The existing accounting standards for the stock options are adequate enough, and, thus, the new standards are redundant.
- It is only cash flow that matters and non-cash incentives should not be expensed.

Other than the aforementioned points that are loudly standing out against the proposed rule, antagonists have come up with various arguments from time to time. One of the most active

lobbyists over the years against the rule has been a collection of some major companies called the International Employee Stock Options Coalition. However, as solid of a fight such opponents have raised, an equally solid challenge has been given by the proponents of the stock options expensing.

The proponents vehemently argue and praise that the proposed rule will divest many companies of their tool to violate integrity in financial reporting. SFAS 123(R) has been backed as being in the shareholders' best interest because:

- It will reduce the dilution effect on the value of company's stock.
- It will level the playing field between stock option grants and other forms of stock and cash compensation in financial statements' reporting because, currently, restricted stock grants are considered an expense and stock option grants are not.
- Contrary to the opponents' hypothesis, the Black-Scholes model and lattice option-pricing model (binomial model) are touted as the best instruments available to measure the fair value of stock options because they have evolved over the years and are used by some major companies around the world.
- The proposed standards provide parity with International Accounting Standards Board's (IASB) treatment for share based payment.
- No-expense artificially inflates stock prices and has contributed to the recent financial "bubble burst."
- It will improve comparability.

Over the years, some rational and concrete arguments mentioned above have been the basis of the fight between the opposing sides. Although FASB has set the deadline to comply

with its proposed amendment to SFAS 123(R) rule, many companies are still reluctant in accepting it in its entirety, and that is why the struggle is still on.

The Thesis Purpose

The reason I chose Expensing Stock Options as the topic of thesis is because the importance and implications of the problem of Expensing Stock Options are related to a vast majority of people. With this thesis, I want to provide a thorough understanding of the problem by illustrating essential terminology, going into the history of stock options, detailing SFAS 123(R) requirements, and comparing the merits and demerits of the problem. The most important part of my thesis is to focus on the ultimate essence of the debate related to the problem, which is, the effect expensing would have on investors and stock prices. So far, investors have been very indifferent to the problem. To estimate investors' reaction, in this thesis I have researched and analyzed Earnings Per Share of 73 S&P 500 companies that have voluntarily decided to show the fair value expense of stock options in their footnote disclosures. Another pivotal segment in this thesis is to focus on how all companies would react to expensing requirement. To estimate this, I have covered and studied a survey done by Dow Jones Company on 150 companies that have, again, voluntarily decided to expense stock options. Irrespective of these two researches, it would be very appealing to see the actual response of investors and companies' panacea once the stock options are begun to be expensed under FASB's new requirement.

Chapter 2

Putting Stock Options Under a Microscope

The first chapter is an overview of the problem of expensing stock options. This chapter brings forth the various microscopic details related to stock options in order to understand the technical jargon of the problem from the very within.

A. Definition

There are plenty of financial instruments available for investors in the contemporary financial markets. One of these instruments is called an **option**. An **option** is a derivative security that represents the right, but not the obligation, to buy or sell a specified amount of an underlying security, commodity, currency, index, or debt at a specified price (the strike price) within a specified period of time. In the preceding definition, the term ‘derivative security’ is used. To understand option securities, it is first important to comprehend the term derivative security. A derivative security is simply a financial instrument whose value is derived from that of another security, financial index or rate¹. Out of the vast pool of derivative securities available today, some of the major ones are:

- Options
- Futures contracts
- Swaps
- Hybrids

Since the focus over here is on options, other derivative securities will not be defined. To elaborate options, it is essential to recognize the two parties – a buyer, called the holder, and a

¹ Yahoo Financial Glossary, Derivative Security < <http://biz.yahoo.com/f/g/dd.html>>

seller, known as the writer – that are involved in any type of option transaction. An option contract is created when the holder and writer come together to create an agreement between themselves regarding their future financial behaviors. If the option contract is exercised, the writer is responsible for fulfilling the terms of the contract by delivering the shares of the appropriate party.

The flexible and controllable nature of options provides many companies to use it as a tool to their benefits. In fact, during the 1990's economic boom, many companies around the world used a form of options called **stock options** as a major financial instrument to compensate their employees, especially their top level managers. **A stock option is defined as a specific type of an option in which the *underlier* (a security or commodity which is the subject to delivery upon exercise of an option contract) is the common stock of a corporation, giving the holder the right to buy or sell its stock, at a specified price, by a specific date.** Stock options are also called equity options.

Worldwide, many companies have used stock options as a mutually beneficial tool. The practice by companies of awarding equity shares, equity share options, or other equity instruments to their key personnel is known as **share-based payment**. Share-based payment helps both companies and employees. It is offered mainly to companies' inseparable top level managers as a way to tie their compensation to the success of the company. Since any corporation's ultimate goal is the maximization of shareholders' wealth, corporations want to ensure that there is no compromise in any action leading towards achieving this goal. Agency problem, conflict of interests between managers and shareholders, is a major hurdle for many corporations that strive to accomplish their ultimate goal. To counter this problem, they often issue stock options to their key managers and decision makers in order to bond their personal

financial success with the company's stock performance. In effect, this strategy helps companies to tame the ever-intimidating agency problem. Companies usually summarize issuing of stock options for following reasons:

- They want to attract and keep good workers.
- They want their employees to feel like owners or partners in the business.
- They want to hire skilled workers by offering compensation that goes beyond a salary. This is especially true in start-up companies that want to hold on to as much cash as possible.

How do Stock Options work?

Having gained the conceptual understanding of stock options and share-based payment, it is now essential to fully understand the process of how stock-options and share-based payment work. The functionality of stock options depends on the behaviors of the holders (employees) and the writers (companies). Corporations engage in legal contracts with their key employees that grant them the right to purchase stock in the company at a future date. The price and expiration date of the stock option is set while scripting the legal contract. Hence, if the option price is surpassed by the company's current share price within the legal period, the holding employees may exercise the stock option in order to gain from a higher share price of the company in the market. The price that companies set on the issued stocks (called the **grant** or **strike price**) is discounted and is usually the market price of the stock at the time the employee is given the options. Since those options cannot be exercised for some time, the hope is that the price of the shares will go up so that selling them later at higher market price will yield a profit. Nonetheless, the usage of stock options and making profits depend fully on the **vesting period**. The following is a pragmatic example on how exactly stock options work:

Say, Company A gives or grants one of its employees options to buy 10 shares of stock at \$10 per share. The employee can exercise the options after one year. At the end of one year, the share price is expected to be either \$5 or \$15. If the price hits \$5 in one year, the employee (holder) would obviously not exercise the options because of the \$5 loss per share. By the same token, if the price hits \$15, the employee can exercise the options and convert them to stocks. She may then sell those converted stocks at \$15 to earn a profit of \$5 per share. Some of the other alternatives that she may use are:

- Sell some of the stock after the waiting period and keep some to sell later. Again, she has to buy the stock at \$10 a share first.
- She may also change all the options to stock, buy it at the discounted price and keep it with the anticipation of selling it later with a higher profit on each share.

An important factor in stock option is the vesting period. The vesting period determines when and how exactly can the options be used. An example of a vesting period schedule may be something like this: a spread of four years, with one-fourth of total options vested each year. This means that only 25% of options can be bought at the strike price at the end of each year until the options are fully vested by fourth year.

