Accounting for stock options

Social problems often grow to uncomfortable proportions before democratic societies can muster the consensus needed to deal with them. Then the steps taken are often sudden and ill-considered. David Rowe argues that this common pattern is playing itself out relative to accounting for stock options, and suggests an alternative to the current 'expensing' approach

In 1975 Allen Kneese and Charles Schultze wrote a wise and prophetic book entitled *Pollution, Prices, and Public Policy.*[1] In it they argue for using market-based approaches to achieve environmental goals. In passing, they discuss why such structurally sensible approaches often have difficulty gaining political support. Their answer, in part, is that the political process tends to concentrate too much on what is to be accomplished and not enough on how to accomplish it.

A social consensus to address an issue often forms rapidly, driven by some dramatic catalysing event. At that point, politicians strive to be seen to be addressing the issue as quickly as possible. Careful analysis of how to address the issue is easily characterised as foot dragging and, in fairness, delay may lead to loss of the political momentum needed to implement any corrective action. But this often results in ill-considered and inefficient solutions that need to be overhauled years later when their shortcomings have been fully manifested. This all-too-familiar dynamic is playing out at the moment in the controversy surrounding how to account for employee stock options in corporate financial statements.

An overhang of employee stock options has a dilutive impact on existing equity holders. Clear and transparent disclosure of this impact is an important corporate governance issue, and an essential responsibility of management. But the current headlong rush to force 'expensing' of employee stock options at the time they are granted is likely to leave investors more confused and even misled than enlightened.

The key information investors need is twofold:

- how much dilution would result from the exercise of existing vested employee options, and
- how much would that dilution change over a reasonable range of future time periods and levels of the share price given existing grants and vesting schedules.

Much of the discussion surrounding this issue hinges on whether relevant information should have a direct impact on

David Rowe is group executive vice-president for risk management at SunGard Trading and Risk Systems
e-mail: david.rowe@risk.sungard.com

the financial statements or be reflected only in footnotes. I feel that items affecting the financial statements have greater visibility, and that reflecting the dilutive impact of employee stock options there is appropriate. But the current proposals for expensing options when granted would consistently mis-state the cumulative dilutive impact of outstanding options and distort the timing of changes in this impact on net income.

As I have discussed previously[2], traditional option pricing models are inappropriate for valuing new employee option grants for several reasons. The most important is that vesting occurs over time and is contingent on continued employment. Now we are seeing proposed valuation models that attempt to take into account the probability of options being surrendered. But any such valuation process is an attempt to predict the expected value of a very diffuse distribution. We wouldn't think of booking the value of an in-the-money written option on the day it was sold and then ignoring future value changes as market conditions shift over time. That appears, however, to be exactly what is being proposed relative to accounting for new employee option grants. This approach is also fraught with opportunities for manipulation, given all the parameters that must be estimated to perform the calculation.

An alternative approach would be simpler, more consistent and more useful to investors. Begin by calculating the value of all fully vested options based on their respective strike prices and the prevailing share price at the end of each accounting period and book this amount as a special 'dilution liability' on the balance sheet. From period to period, book an expense amount equal to the change in the balance in this dilution liability. (In times of falling stock prices, this expense item could be negative.)

The above procedure would show a correct cumulative dilution impact of outstanding employee options at any given point in time. It would not, however, reveal the potential change in that impact from the future vesting of option grants outstanding or changes in the stock price. This would be disclosed by mandating the publication of a footnote table showing what the dilution balance would be over quarterly intervals into the future and at a range of values for the share price (both up and down). This table should reflect the vesting schedules on a 'worst-case basis' (from the existing shareholders' perspective) assuming no unvested option grants were surrendered over the period of these scenarios. The market would be left to judge, based on past experience, how excessively conservative this no-surrender assumption is. In the spirit of International Accounting Standards more than Generally Accepted Accounting Principles, there should also be a mandate for accountants to assure that these tables do not hide big surprises at points just beyond the range of scenarios for future periods or share prices.

It would be great to see adoption of a simple, consistent and informative approach to this issue initially, rather than suffering years of confusing, inconsistent and distorted financial statements before allowing common sense to prevail. Unfortunately, on this issue, my instinctive optimism fails me. ■

[1] *Kneese, Allen and Schultze, Charles: Pollution, Prices and Public Policy, The Brookings Institution, 1975*

[2] *Rowe, David: Factoring in Stock Options, Risk Magazine, October, 2002*