

# COALITION TO PRESERVE AND PROTECT STOCK OPTIONS

*(PROMOTING INNOVATION AND ECONOMIC GROWTH THROUGH EMPLOYEE OWNERSHIP)*

## Why Employee Stock Options Should Not Be Expensed

Both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) currently are considering new rules that would require that companies estimate the value of long-term, nontransferable stock options given to employees and treat that estimate value as an expense, reducing earnings. Some favor this approach because they view employee options as just like other forms of employee compensation that must be expensed. However, for the reasons stated below, employee options should not be treated like other forms of employee compensation.

- **Option valuation methods are inadequate:** Available stock options valuation models were designed for pricing short term (6-month) options traded on exchange. Application of those models to employee options which are long-term (10-years), unvested and nontransferable produces results that are little more than an educated guess. Using the available option pricing models for financial statement purposes would give investors and other financial statement users a misleading picture of a company's financial performance. In addition, because each company would be free to use its own assumptions and judgments in applying the pricing models, it would be difficult for investors to compare the financial statements of otherwise similarly situated companies. Using the available option pricing models in the expensing of employee stock options would mislead investors, not enlighten them.
- **Unlike other forms of compensation, stock options impose no financial drain on a company.** An employee stock option is a contract between the company and the employee obligating the company to sell stock to the employee in the future at a predetermined price. If the employee exercises the option, the employee pays cash to the company in exchange for the share of stock. The company is not obligated to deliver to the employee any asset of the company or to expend any asset of the company on the employee's behalf. In this regard, the transaction between the company and the employee is fundamentally different from all other forms of employee compensation such as salary, health benefits and pensions where the company must deplete some asset of the company in order to deliver the agreed upon value to the employee. Because of this fundamental difference, stock options should not be accounted for in the same manner as other forms of employee compensation.

- **From an economic standpoint, stock options are a transaction between the employee and existing shareholders and the true “cost” is represented by the potential dilution of their interest in the company.** The grant of an employee stock option raises the potential for an increase in the number of shares outstanding which, if the option were exercised in the future, would decrease the value of the existing shareholders interest in the company. Consider a shareholder owning two percent of the outstanding shares of a company. If the number of shares outstanding were to double because of the exercise of stock options by employees, all other things being remaining the same, that shareholder’s ownership of the company would fall to one percent. It is this potential for shareholder dilution that is the true economic cost flowing from the grant of stock options: there is no “expense” to the company that would justify a reduction in reported earnings.
- **The better way to report stock options in the financial statements is through enhanced disclosure.** Current financial accounting rules require that a company estimate the valuation of employee options and either reduce earnings or disclose in a footnote the impact on earnings options would have had if earnings had been so reduced. However, because the real impact of stock options comes not from their impact on earnings but from their potential dilutive effect on existing shareholders, the better approach is to give investors more information regarding the details of the company’s stock option plans so they can better judge the potential dilution that could befall their holdings. Expensing gives investors less information about stock options, enhanced disclosure gives them more information.
- **Expensing options further will erode investor confidence in financial statements prepared using generally accepted accounting principles.** Today, many companies, in addition to issuing their financial statements prepared under GAAP, also disclose what are called “pro forma” results which portray a different picture of a company’s financial performance. One such pro forma earnings metric is called “EBITDA” or “earnings before interest, taxes, depreciation and amortization. In many industries, investors give more prominence to EBITDA than they do to GAAP earnings and many companies often use it as a headline metric in discussing a company's results. However, use of such pro forma metrics detracts from GAAP’s prestige in providing an accurate representation of a firm’s financial performance. Given the magnitude of putative stock options expense will drive many companies to exclude it in their pro forma earnings reports further eroding investor reliance on GAAP earnings.