B. Types of Stock Options:

There is a wide array of stock option grants available for companies to use as a component in share-based payments. The following glossary of terms lists the definition of these various kinds of stock-options grants²:

² ABVFN Financial Glossary, Options <http://www.advfn.com/money-words_term_3477_option.html>

- Restricted Stocks: Restricted Stocks are grants of shares of stock, subject to restrictions on sale and risk of forfeiture until vested by continued employment or by reaching a performance target. This type is one of the most commonly used types by the companies.
- Incentive Stock Options (ISOs): ISOs, also termed as qualified stock options, entitles the *optionee* to favorable tax treatment. Such an option is free from regular tax at the date of grant and the date of exercise. If two holding period tests are met – two years between grant date and sale date and one year between the exercise date and sale date – the profit on the option qualifies as a long-term capital gain rather than ordinary income. If the holding periods are not met, there is a "disqualifying disposition." Once exercised, the value of the options may be taxed under the alternative minimum tax, whether the shares are sold or not. Companies use ISOs heavily as well.
- Nonqualified Option: Nonqualified Option is an employee stock option not meeting the Internal Revenue Service criteria for ISOs, and therefore triggering a tax upon exercise. This type of option requires withholding of state and federal income tax, Medicare, and FICA on the excess of the fair market value over the exercise price on the exercise date.
- Discount Stock Options: Kind of options that have an exercise price below market value at the time of grant are called Discount Stock Options. They are often used when cash compensation is to be deferred by converting it into stock options.
- Performance Options: Options that have some aspect of their vesting or exercise price subject to specified performance criteria are called Performance Options. Options with performance vesting provisions generally become exercisable at or near the end

of the option term, regardless of performance, to secure favorable accounting treatment.

- Premium Stock Options: Premium Stock Options are the ones that have an exercise price above market value at the time of grant.
- 'Phantom' Options: Phantom Option is a grant in which the recipient is not issued actual shares of stock on the grant date, but receives an account credited with a certain number of hypothetical shares. The value of the account increases or decreases over time based on the appreciation or depreciation of the stock price and the crediting of phantom dividends. Payout may be settled at a predetermined date in cash or stock.

Companies have used these various types of stock options to compensate their employees over the past decade. These types provide companies with a pool of alternatives to decorate their employees' compensation structure.

C. History of Stock Options and Expensing

For many companies, stock options have acted like a magic wand. Employees have received options that may someday be worth millions, but unlike salary or bonuses, they do not show up as an expense on the income statement. The use of options in share-based payments has exploded tremendously in the last 13 years. From 1992 to 2002 alone, the number of employees receiving options burgeoned from 1 million to 10 million, according a statistic from Business Week. Although different levels of employees are receiving stock options these days, most of the options are still vested to CEOs of the companies because they hold the very essential decision making powers. According to one more statistic on stock options, The Economist has ascertained

that stock options accounted for 58 percent of CEOs' pays in the year 2001. 58% is a huge number in CEOs' salaries. The extent by which equity options can be profitable for the CEOs is demonstrated by the fact of \$56 million realized by Richard D. Fairbank, the CEO of Capital One Financial Corporation, earlier this year in March.³ It is not that only CEOs or key decision makers get large equity options as part of their salaries; many companies have granted options to most of their employees. Such companies are low on cash flow and thus use stock options as an incentive, rather than cash bonuses. Companies in technology industry are the ones that usually run low in free cash flow. In 1990s, especially, equity options provided an ideal nostrum to this tech sector's predicament as it worked as an incentive to retain their intellectual manpower without spending anything. For this reason, the tech sector has been ferociously fighting against FASB's SFAS 123(R) of expensing stock options.

Initially, the question of whether or not to expense employee stock options arose in the 1970s. In 1972, the Accounting Principles Board (APB) adopted an accounting method – APB No. 25 – that did not require options expensing. The main reason that APB No. 25 did not require option expensing was that a reasonable method of valuing the options did not exist. However, with the advent of the Black-Scholes model – which was published in the *Journal of Political Economy* in 1973, and other types of valuation models – the question on valuing stock options blurred and many companies increasingly issued stock options to their top personnel. In 1991, FASB floated a draft of a proposed new accounting standard. FASB indicated that a level of playing field did not exist in the reporting of management incentive compensation. Companies that reward with cash bonuses were required to report a compensation expense for the amount of the bonus paid, thereby reducing net income. In contrast, FASB stated, companies that rewarded management with stock options did not have a comparable reduction in net income. FASB's

³ Wall Street Journal (Eastern Edition), *Financial Services Brief*, (New York, NY: March 22, 2005), pg 1.

proposal was to record an expense of an equity option at “fair value of the option.” The pricing method was not to be mandated. Nevertheless, the ones that were highly suggested were the most widespread used Black-Scholes and binomial-option pricing models. Subsequent to the floating of the draft proposal by FASB in 1991, many hi-tech companies voiced strong objection. They argued that employee equity options were the primary incentive they had to recruit technology professionals and motivate various levels of employees. The opposition by technology companies did not immediately influence FASB, and the development of a proposed standard requiring expensing continued. At that point, hi-tech companies began contacting their Congressional representatives. Many members of Congress sided with the hi-tech companies and moved to have FASB back off on their proposal. Following a storm of debate and congressional lobbying, FASB was forced to rescind the proposed rule in late 1994. In repose, nevertheless, FASB revised its proposal into FASB 123 and required companies to have equity option expense as a footnote disclosure and its pro-forma effect on net income and earnings per share if an expense had been recorded. The following table summarizes some vital announcements made by FASB related to stock options expensing problem:

Announcements’ Timeline

Date 1	6/30/1993	FASB issues proposal to expense stock options
Date 3	12/14/1994	FASB rescinds proposed rule
Date 4	7/6/1995	FASB requires footnote disclosure
Date 5	March 2003	Second project is launched to consider expensing options.
Date 6	3/31/2004	FASB issues Exposure Draft on Share-Based Payment
Date 7	12/16/2004	FASB issues SFAS 123(R)
Date 8	6/15/2005	<i>Deadline for large public entities to begin expensing share based payment</i>
Date 9	12/15/2005	<i>Deadline for small non-public entities to begin expensing share-based payment</i>

D. SFAS 123 and SFAS 123(R)

It is very much imminent from the first chapter and history of stock options expensing that the entire problem encircles around the two critical accounting rules set by FASB – SFAS 123 and SFAS 123(R). To move on with the thesis, it is thereby pivotal to discuss these two accounting standards.

SFAS 123 – Accounting for Stock Based Compensation

Issued in October, 1995, the Statement No. 123 establishes financial accounting and reporting standards for stock-based employee compensation plans. Those plans include all arrangements by which employees receive shares of stock or other equity instruments of the employer or the employer incurs liabilities to employees in amounts based on the price of the employer's stock. Some of the examples are stock purchase plans, stock options, restricted stock, and stock appreciation right, This Statement also applies to transaction in which an entity issues its equity instruments to acquire goods or services from non-employees. Those transactions must be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. It requires for equity options to be either recognized in footnote disclosure or expensed in income statements at fair value. When disclosed in footnotes to financial statements, the Statement requires that the pro-forma effect of equity based compensation should be included. It should show the pro-forma net income and pro-forma earnings per share.

