

Fall 2007

Financial Accounting Standards Board Statement 123 (R): The Expensing of Options

Daniel D. Acton

Robert G. Hutter

Mary Stermole

Follow this and additional works at: <https://digitalcommons.fairfield.edu/nealsb>

Recommended Citation

Acton, Daniel D.; Hutter, Robert G.; and Stermole, Mary (2007) "Financial Accounting Standards Board Statement 123 (R): The Expensing of Options," *North East Journal of Legal Studies*: Vol. 14 , Article 6. Available at: <https://digitalcommons.fairfield.edu/nealsb/vol14/iss1/6>

This item has been accepted for inclusion in DigitalCommons@Fairfield by an authorized administrator of DigitalCommons@Fairfield. It is brought to you by DigitalCommons@Fairfield with permission from the rights-holder(s) and is protected by copyright and/or related rights. You are free to use this item in any way that is permitted by the copyright and related rights legislation that applies to your use. For other uses, you need to obtain permission from the rights-holder(s) directly, unless additional rights are indicated by a Creative Commons license in the record and/or on the work itself. For more information, please contact digitalcommons@fairfield.edu.

³¹ Agricultural Marketing Act, 7 U.S.C. § 1621.

³² Michael Owen Johanns grew up in an Iowa family of dairy farmers. A practicing attorney, he began his Republican political career in 1983 in Lincoln, Nebraska and served two terms as Nebraska's governor from 1999 to 2005, until his nomination by President George W. Bush for U.S. Secretary of Agriculture in 2005.

³³ Letter from John E. Sweeney, Member House of Representatives, to Michael Johanns, Secretary United States Department of Agriculture (January 17, 2006).

³⁴ *The Humane Society of the United States v. Johanns*, No. 06-265, U.S. Dist. DC, (Memorandum Opinion March 14, 2006).

³⁵ Administrative Procedure Act, 5 U.S.C. § 553 (2000).

³⁶ *Id.* at 5 U.S.C. § 706.

³⁷ National Environmental Policy Act of 1969, 42 U.S.C. § 4321 (1970).

³⁹ *Humane Society of the United States*, at 8.

⁴⁰ *Id.* at 20.

⁴¹ Amanda Duckworth, *Federal Hearing on Horse Slaughter Draws Large Crowd*, *The Blood Horse*, July 2006, at 13.

⁴² Chad Mendell, *Agriculture Subcommittee Strongly Disapproves of Slaughter Bill*, *The Blood Horse*, July 2006, at 19.

⁴³ Sweeney, *supra* note 33 at 13.

⁴⁴ *Id.*

⁴⁵ Letter from Michael Johanns, Secretary United States Department of Agriculture, to Bob Goodlatte, (R-VA) Chairman, Committee on Agriculture House of Representatives, (Sep. 6, 2006).

⁴⁶ *The Humane Society of the United States v. Johanns*, No. 06-265, U.S. Dist. DC, (Memorandum Opinion March 14, 2006).

FINANCIAL ACCOUNTING STANDARDS BOARD
STATEMENT 123 (R): THE EXPENSING OF OPTIONS

By

Daniel D. Acton*
Robert G. Hutter*
Mary Stermole*

Introduction

In the 1980's Nelson Pelz benefited greatly from Michael Milken's junk bond financing. Pelz successfully bought and sold Triangle Industries. He then turned his attention to obtaining control of Triarc Companies, owner of Arby's, R.C. Cola and other brands. At the time of acquisition the market priced Triarc at \$18 per share. Pelz immediately granted himself options on 600,000 shares at that price exercisable over the following decade. Under Pelz's leadership the price of the stock dropped to half its former value leaving

*Alfred University

Pelz's options under water. Pelz then announced that his salary would be \$1 per year but took an additional 75,000 options at the new price level. As the stock struggled along at the new price, Pelz took monthly options grants that eventually totaled almost three million shares. The stock eventually recovered a portion of its original price and Pelz was able to exercise his options and gain a seven million dollar personal profit¹. Pelz had managed to reward himself well for what can be referred to at best as mediocre executive performance. Pelz's case is only one of many that took place before the stock market crash of 2000.

