THE WALL STREET JOURNAL.
The Wall Street Journal, September 3, 2002

Another Option on Options

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More and more companies are stepping forward to voluntarily include the expense of stock options in their income statements. This trend is a welcome step on the road toward reality, away from the present world of illusions in which options expense is usually treated as though it were zero.

But even as this salutary trend gains momentum, there seems to be a pervasive sense that it doesn't do enough to provide wary investors with the information they need about the real impact of options.

Not Ideal

For example, in announcing that General Motors plans to expense options, its Chief Financial Officer John Devine said, "While we are enthusiastic about taking steps such as this to restore investor confidence in business, it is important to point out that current valuation methods available for expensing stock options are not ideal." And prominently heading The Wall Street Journal's online list of companies that have volunteered to show options expense is this warning: "Calculations come from the companies' data and use the Black-Scholes formula, which links the value of an option to such variables as the current share price, the exercise price, expected volatility in share prices and expected dividends. The formula doesn't give an accurate picture of the cost of options."

The problem is that today's accounting rules leave us with a Hobson's choice for calculating options expense: zero, or theoretical fair value. Zero is the frying pan -- options are a form of compensation, and compensation doesn't cost zero to provide. But fair value is the fire. Fair value is subjective -- and what's worse, it's just a snap shot made only once at the time the option is first issued. It's an estimate treated as fact, enshrined forever in earnings regardless of whether the option turns out in the future to be worth millions of dollars or to expire worthless.

The fundamental problem with both of the available methods is that they are looking for options expense in the wrong places. They mistakenly think of options expense as something that happens when an option is first issued. But it's not. At the time of issue, options expense really is zero -- that's the one sense in which the status quo has always been correct. But options expense occurs when the option is exercised.

It's simple. An executive is issued options when his company's stock is at $10. When he exercises the options, they'll entitle him to pay $10 for the stock no matter how high its price in the market. Yes, the company has conveyed something of real value to the executive -- an option contract that the executive would have had to pay money for if he'd bought the same thing from a third party. But the company received something of value, too: the executive's commitment to work for the company, and probably at lower up-front wages than would otherwise be the case.

It's an even trade -- so when the option is first issued there is no net cost, not even an intangible one.

The costs show up when the executive exercises the option sometime in the future. The executive will make a profit of $40 when he exercises his options if his company's stock is at $50. That's a fact. It's so objective, he'll have to pay taxes on that $40.

Since the executive makes $40, it must be that $40 is also the company's options expense -- there's no such thing as a free lunch. It's a real cost: the company has to sell stock to the option-holder at $10 when it could have been issued in a secondary offering at $50. The stock transferred comes from the company's treasure stocks, which is always available for retirement or resale. Often, the company purchased the stock to be transferred to the executives at the $50, and paid either by issuing debt or from retained earnings. Either way, it costs the company $40 to sell $50 stock for only $10.

That's a fact, too. It's objective enough that current tax law allows the company to deduct that $40 from taxable income.

Options expense based on exercise is generally higher over the long run than options expense based on the fair value approach that companies are now signing up to adopt. For example, at General Electric, the exercise value method would have reduced net income by 8.3% on average for fiscal years 1995 to 2001. The fair value method would have reduced it by only 1.3%.

A more profound implication of the exercise approach, though, is that options expense can't be known until the options are exercised. That means that options are risky liabilities of unknown future cost -- a short position in a derivative security, actually. As such, they should be reflected on the company's balance sheet and marked to market every quarter.

CEOs who wanted to keep options expense off the income statement aren't going to like putting options liabilities on the balance sheet, since the latter reveals sharply the higher risk -- exposure of the company -- a cost not reflected in income statements. The accounting profession complied with the arrangement, superficially rationalizing the practice as being consistent with the principle of never putting equity instruments on the balance sheet.

But keeping options off the balance sheet conceals what is potentially a vast liability. The language of "equity" vs. "debt" is misleading in a world where financial instruments have characteristics of both, and where compensation and capital markets have been integrated in practice (though not in accounting). At Microsoft, for example, as of the most recent 10-k, the exercise value of all outstanding options was $23.7 billion dollars. That's a single liability not shown on the balance sheet that was twice as big as all the liabilities that are shown.

But the Financial Accounting Standards Board's tradition-bound rules don't permit investors to see that liability -- the FASB clings to the notion that executive stock options are "equity instruments," and therefore are not allowed on the balance sheet.

Putting options on the income statement reveals their expense. Putting them on the balance sheet reveals their risk. Together, they reveal exactly how and exactly how much a company is paying for its precious human capital.

Compensation Tools

In brief: Options are valuable -- if imperfect -- compensation tools. So CEO's should have nothing to fear by bringing all the costs and all the risks of options into the open. But the worst mistake they could make now would be to jump from the zero-expense frying pan to the fair-value fire, simply trading off one erroneous method for another, all in the name of corporate accountability. Putting options on the balance sheet, and counting their objective exercise value as their cost, is a solution beyond the frying pan and beyond the fire, too. It turns the cliché of "people being a company's most important asset" into sharp, numerical reality.

By bringing the true cost and nature of options into explicit public view, the debate will focus on the fundamental issues behind the accounting façade. One such issue is the role of boards and the functioning of markets for corporate control in awarding these compensations, and significantly altering the companies' risk profile. Another is whether or not linking compensations to stock prices, rather than companies' actual performance, is a good idea to start with.

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