This Statement defines the *fair value based method* of accounting for an employee stock option or similar equity instrument and encourages all entities to adopt that method for all of their employee equity compensation plans. However, it also allows an entity to continue to measure compensation cost for those plans using the *intrinsic value based method* of accounting

prescribed by APB Opinion No. 25, Accounting for Stock Issued to Employees. The fair value for stock options is determined using an option-pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividends on it, and the risk-free interest rate over the expected life of the option. Non-public entities are permitted to exclude the volatility factor in estimating the value of their stock options. The fair value of an option estimated at the grant date is not subsequently adjusted for changes in the price of the underlying stock or its volatility, the life of the option, dividends on the stock, or the risk-free interest rate.⁴

SFAS 123(Revised 2004) – Stock-Based Payment

SFAS 123(R) was issued in December of 2004 by FASB. Under the revised Statement, public entities are required to measure the cost of employee services received in exchange for an award of equity instruments, with limited exception, based on the award's grant-date fair value. Under this Statement, the cost will be recognized over the period during which an employee is required to provide service in exchange for the award—the requisite service period, usually the vesting period. In contrast to SFAS 123, this Statement eliminates the ability to account for share-based compensation transactions under the intrinsic-value method utilizing APB Opinion No. 25 and requires companies to expense all of the options at fair value in income statements.

SFAS 123(R) says that a public entity will initially measure the cost of employee services received in exchange of liability instruments based on its current fair value; the award's fair value will be measured again subsequently at each reporting date through the settlement date. Changes in fair value during the requisite service period will be recognized as compensation cost over that period. It requires that the fair value of instruments be estimated using a valuation

⁴ Financial Accounting Standards Board, Statement No. 123. <<http://www.fasb.org/st/summary/stsum123.shtml>>

techniques that is applied in a manner consistent with fair value measurement objective and the other requirement of the revised Statement based on established principles of financial economic theory generally that are applied in that field. Although the valuation techniques have not been standardized, FASB has, nonetheless, stressed the importance of Black-Scholes and binomial-optional pricing models. Excess tax benefits are also required to be recognized as an addition to paid-in capital under this Statement.⁵

Ever since the issuance of SFAS 123(R), many companies are pushing hard to comply with its rules on time. Although the deadlines are of June 15 and December 15, some corporations have pro-actively started to expense stock options in financial statements. As of December, 2004, as many as 750 firms were expensing equity options.⁶ Many firms, nevertheless, are still putting their fight against this Statement by trying to propose diverging instruments that try to mimic employee stock options in a bid to reduce the impact of this historical accounting shift.

⁵ FASB, Statement No. 123(R). < <http://www.fasb.org/st/summary/stsum123r.shtml>>

⁶ Tom Fowler, Knight Ridder Tribune Business News (Washington: Dec 17, 2004), pg 1.

Chapter 3

Expensing Stock Options: The Merits

As pointed before, there is an ongoing heated debate over the benefits and losses of expensing stock options. Supporters and detractors have incessantly fought for the past few years. This chapter brings forth a vast list of merits that supporters have allegedly claimed in favor of expensing stock options and SFAS 123(R). It will also be pointed out in the following discussion on how investors will be benefited from expensing.

1) Tames Integrity Violation: Post-Enron era has been very dramatic in business world in the United States. The unprecedented corporate debacles since 2001 of companies like Enron and WorldCom have stunned and stalled everyone from stock market to general public. Unprecedented debacles have triggered unprecedented measures that are being taken to fix the beleaguered system. In wake of these business catastrophes, there has been a critical reformation in every business sector. Proper ethical conduct has become at the top of the agenda for government, regulators, law makers, watchdogs, investors, board of directors, and, above all, the general public. Sarbanes-Oxley Act of 2002 has taken the responsibility and accountability levels to a much austere point. It covers and audits each and every business sector from information systems' control environment to financial statements reporting. It now requires business managers to sign and authorize almost every financial paper work, so that it is easier to bring in justice later in case of any biased manipulations and wrong doings.

SFAS 123(R) works under the shadows of Sarbanes-Oxley. With expensing of stock options, it would become extremely bumpy for corrupt managers to play with integrity of financial statements. Expensing would cut-short the room for executives to inflate or deflate

financial statements according to their personal unethical benefits. Warren Buffett, a highly regarded investment guru and owner of Berkshire Hathaway, once wrote in the New York Times:

“There is a crisis of confidence today about corporate earnings reports and the credibility of chief executives. And it’s justified.

For many years, I’ve had little confidence in the earnings numbers reported by most corporations. I’m not talking about Enron and WorldCom – examples of outright crookedness. Rather, I am referring to the legal, but improper, accounting methods used by chief executives to inflate reported earnings.”⁷

Other than Warren Buffett, even Allan Greenspan, the Federal Reserve Board Chairman, has supported expensing decision by saying, “The failure to expense stock option grants has introduced a significant distortion in reported earnings.”⁸ Their support for expensing is significant because these people are critically respected for their business acumen among the investors. For investors’ benefit, expensing is likely to tame integrity violation in financial statements reporting.

2) Improves Comparability: Although a number of entities have voluntarily adopted the fair-value-based accounting method in Statement 123, it would have been very unlikely in the foreseeable future that all entities would have done that had SFAS 123(R) not been introduced. Such voluntarily adoption has improved the transparency of financial statements, however, it has also created less comparability between the entities that expense and that do not. Therefore, the expensing decision is a sincere and strategic effort to reduce disparity across all the entities for investors to compare financial statements on a same platform.

⁷ Warren Buffett, New York Times, *Op-Ed piece* (New York: July 24, 2002).

⁸ Allan Greenspan, Globe and Mail, “Expensing Options is a Bandwagon Worth Joining.” (August 16, 2002).

- 3) International Convergence: FASB's SFAS 123(R) converges with international treatment for share-based payments. Effective of the beginning of this year, IASB's new rule, International Financial Reporting Standards 2 (IFRS2), has required all entities to expense share based payments using the fair value method.⁹ Requirements of SFAS 123(R) very much converges with IFRS2 and hence create comparability with international entities as well. Again, investors would be benefited by being able to compare financial statements across the international entities also for their outside investment decisions.
- 4) Levels the Playing Field: The current accounting standards require companies to recognize the cost of cash bonuses given to employees as incentive or reward in income statement. Thus, the incentive cash bonuses reduce earnings and investors get to see the loads of expenses born by the companies. To bring in more transparency in financial reporting of share based incentives to employees, the expensing of stock options is an ideal decision. In his New York Times article, Warren Buffett also pointed out, "When a company gives something of value to its employees in return for their services, it is clearly a compensation expense. And if expenses don't belong in the earnings statement, where in the world do they belong."¹⁰ In light of this statement, expensing would enable the investors to fathom the entire loads of companies' expenses for them to make wiser decisions on complete and reliable information.
- 5) Reduces Artificial Inflation of Stock prices: It has been touted by the supporters that no-expensing of equity options artificially inflates companies' earnings. Some companies that do not expense regularly deduct the cost of exercised stock options when filing tax returns. It has been estimated that US companies were able to get tax deductions of a remarkable \$56

⁹ ACCA. "Share based payments." <<http://www.accaglobal.com/ifrs/technical/relevantarticles/1123867>>

¹⁰ Buffett. July 24, 2002.

billion for stock options. Enron took a whopping tax deduction of \$1.4 billion in 2000 alone for stock options given to top executives.¹¹ At the same time when companies take tax deductions, they do not report cost of stock options in earnings statements. This artificially inflates the companies' net income and earnings per share. The inflated EPS gives a misleading picture to investors and stock prices move upwards on encouragingly superficial financial figures. Harshly attacking such inflated financial reporting environment, some supporters have gone as far as saying that this has contributed to the recent "financial bubble burst."