The Financial Accounting Standards Board (FASB) now requires that stock options be reported as an expense on the corporation's income statement. However, it is the authors' contention that this treatment is not theoretically sound. Stock options are, in fact, a redistribution of equity from existing shareholders to option recipients. The proper way to record these options would be similar to the method in which stock dividends are recorded, i.e. as a decrease in retained earnings and an increase in paid-in-capital.

An option may be defined as the right (but not the obligation) to buy a set number of shares of stock at a specific, fixed price by a specific date in the future². This is known as a call option. A put option gives the holder the right to sell a set number of shares of stock at a specific, fixed price by a specific date in the future³. Options have been used since the days of Benjamin Graham, mentor at Columbia University to Warren Buffett. Graham believed a grant of options would offer a small financial incentive to executives when good management performance was reflected in increased stock price. Most options grants in the earlier days resulted in an additional \$10,000 to \$15,000 to successful executives.

By the 1980's the options landscape had changed considerably. Founders of high technology companies were usually short on funds to lure talent away from larger

companies such as IBM or Hewlett Packard. As an added incentive, new hires were given an ability to grow with the new companies through grants of options. Many young engineers and computer scientists became millionaires in a few short years through the exercise of these grants during the stock market increases of the 1980's and 1990's. CEO's, especially in Silicon Valley, were almost uniformly given tens of thousands of options grants annually. The companies were attempting to align the performance of the executives with the interests of the stockholders⁴. Not surprisingly, accounting rules were often bent and stretched to maximize earnings and inflate stock prices. Even after the sharp decline in stock values after March 31, 2000, Silicon Valley industries have remained the staunchest proponent of both options grants (even at lower re-pricing) and as against expensing their cost on the earnings reports.

Accounting for Stock Options

The October 1972 Accounting Principals Board Opinion No. 25 (APB 25) became the first accounting standard written specifically for stock options⁵. A measurement date concept determined the value of options. Using the intrinsic value method to calculate this amount, the "charge to earnings was equal to the excess of the fair market value of the stock at that date over the amount payable by the employee, if any", the amount being determined on the measurement date, or "the first date on which both the number of shares and the price to be paid...are fixed"⁶. But companies used fixed options to find ways around recording stock option expenses. This was accomplished by setting the exercise price equal to the fair market value on the date of grant.

Two different forms of options, incentive stock options and nonqualified stock options, offer varying advantages and drawbacks. Incentive stock options are "qualified" stock options because they qualify to receive special tax treatment. The employee can defer income tax on the qualified options,

past the grant and exercise dates, to the date of sale. The difference between the exercise (strike) price and the sale price is then taxed at the capital gains tax rate if the sale occurs after completion of the holding period.⁷ However, if the sale occurs before the completion of the holding period, the difference between the exercise price and the fair market value of the stock at the time of option exercise is taxed at the employee's ordinary income tax rate. Since the employee receives special tax treatment for the incentive option, the company is not allowed to receive a tax deduction for the value of the option. Employers offering incentive stock options are able to attract and keep talented employees without the cash drain from paying higher salaries.

Several different conditions must be met for an option to qualify as an incentive stock option. Section 422 of the Internal Revenue Code requires that the options:

- Be granted to employees only;
- Be exercised by any employee during employment or prior to three months from termination of employment;
- Be for the issuing company, its parent company, or any of its subsidiaries.
- Be under a written plan, which must be approved by the stockholders within 12 months before or after plan adoption;
- Be granted within 10 years of the earlier of adoption or shareholder approval, and...exercisable only within 10 years of grant;
- Be of equal or higher value than the fair market value of the underlying stock at the time of grant;
- Not be issued to any employee owning stock with greater than 10% of the voting power of all stock outstanding...unless the option exercise price is at least 110% of the fair market value and the option is

not exercisable more than five years from the time of the grant;

- Not be transferable by the option holder other than by will or by the laws of descent and that the option cannot be exercised by anyone other than the option holder;
- Not have an aggregate fair market value exceeding \$100,000 in a calendar year.⁸

Stock options that do not meet these conditions are nonqualified stock options. These options have little tax benefit for employees, but are tax deductible for the employer. As indicated above the employee must pay income tax on the spread between the grant price and the stock's market value⁹ on the date of exercise; this same amount can then be deducted from the employer's taxes. A distinct disadvantage of nonqualified stock options results from the employee having to report income even if, as he or she holds the stock, the market crashes and the stocks lose value. In this case the employee cannot offset the income previously reported.

