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How FASB and Intel Can Both be Right about Stock Options

By Donald P. Delves

To expense or not to expense, is no longer the question when it comes to stock options. After much delay and debate, the Financial Accounting Standards Board (FASB) is moving ahead with accounting rules to require stock option expensing, more than a decade after it first started the process. In taking action to require stock option expensing the FASB is certainly right.*

The FASB Proposal

Under the FASB's proposal, the effective date for when the expense is calculated is the day that the options are granted—as opposed to alternative dates in the future, such as when the options vest (vesting date) or when they are exercised (exercise date). The valuation is based on the fair value of an option, determined by using an option-pricing model such as the Black-Scholes or Binomial models. These models typically result in valuations that are approximately 30 to 50 percent of the face value of an option. Thus, an option grant of 1000 shares with an exercise price of $10 a share would have a face value of $10,000 and a fair value of $3000 to $5000. Under the proposed FASB rules, once the expense is fixed, it would not change, regardless of the future performance of the stock. Whether the stock skyrockets to $100 a share or plummets to $1, the expense is the same.

While the FASB's proposal is logical from an accounting theory standpoint, it does present problems for technology companies, many of which have seen their stock prices plummet and their options go "underwater," meaning that the current stock price is far below the exercise price. Given this fact, tech companies rightly complain that the FASB rule that sets the expense as of the grant date—with no ability to adjust it in the future—is inaccurate and unfair.

The Tech Point of View

To consider more closely technology companies' point of view, let's assume that an executive holds an option for 1000 shares with an exercise price of $10. At the time the option is exercised, the stock has skyrocketed to $100 a share (which was hardly farfetched in the go-go days of the tech stocks). When the option is exercised, the company sells stock to the executive for $10 a share, even though the stock could have been sold to someone else for $100. A very real cost incurred by the company in this transaction is $90 a share. Further, the company must now produce a return on an additional share of stock that is valued at $100, but only has an additional $10 to invest.

Now let's take the opposite scenario: An executive has a $10 option on a stock that has fallen to $1. In this instance, the option would expire worthless without being exercised, and the company incurs no cost whatsoever. Yet, under both scenarios—the $100 stock that costs the company $90 and the $1 stock that results in the option expiring without being exercised—the FASB rules would result in exactly the same expense. Since the expense is determined upfront as of the grant date, there is no way of knowing what the true cost to the company will be. This, the technology companies correctly argue, is absurd.

Bear in mind that the tax treatment for options, which has not and will not change, reflects the true cost to the company, based upon the difference between the exercise price and the prevailing stock price as of the exercise date. In the case of the executive who exercises a

Director Summary: FASB's intent to compel expensing of stock options is not too problematic for traditional companies. The author argues that high-tech and startup companies that grant options freely should be permitted to consider options as a trade for human capital and they should appear on the balance sheet as such.

***Ed. Note:** See Dennis Beresford's November 2003 Viewpoint "Should Your Company Volunteer to Expense Stock Options?"

$10 option to buy a $100 stock, the company has an expense for tax purposes, and a very nice tax deduction, of $90.

Possible Alternatives

So what can be done to address the concerns of the technology companies that have valid arguments, while proceeding with the FASB's correct intention to have an expense for options?

One possible solution would be to change the FASB's expensing methodology and record an expense at the time the options are exercised, instead of when they are granted. The expense would reflect the spread between the exercise price and the market price, which is also known as the intrinsic value. Thus, if an executive exercised an option for 1,000 shares at $10 when the stock was trading at $25 a share, the intrinsic value would be $15 a share, resulting in an expense of $15,000. This would also make the accounting treatment exactly the same as the tax treatment.

Further, this method would allow the true economic cost of the options to be expensed at the time it becomes a real cost to shareholders. This means when the options are exercised and the shares are issued—at whatever discount to the current stock price—that impact on the company and the shareholders is recorded at that time. Conversely, if options were not exercised for whatever reason, there would never be an expense to the company.

The problem, however, is that the intrinsic value/exercise date method would result in an unpredictable and potentially very large expense. From the time the option is granted until it is exercised, a company would not be able to pinpoint accurately what the expense would be. That is why so many mainstream companies have lined up behind the grant date/fair value methodology. It is clearly seen as the lesser of all possible expense "evils." When all the wrangling about option expensing is over, the FASB's proposed methodology is not really that much of an issue for most non-tech companies. For them, the proposed accounting rules will most likely result in a nice predictable expense that will not be all that large.

Special treatment for startups. An option granted by a startup company is far different from an option in an established company. In a startup, an executive typically receives less cash compensation but is given stock and/or options, which may have little value when granted, but could have significant value in the future. Similarly, vendors that provide goods and services to startups frequently receive partial payment in stock or options.

Like a financial investor putting cash into a venture in return for stock, in the case of the startup company executive, the option and/or stock is granted in exchange for the contribution of time, talent, creativity, ideas, innovation, and expertise. Taking the next step in this thinking, when cash is exchanged for stock, the transaction is accounted for on the balance sheet: debit cash, credit paid-in capital. Why shouldn't a human-capital investment be reflected in a similar way?

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Options on the balance sheet—as liabilities. Under the current and proposed new accounting rules, options are treated as equity instruments. This was the result of a crucial decision point back in the 1980s, before the accounting issue heated up publicly, when the FASB decided to treat options as equity instead of as a liability. There was and still is, however, a very good argument for considering option grants as a liability. Options represent a substantial and largely unknown obligation by the company and its shareholders to sell stock to employees at an undetermined discount, which could be very large or nothing.

With this approach, all outstanding options would be treated as a liability, whose size varies and must be estimated and accounted for on the balance sheet. This would be an important step toward reflecting the risk and exposure borne by the shareholders as a result of a company's stock option practices. Given the fact that many companies—and technology firms in particular—now have very large quantities of stock options outstanding, disclosing this risk as a liability on the balance sheet may be as important as an accurate reflection of pension liabilities or retiree medical benefit obligations.

Summary

The FASB accounting treatment looks only at the fair value of an option as of the grant date and ignores the true economic cost and potential exposure incurred with options. The proposed accounting rules do not acknowledge the evolution that continues, as companies look to acknowledge and reflect the investment of human capital. ■

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