- 6) Less Dilution of Company' Stock Value: To provide incentive to employees, companies have increasingly issued options. Nonetheless, they get unaware of the fact that this reduces their stock value. When more and more company shares are printed, each share is worth less because the EPS is reduced. So, every time equity options are granted to employees, the value of outstanding shares declines, which is not good from investors' point of view. Expensing curtails this dilution. Companies will have to make a choice between increasing their expenses or increasingly grant options. If they stick with granting, their expenses will grow steeper and steeper. Hence, they will be practically inclined to not issue options ceaselessly.
- 7) Availability of Proper Valuation Techniques: Contrary to detractors of expensing argument, people favoring it rely on the accuracy of valuation techniques used to value options. Although in SFAS 123(R) FASB has not standardized any particular valuation techniques, it has, however, indicated that the Black-Scholes and binomial option pricing models may provide accurate calculation of options at fair value. These models have evolved over the

¹¹ Citizen Works, "What stock options are and why they should be expensed?"
<<http://www.citizenworks.org/corp/options/talking-points.php#taxes> >

years and are being used by some companies already. For this reason, proponents have blasted detractors' argument of non-availability of proper valuation methods for valuing options.

These merits of expensing stock options provide a picture of one-side of the problem. Some of the key entities that have waged their support for FASB's decision include the CFA Institute, Council of Institutional Investors, the Corporate Library, and the National Center for Employee Ownership. With the impending deadlines approaching fast, many companies have started to realize the importance of expensing and have voluntarily started to incorporate SFAS 123(R) in their financial statements to prepare themselves for the accounting shift. The accounting shift is at least likely to bring in the aforementioned benefits for investors, and supporters are interestingly looking forward to it in order to see how much accurate their predictions have been.

Chapter 4

Expensing Stock Options: The Demerits

Like every coin has two aspects, the problem of expensing stock options has its own head and tail. The merits have been equally contested with the demerits. Opponents have regularly come out with some strong factual points on how expensing could jeopardize the future of financial reporting. With the following discussion, some key demerits will be brought forward. Parallel to the merits' discussion, it will also be revealed on how expensing could harm the investors.

1) Hurt the Competitiveness of American Industry: Expensing of options is set to wax the incurred companies' expenses, and in effect, wane the net income. With American economy trying to come out of its past few years' woes, expensing may hit all the industries. The reduced net income and EPS will result in lower stock prices and investors will get indisposed of taking big investment decisions in wake of the lower stock prices. For instance, a study by Bear Stearns researchers estimated an average reduction of 8% and 42% in 2003 income of the S&P 500 and NASDAQ 100, respectively, had these companies been using the fair value method to expense employee options.¹²

The expensing rule will also hurt small startup firms that lack the cash to attract top talent and depend on non-cash bearing incentives, such as equity options. Such a rule may undermine entrepreneurship. Furthermore, not just small companies but also big companies rely heavily on providing incentives to their intellectual manpower through options. Expensing would deter this incentive and curtail American innovation and creativity, variables of American dominance. In effect, the overall competitiveness of the American

¹² Global Power Report (New York: December 23, 2004), pg 7.

industry may have to weather a huge blow, and the economy may revert back to its money losing ways again.

- 2) Complex and Expensive Valuation Techniques: The two most common methods of option valuation – the Black-Scholes and binomial-option pricing models – are extremely complex for companies to use. It has been reported that approximately 90% of US firms are currently using the Black-Scholes model, or some variation of it. Most others use the binomial-option pricing model.¹³ These models require the user to forecast the future, and models' output can be sensitive to the input assumptions. The requirement of forecasting the future makes these models very subjective, and hence, there may be compromise to reliability and comparability of financial information. Moreover, the complexity nature of these models makes them really expensive for companies to use them. All of these factors will portray a burdensome compliance issue for companies and their net earnings will take a hit, which may deter investors from investing in such companies. The complexity issues may also create confusion among the investors on the way each company calculates fair value of its options.
- 3) Lack of Field Testing: FASB usually *field tests* all its proposals before making any changes to the existing standards or adding the new ones. *Field test* is the term used by FASB to describe a formal application of a proposed Statement by a group of entities to their particular circumstances. A *field test* may involve having the participating entities prepare financial statements in accordance with the proposal to accounting for a particular type of transaction. One of the major demerits of SFAS 123(R) is that this Statement lacks FASB's *field testing* and is not backed with practical and factual application. FASB has only done *field visit* before setting the proposal for expensing into a standard. The term *field visit* is used by FASB to describe meetings with companies or firms to discuss a possible change in

¹³ Joan Harrison, "Challenges for Companies Valuing Options," Mergers & Acquisitions (November 2002).

the way a transaction, such as a share-based payment transaction, is accounted for. From investors' perspective, lack of *field testing* for SFAS 123(R) signifies a possibility of some cracks that may exist in the standard and may get exposed in the future.

- 4) Job Loss: It has been already mentioned that expensing equity options will create an additional burden of expenses on companies and will hurt net income. The burden will be mostly felt by the tech sector as it has high number of options in its employees' hands. Once the expensing starts, the tech companies will have to look for alternative methods to cut their costs. With the recent spate of outsourcing among the US firms that are looking to get cheaper workforce outside the country's boundaries, expensing may provide another reason for such tech companies to export jobs offshore, and the general public will feel the pressure of it. John T. Chambers, the CEO of networking giant Cisco Systems, was once quoted saying against the expensing and on job loss effect as, "I think it will impact whether we grow headcount again to the same extent in the US or not."¹⁴
- 5) Cash Flow is the King: One of the arguments in favor of expensing has been that it would bring in transparency in financial statements because companies would have recognize all sorts of expenses that they bear, irrespective of whether they are in cash or not. Proponents contend that this would help analysts and investors get a complete picture of a company's financial position. However, it is stressfully taught in schools that an essential step in financial valuations is to determine the cash flow. Since stock options are virtually worthless and have no cash flow attached, the very core of the financial principles and calculations are challenged by the decision of expensing stock options. This makes analysts and investors consider something that has not been expensed in cash.

¹⁴ Business Week Online, "Will Expensing Cost the US Jobs?"
<http://www.businessweek.com/careers/content/dec2003/ca20031230_2068_ca004.htm>

6) Adequacy of Existing Standards: The current accounting standards under SFAS 123 require companies to either expense options at fair value or show the pro-forma effect of options fair value on net income and EPS in footnote disclosures. Again, if the purpose of expensing is to bring in transparency, the existing standards serve this purpose to most extent. Investors may make references to footnote disclosures related to options and decide for themselves the financial position of a firm to make their investment decisions.

The demerits of expensing equity options equally challenge the merits of it, and this has been the reason of a balanced debate between the opposing sides over the years. Some key opponents that have kept the fight alive include the Business Roundtable, a coalition of 150 CEOs of the leading corporations, the US Chamber of Commerce, Information Technology Association of America, and TechNet. The head-to-head fight had kept the problem to a virtual standstill until FASB announced SFAS 123(R). Nevertheless, the FASB's announcement made opponents to work rigorously, and their diligent efforts brought them a little respite as the US House of Representatives passed a bill in July of 2004 that requires expensing of options for only the top five executives of publicly traded companies.