Since they did not have to worry about the expense associated with fixed options, companies disbursed large amounts of options to employees. Executives received nearly their entire compensation in the form of options. Executive had an incentive to increase the value of the stock within the vesting period in order to sell them at a later date. Since stock options were the basis of most accounting frauds during this period, the Financial Accounting Standards Board (FASB) implemented Statement No. 123¹⁰ in order to influence employers to report the impact of options on the corporations' financial statements.

FASB 123

As early as 1984, the FASB searched for ways to update APB 25 to fit the needs of the modern corporation and its investors. In 1995, they attempted to implement Statement 123, which required companies to expense the value of all employee stock options granted. The value of the options was calculated using the Black-Scholes valuation method and then amortized...over the expected period of benefit, which is usually the period from the date of the grant to the date of vesting¹¹.

The impact on the financial statements can be understood by an illustration. Assume 1,000 options are granted with a two-year vesting period, a \$5 exercise price, and that the options are exercised in the third year after the grant when the market value of the stock is \$16 per share. Assume also that the fair value of the options using the Black-Scholes model is \$15 per share. The net impact on the income statement and the balance sheet after the three-year period will be a reduction in net income of \$15,000-the fair value of the options, and an increase in paid-in capital of \$20,000-the \$16 per share market value at the date of the exercise plus \$4 per share- the difference between the \$15 fair value per share deducted from the difference between the \$16 market value and the \$5 cash received upon exercise

The fall of FASB 123s

After the attempted implementation of Statement 123, the FASB received harsh criticism from companies and members of Congress. The new regulation would greatly reduce earnings and high-tech executives, led by John Doerr, the venture capitalist...engineered a public rally to demonstrate the supposedly grassroots support for stock options.¹² The outcry continued as members of Congress slowly began

pressuring the Board to change their position on stock options. Since the FASB feared it would lose its private-sector, standards-setting authority,¹³ they relented and made Statement 123 voluntary. Companies could comply with Statement 123 or use APB 25; however, with APB 25, companies still had to make pro forma footnote disclosures stating what the financial statements (in particular, net income and earnings per share) would be using Statement 123 and how many options were unexercised.

Legislative Attempts

In order to further weaken the FASB's authority high tech companies lobbied members of Congress to bypass the FASB by passing options legislation. The House of Representatives on July 20, 2004, passed HR-3574, the Stock Option Reform Bill by a vote of 312-111.¹⁴ The legislation required expensing only the five largest individual option grants, presumably received by the top executives. Stock option grants to other employees were subject only to a footnote in the annual report. The bill further reduced the price volatility assumption underlying the "fair value" method of expensing option to zero, which meant that the price of any of the stock involved was not presumed to fluctuate.

This bill was harshly criticized by the public at large. The most common complaint was that expensing some options and not others would give an even more distorted financial picture of the corporation. The Chairman of the Senate Banking Committee, Sen. Shelby of Alabama, voiced his immediate opposition to the House bill and the bill never made it out of committee in the Senate.

The FASB's inability to require Statement 123 led to extensive debate between the supporters and opponents of expensing stock options. Slowly the Board gained the support of the investment industry which emboldened them to reconsider the statement. They issued Statement 123(R) which

required companies to expense stock options for reporting periods beginning after June 15, 2005.

Effects of FASB 123(R)

Corporations, and particularly high tech corporations, took several steps in anticipation of the new rule. Many accelerated the vesting period for option grants so they would not be expensed.¹⁵ Some corporations began to phase out stock options for new employees. Microsoft for example, discontinued stock option grants and replaced them with outright grants of restricted stock. The use of option grants in hiring declined, which would suggest that now it is more difficult to hire new, talented employees.