Chapter 5

Expensing and Investors' Reaction

The merits and demerits of expensing equity options cover the entire problem and associated facts and assumptions related to it. These facts and assumptions encircle around the gist of the problem, nevertheless, which is based on two very pivotal questions:

- a) What effect would expensing of equity options have on stock prices and investors?
- b) How would companies react to the expensing equity options' requirement by FASB?

Over the years, the proponents and opponents have tried to answer these two invaluable questions with their respective cases. This chapter covers the first question, and to answer it, I have researched and analyzed 73 companies that are listed on S&P 500 Index and have voluntarily decided to disclose the stock options' expense in footnotes to financial statements using the fair value method of accounting. In studying these companies that belong to different industry groups, my purpose was to focus on investors' reaction to expensing using the fair value method. Since investors' directly react to stock prices, and that, in effect, are dependent on companies' EPS, I focused my study basically on the EPS of these 73 companies. Some of the necessary information that I took into consideration includes companies' reported EPS in income statement and pro-forma EPS (adjusted for stock options expense) for the year 2004. With these two figures, I took the differences of both EPS numbers for all companies and then calculated percentage reduction in the EPS by dividing the difference by the reported EPS. The percentage reduction in EPS shows how each company gets affected by expensing at fair value. The EPS statistic is indispensably significant for investors because they value most of their investment decisions on its basis. A higher EPS means a profitable situation for investors and a vice versa. Therefore, the following study on EPS effect due to expensing equity options would throw some

light on investors' reaction when all companies file financial statements under the FASB's rule of SFAS 123(R).

A. EPS Effect on Specific Industries

It has been mentioned before that expensing would hit the technology industry the hardest because of the huge amounts of options that have been issued by the technology companies. As true as this fact is, it is pivotal to say that expensing would have its sporadic effects on each industry. The following table summarizes eleven major industries and the percentage reduction in each industry's average EPS:

Effect of Expensing on Industry's Average EPS			
Industry	Number of Companies Considered		% Reduction in Avg EPS
Utilities	5	7%	6.35%
Technology	2	3%	3.59%
Capital Goods	4	5%	3.57%
Transportation	2	3%	2.70%
Consumer Cyclical	8	11%	2.21%
Services	14	19%	2.06%
Basic Materials	3	4%	1.73%
Financial	25	34%	1.55%
Conglomerates	2	3%	0.67%
Energy	6	8%	0.16%
Consumer Non-Cyclical	2	3%	0.10%
Total # of Companies	73	100%	
<i>The entire list of all 73 companies is given in Appendix A at the end of this chapter.</i>			

The table has been sorted out with decreasing percentages. It shows how some industries' average EPS get seriously affected by expensing, while others remain literally indifferent. One

important factor to consider over here is the number of companies studied in each industry. For instance, in Services and Financial industries, a significantly larger number of companies – 14 and 25, respectively – have been researched. The reason these industries do not show a high percentage reduction in EPS is because more companies have been considered and that balances the overall effect of EPS to some extent. It is, nevertheless, good to have more companies for study as it shows a more transparent picture of the industry's average. On the contrary, fewer companies may reflect a lopsided effect on the industry.

Barring the aforementioned factor, it can be analyzed from the table that Utilities, Technology, and Capital Goods industries would probably be the worst affected by expensing of equity options. This shows that these industries' compensation structures have large amounts of option grants because of the non-availability of free cash flow. It can thus be forecasted that the companies in these industries would considerably wane the number of option grants to their employees (*this also answers the second question on the companies' reaction to expensing*). Consequently, this would trigger an environment of less incentive plans offered to employees and the overall employee productivity may take a nosedive. The reduced productivity means a discouraging performance for the company, which may very well be reflected in the financial figures after some time. The investors, for this reason, may not invest in such industries or some companies in such industries.

B. Notable Mentions

It is unquestionably imperative to study the impact of expensing on the entire industry, but what is equally vital is the impact it would have on some individual companies and how investors would react in relation to those companies. For this purpose, I want to analyze the subsequent table listing some of the notable mentions from my study of 73 S&P 500 companies.

S&P 500 Companies that have Voluntarily Decided to Expense at Fair Value					
Companies	2004 EPS As Reported	Pro-forma EPS (adjusted for Stock Options Expense)	Industry	Diff. in EPS	Percentage Reduction in EPS
Computer Associates	0.04	-0.08	Technology	0.12	300.00%
Boeing	3.01	2.3	Capital Goods	0.71	23.59%
CSX	1.52	1.42	Transportation	0.10	6.58%
J.P. Morgan Chase (Bank One)	1.55	1.48	Financial	0.07	5.12%
Equity Office Properties	0.24	0.23	Services	0.01	4.32%
Transocean	0.47	0.45	Energy	0.02	4.26%
Tupperware	1.48	1.43	Consumer Non-Cyclical	0.05	3.38%

The entire list of all 73 companies is given in Appendix A at the end of this chapter.

From above table, one may easily infer that the company called Computer Associates (NYSE: CA) has had the most negative blow to its EPS due to the expensing of options. It is also worthwhile to mention that this company also belongs to the technology industry, which has been estimated to have a really negative impact of expensing. In addition, the 23.59% reduction for Boeing can also be considered as a sizeable decline. Due to very discouraging EPS numbers, the rational investors in these two companies would possibly look for alternative investment options.

Computer Associates decided to value options at fair value starting of the fiscal year of 2004. Its fiscal year ends on March 31. To further study the investors' reaction for this particular company, let us look at its stock performance following its fair value expensing decision and the subsequent reporting of its financial statements at the end of March, 2004.



This chart depicts that their stock performance has been somewhat volatile for the last one year. Over the period, the stock value has ranged between \$22.37 and \$31.71. It is notable to mention that their stock performance was very discouraging for some period following their annual statements filing in March, 2004. Needless to say, one of the reasons for their dismal performance may be attributed to the fair value expensing of their option grants.

The above analysis on the industries and individual companies is very helpful in reflecting foreseeing investors reaction in the coming years following the deadlines of expensing stock options under SFAS 123(R).

APPENDIX A

S&P 500 Companies that have Voluntarily Decided to Expense at Fair Value

S. #	Companies Expensing Stock Options	2004 EPS - As Reported	Pro-forma EPS (adjusted for Stock Options Expense)	Industry	Focus	Diff. in EPS	Percentage Reduction in EPS
1	Dow Chemical	2.93	2.91	Basic Materials	Chemicals - Plastics & Rubber	0.02	0.68%
2	Du Pont	1.77	1.73	Basic Materials	Chemicals - Plastics & Rubber	0.04	2.26%
3	Rohm & Haas	2.22	2.16	Basic Materials	Chemicals - Plastics & Rubber	0.06	2.70%
	AVERAGE	2.31	2.27			0.04	1.73%
4	Boeing	3.01	2.30	Capital Goods	Aerospace & Defense	0.71	23.59%
5	Centex	6.40	6.29	Capital Goods	Construction Services	0.11	1.72%
6	Pulte Homes Inc.	7.58	7.54	Capital Goods	Construction Services	0.04	0.53%
7	Cummins	7.39	7.38	Capital Goods	Misc. Capital Goods	0.01	0.14%
	AVERAGE	6.10	5.88			0.22	3.57%
8	Emerson Electric	2.98	2.97	Conglomerates	Conglomerates	0.01	0.34%
9	General Electric (2003 data)	1.49	1.47	Conglomerates	Conglomerates	0.02	1.34%
	AVERAGE	2.24	2.22			0.01	0.67%
10	Jones Apparel Group	2.36	2.34	Consumer Cyclical	Apparel / Accessories	0.02	0.85%
11	General Motors	4.97	4.92	Consumer Cyclical	Auto & Truck Manufacturers	0.05	1.01%
12	Paccar	5.16	5.15	Consumer Cyclical	Auto & Truck Manufacturers	0.01	0.19%
13	Genuine Parts	2.25	2.24	Consumer Cyclical	Auto & Truck Parts	0.01	0.44%
14	Johnson Controls	4.24	4.22	Consumer Cyclical	Auto & Truck Parts	0.02	0.47%
15	Visteon	-11.96	-12.04	Consumer Cyclical	Auto & Truck Parts	0.08	-0.67%
16	Leggett & Platt	1.45	1.44	Consumer Cyclical	Furniture & Fixtures	0.01	0.69%
17	Masco	1.96	1.93	Consumer Cyclical	Furniture & Fixtures	0.03	1.53%
	AVERAGE	1.30	1.28			0.03	2.21%
18	Tupperware	1.48	1.43	Consumer Non-Cyclical	Personal & Household Products	0.05	3.38%
19	RJ Reynolds	-41.17	-41.16	Consumer Non-Cyclical	Tobacco	-0.01	0.02%
	AVERAGE	-19.85	-19.87			0.02	0.10%
20	Conoco Phillips	11.60	11.58	Energy	Oil & Gas - Integrated	0.02	0.17%
21	ExxonMobile	3.89	3.89	Energy	Oil & Gas - Integrated	0.00	0.00%
22	Marathon Oil	3.73	3.75	Energy	Oil & Gas Operations	-0.02	-0.54%
23	Unocal	4.48	4.47	Energy	Oil & Gas Operations	0.01	0.22%
24	Anadarko Petroleum	6.36	6.34	Energy	Oil & Gas Operations	0.02	0.31%
25	Transocean	0.47	0.45	Energy	Oil Well Services & Equipment	0.02	4.26%
	AVERAGE	5.09	5.08			0.01	0.16%
26	AMBAC Financial Group	6.53	6.47	Financial	Insurance - Prop. & Casualty	0.06	0.92%
27	Hancock John Finl Svcs (2003 data)	2.79	2.69	Financial	Insurance	0.10	3.58%
28	Hartford Fin'l	7.12	7.08	Financial	Insurance - Prop. & Casualty	0.04	0.56%
29	MGIC Investments	5.63	5.59	Financial	Insurance - Prop. & Casualty	0.04	0.71%
30	Principal Financial Group	2.62	2.61	Financial	Insurance - Life	0.01	0.38%
31	Progressive	7.63	7.62	Financial	Insurance - Prop. & Casualty	0.01	0.13%
32	Prudential Financial	3.31	3.26	Financial	Insurance - Life	0.05	1.51%

33	Travelers Property Casualty	1.68	1.63	Financial	Insurance - Prop. & Casualty	0.05	2.98%
34	XL Capital	8.13	7.92	Financial	Insurance - Prop. & Casualty	0.21	2.58%
35	Bear Stearns	9.76	9.54	Financial	Investment Services	0.22	2.25%
36	Goldman Sachs Group	8.92	8.61	Financial	Investment Services	0.31	3.48%
37	Mellon Financial Corp.	1.89	1.83	Financial	Investment Services	0.06	3.17%
38	Morgan Stanley	4.06	4.06	Financial	Investment Services	0.00	0.00%
39	Federated Investors, Inc.	1.64	1.62	Financial	Misc. Financial Services	0.02	1.22%
40	Bank of America	3.69	3.69	Financial	Money Center Banks	0.00	0.00%
41	Bank of New York	1.85	1.81	Financial	Money Center Banks	0.04	2.16%
42	Citigroup	3.26	3.23	Financial	Money Center Banks	0.03	0.92%
43	J.P. Morgan Chase (Bank One)	1.55	1.48	Financial	Money Center Banks	0.07	4.52%
44	Wachovia	3.81	3.78	Financial	Money Center Banks	0.03	0.79%
45	Comerica	4.36	4.32	Financial	Regional Banks	0.04	0.92%
46	KeyCorp	2.30	2.28	Financial	Regional Banks	0.02	0.87%
47	National City Corp.	4.31	4.29	Financial	Regional Banks	0.02	0.46%
48	PNC Fin'l Services	4.21	4.15	Financial	Regional Banks	0.06	1.43%
49	State Street	2.15	2.04	Financial	Regional Banks	0.11	5.12%
50	Washington Mutual	3.26	3.21	Financial	S&Ls/Savings Banks	0.05	1.53%
	AVERAGE	4.26	4.19			0.07	1.55%
51	Moody's	2.79	2.71	Services	Business Services	0.08	2.87%
52	AT&T	-8.14	-8.28	Services	Communication Services	0.14	1.72%
53	Sprint Corp PCS Group	-0.71	-0.73	Services	Communication Services	0.02	2.82%
54	Verizon Communications	2.79	2.77	Services	Communication Services	0.02	0.72%
55	Cendant	2.02	1.96	Services	Hotels & Motels	0.06	2.97%
56	Block, H&R	3.86	3.80	Services	Personal Services	0.06	1.55%
57	Washington Post	34.59	34.33	Services	Printing & Publishing	0.26	0.75%
58	Apartment Inv. & Mgmt.	1.88	1.85	Services	Real Estate Operations	0.03	1.60%
59	Equity Office Properties	0.24	0.23	Services	Real Estate Operations	0.01	4.17%
60	Amazon	1.39	1.33	Services	Retail - Specialty	0.06	4.32%
61	Home Depot	2.26	2.19	Services	Retail - Home Improvement	0.07	3.10%
62	Lowe's Companies	2.71	2.66	Services	Retail - Home Improvement	0.05	1.85%
63	May Department Stores	1.70	1.65	Services	Retail - Department & Discount	0.05	2.94%
64	Winn Dixie	-0.71	-0.76	Services	Retail - Grocery	0.05	7.04%
	AVERAGE	3.33	3.27			0.07	2.06%
65	Cooper Industries	3.58	3.57	Technology	Electronic Instruments & Controls	0.01	0.28%
66	Computer Associates	0.04	-0.08	Technology	Software & Programming	0.12	300.00%
	AVERAGE	1.81	1.75			0.07	3.59%
67	CSX	1.52	1.42	Transportation	Railroads	0.10	6.58%
68	United Parcel Service	2.93	2.91	Transportation	Trucking	0.02	0.68%
	AVERAGE	2.23	2.17			0.06	2.70%
69	Entergy	3.93	3.88	Utilities	Electric Utilities	0.05	1.27%
70	AES Corp.	-6.60	-6.88	Utilities	Electric Utilities	0.28	4.24%
71	Ameren	2.84	2.84	Utilities	Electric Utilities	0.00	0.00%
72	Pinnacle West Capital	2.66	2.65	Utilities	Electric Utilities	0.01	0.38%
73	Keyspan	2.84	2.82	Utilities	Natural Gas Utilities	0.02	0.70%

Chapter 6

Expensing and Companies' Reaction

How would companies react to expensing stock options? This is another crucial question that needs to be answered in order to understand the overall impact of expensing stock options. This question can specifically be rephrased as how would companies change their equity compensation programs in response to new FASB requirements? Now, to gain insight on this question, I looked and studied the survey done by Dow Jones Company on 150 companies that have, again, voluntarily decided to expense stock options.¹⁵ The results of the survey were published in The CPA Journal in the month of January this year. Basically, it focused on three questions related to expensing stock options which were asked from the human resources directors for the participating companies. The questions were:

- A. Stock Options to Remain Primary Long-Term Incentive Vehicle?
- B. Plan to Place More Emphasis on Other Forms of Long-Term Compensation?
- C. Plan to Reduce Eligibility for Long-Term Compensation?