Ironically, grants to higher management have increased rather than decreased¹⁶. This has become evident due to the visibility of options in quarterly financial statements.¹⁷ Expensing stock options reduces reported earnings and as a result, opponents expected the value of corporate stock to decline. However, expensing stock options has not resulted in a decline in the stock market nor damaged the economy. To the contrary in the first quarter of 2006, the S & P 500 Index rose nearly five percent.

Conclusion

It is our position that employee stock options should not be reported as an expense on the corporate income statement. In support of this Statement of Financial Accounting Concepts 5 states that "expenses and losses are generally recognized when an entity's economic benefits are used up in delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations or when previously recognized assets are expected to provide reduced or no further benefits"¹⁸. Utilizing this explanation, opponents of expensing argue that stock options do not fit under the requirements to be classified as an expense; they are not part of the operations of the company, not the main business activities that generate revenues or use assets.

Also, expenses are sometimes described as costs relating to transactions with third parties. Since the stock options in question are given to employees, technically the two parties involved are both part of the same entity. In this situation neither corporate assets nor corporate liabilities have changed, total equity remains unchanged...but total equity has been redistributed¹⁹. Expenses normally result in use of an asset or a creation of a liability. Stock options do not produce either of these results, and therefore should not be classified as expenses. An additional criticism is that expensing employee options results in an income statement equation which is inconsistent with generally accepted accounting principles, i.e., Revenues – Expenses – Stock = Net Income. The normal equation is that Revenues – Expenses = Net Income.

Stock options should be reported in the same way as stock dividends, i.e. as a redistribution of retained earnings. The impact on the financial statements can be understood using the same data as in our earlier example. Under our proposal, at the end of the third year after the option grant date, the income statement would be unchanged. Recall that under Statement 123(R) net income was lower by \$15,000. Under our proposal paid-in capital on the balance sheet would increase by \$20,000 and retained earnings would decrease by \$15,000, the same as Statement 123 (R). The difference is that under our proposal the \$15,000 reduction in retained earnings does not appear on the income statement as an expense; it is a direct reduction in retained earnings. The net income reflects the results of operations and not the redistribution of equity by means of a stock option. This provides a more representative income measure which better serves the investment community.

ENDNOTES

¹ Origins of the Crash: The Great Bubble and its Undoing, Roger Lowenstein, The Penguin Press, New York, NY, 2004, pp.37-38.

² Getting Started in Options, Michael C. Thomsett, John Wiley and Sons, New York, NY, 3rd Ed, 1997, p. 12.

³ Id at pp. 13-14.

⁴ Infra, footnote 1 at pp. 15-34.

⁵ APB Opinion No. 25 Accounting for Stock Issued to Employees, Financial Accounting Standards Board Original Pronouncements, John Wiley and Sons, Inc, New York, NY, 1995-96.

⁶ Id p. 286.

⁷ Id

⁸ Id

⁹Id

¹⁰ FASB No 123 Accounting for Stock Based Compensation, Financial Accounting Standards Board, Norwalk, CT. 1995.

¹¹ Financial Accounting: An Introduction to Concepts, Methods, and Uses, Clyde P.Stickney, Roman L. Weil, 11th Ed., Willard, Ohio. 2005, pp. 536-538.

¹² Infra, footnote 1 at p. 44.

¹³ "Stock Option Accounting: Defying the Usual Answers," Gregory J.Baviers, and Larry M.Walther, The CPA Journal, April 2004, pp. 36-39.

¹⁴ Accounting for Employee Stock Options, Douglas Holtz-Eakin, Congressional Budget Office, pp.5534-37.

¹⁵ "Tech Companies Give Stock-Options Value, and Actually Survive," Lee Gomes, The Wall Street Journal, March 22, 2006, p. B1.

¹⁶ Id

¹⁷ Id

¹⁸ Statement of Financial Accounting Concepts No. 5 Recognition and Measurement in Financial Statements of Business Enterprises, Financial Accounting Standards Board, Norwalk, CT. 1984, p.31.

¹⁹ Infra footnote 14 at p.37.