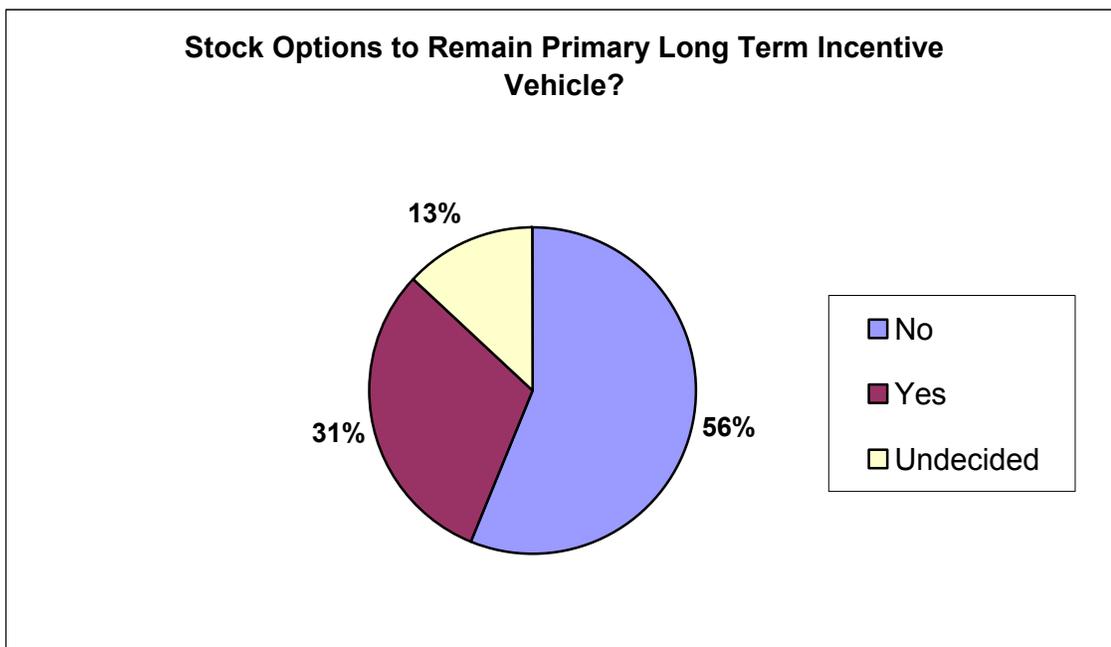
The survey results for each of these three questions help in ascertaining the future of stock options and other non-cash related incentives in light of the expensing requirement. As in earlier study of 73 S&P 500 companies, it is also essential to note here the number of companies that were considered for the survey from each of the industries.

¹⁵ J Gregory Kunkel & Richard T Lau, The CPA Journal, Vol. 75, Iss. 1, (New York: January 2005), 3 pgs.

Dow Jones Study of 150 Companies that have Voluntarily decided to Expense Stock Options	
Industry Distribution	Percent
Banking/Investment	26%
Manufacturing	26%
Real Estate/Property Management	11%
Insurance	8%
Others	7%
Retail	6%
Oil & Gas	5%
Utilities	5%
Telecommunications	4%
Hi-Tech/Internet	2%

A. Stock Options to Remain Primary Long-Term Incentive Vehicle?

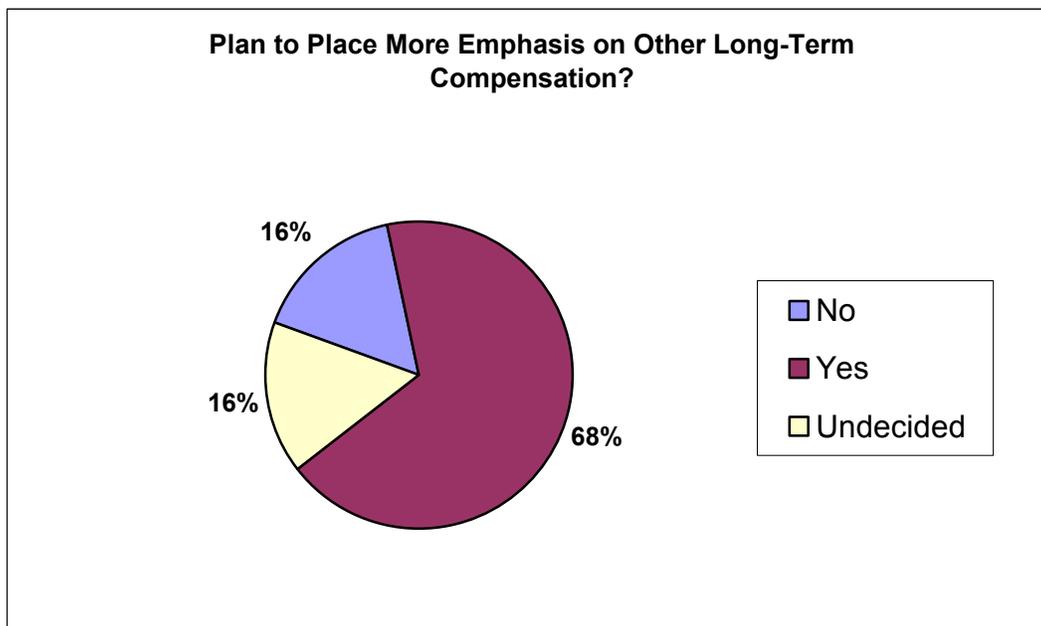
The survey results for the first question were as follows:



More than half of the 150 companies surveyed said that they do not want to keep stock options as a primary long-term incentive vehicle for their company. This indicates that companies are wary of accepting the new norm for expensing set by FASB and would most likely reduce the number of option grants in the near future.

B. Plan to Place More Emphasis on Other Forms of Long-Term Compensation?

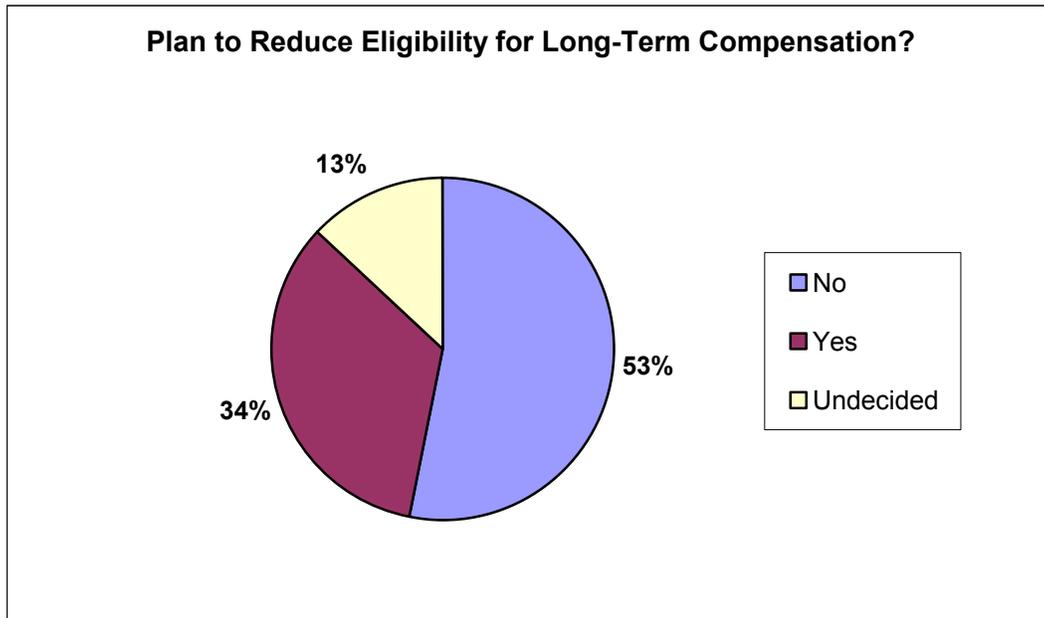
The survey results for this question produced a whopping 68% companies being positive, and a 16% each being negative and undecided.



The results point out that the new FASB requirement of expensing may bring in new types of long-term incentive plans in the company's compensation structure. Again, it signifies the wariness of the companies to expensing, but may also very well result in a promoted innovativeness in compensation plans. Like 1990s, companies will once again be pressurized to come out with creative ideas to provide incentives to their employees.

C. Plan to Reduce Eligibility for Long-Term Compensation?

To the question on reducing the eligibility for long-term compensation plans, more than half of the surveyed companies (53%) responded by yes, 34% said no, and the balance were undecided.



The result of more than half the companies favoring the no-reduction for eligibility of long-term compensation implies that companies believe in the efficaciousness of long-term incentive plans in retaining and motivating their key personnel, and thus have a high employee retention ratio. This also shuns the possibilities of any ceasefire against the employees receiving long-term benefits from their companies.

Although these survey results help analyze a lot of key points related to companies' reaction, it should be kept in mind that many factors, like maturity, growth potential, industry, and market conditions, may very well change a company's decision regarding what type of long-term incentive program to use. Nonetheless, it can be generalized from the survey's overall findings that the role of stock options in the compensation package will be diminished and other forms of compensation will gain more prominence.

Chapter 7 **Conclusion**

The problem of Expensing Stock Options has become one of the most highly contested issues in the business world. The significance of the problem has spanned from companies to investors to law makers. For more than a decade, many people have fought either in favor or against the rule of expensing equity options. Although, the problem's roots originated in early 1970s, it did not gain widespread attention until FASB issued a proposal to expense options in 1993. Initially subdued by opposing companies' incessant pressure, the momentum to set a standard for expensing augmented again after the corporate debacles in the new millennium. This time around, nevertheless, FASB had the upper hand on opponents and followed its Exposure Draft on Share-Based Payments with a new accounting policy in SFAS 123(R).

Now that the deadlines to comply with FASB's new requirements for large and small business entities are approaching rapidly, many companies are proactively making their moves to prepare for the unprecedented accounting shift. For instance, International Business Machines (IBM) decided to expense stock options using the fair value approach earlier this year in April. On the other hand, some companies are still forcing law makers to rescind the new rule or make amendments to it. On May 12, 2005, for example, Cisco proposed a new way to value employee options as reported by Wall Street Journal.¹⁶ Opponents are still active and believe that the new rule would do more bad than good in the US business world. Their opposing efforts paid off in the middle of last year, to some extent, when the House of Representatives announced the employee equity options are needed to be expensed only for the top five executives of a company.

¹⁶ Scott Thurm & Deborah Solomon, "Cisco Proposes New Way to Value Employee Options, Wall Street Journal (New York: May 12, 2005), pg B4.

The requirement for expensing may have been chopped, but the most important issue is to determine the effect of expensing on investors and companies' compensation structures. These two focus questions have remained the nucleus of the entire problem. From the two studies mentioned in this thesis, the answers to the focus questions can be deduced reliably. The first study on 73 S&P 500 Companies that have voluntarily decided to disclose their equity options' expense in footnotes elaborates that expensing has sporadic effects on each industry, and, therefore, investors would react accordingly. Utilities, technology, and capital goods industries will be the hardest hit by expensing. Investors would curtail their investment plans in the companies of these industries. The Dow Jones survey on 150 companies reveals that companies will probably shrink the number of options they give to their employees as a result of expensing requirement. However, employees may look forward to getting some entirely new and innovative incentive plans because companies will want to come up with an equally effective alternative.

With this thesis, a sincere attempt has been made to provide a thorough understanding of the problem of Expensing Stock Options by focusing on its related terminology, history, rules, merits, demerits, and above all, crux of the problem. Although the results and findings illustrate a great deal about the problem, it will be enigmatically interesting to see how SFAS 123(R) on expensing stock options plays a revolutionary role the companies' financial statements reporting in the coming years.

Works Cited

- ABVFN Financial Glossary, Options, <http://www.advfn.com/money-words_term_3477_option.html>
- ACCA. “Share based payments.” <<http://www.accaglobal.com/ifrs/technical/relevantarticles/1123867>>
- Buffett, Warren. New York Times, *Op-Ed piece*. (New York: July 24). 2002.
- Business Week Online, “Will Expensing Cost the US Jobs?”
<http://www.businessweek.com/careers/content/dec2003/ca20031230_2068_ca004.htm>
- Citizen Works. “What stock options are and why they should be expensed?”
<<http://www.citizenworks.org/corp/options/talking-points.php#taxes>>
- Financial Accounting Standards Board, SFAS 123 & SFAS 123(R).
<<http://www.fasb.org/st/summary/stsum123.shtml>>
<<http://www.fasb.org/st/summary/stsum123r.shtml>>
- Fowler, Tom. Knight Ridder Tribune Business News, (Washington: Dec 17, 2004). pg 1.
- Global Power Report (New York: December 23, 2004), pg 7.
- Greenspan, Allan. “Expensing Options is a Bandwagon Worth Joining.” Globe and Mail (August 16, 2002).
- Harrison, Joan. “Challenges for Companies Valuing Options.” Mergers & Acquisitions (November 2002).
- Kunkel, Gregory J & Lau, Richard T. The CPA Journal, Vol. 75, Iss. 1_(New York: January 2005), 3 pgs.
- Thurm, Scott & Solomon, Deborah . “Cisco Proposes New Way to Value Employee Options, Wall Street Journal (New York: May 12, 2005), pg B4.
- Wall Street Journal (Eastern Edition), *Financial Services Brief*. New York, NY: March 22, 2005, pg. 1
- Yahoo Financial Glossary, Derivative Security. < <http://biz.yahoo.com/f/g/dd.html>>