For the last time: Stock options are an expense

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The case for expensing options is overwhelming. Stock option grants have real cash flow implications that need to be reported. There are ways to quantify these implications. Footnote disclosures are not an acceptable substitute for reporting the transaction in the financial statements. And the full recognition of option costs need not destroy the incentives provided by startups to their employees.

Fallacy 1: Stock options do not represent a real cost.

It is a basic principle of accounting that financial statements should record economically significant transactions. The argument that stock options are not economically significant is not tenable. Transfer of value does not necessarily imply transfer of cash. Acquiring raw materials on credit, for example, results in an accounting transaction, even if no cash changes hands.

Issuing stock options to employees involves a sacrifice of cash. A company can sell the options in the market and generate cash. It could be argued that the company saves cash by paying employees less. But not expensing stock options would be tantamount to underreporting compensation costs.

Fallacy 2: The cost of employee stock options cannot be estimated.

Option pricing models are available. Employee stock options may be less liquid, compared to market traded options. But the absence of a liquid market has little effect on their value to the shareholder. The beauty of option pricing models is that they are based on the characteristics of the underlying stock. Formula based or underwriters' estimates of the cost of employee stock options are less precise than cash payouts or share grants. But financial statements should try to be reasonably correct rather than completely wrong in reflecting economic reality. There are many other situations, where estimates are involved, such as depreciation and provisions against contingent liabilities.

Fallacy 3: Stock option costs are already adequately disclosed.

Disclosures by way of footnotes are not the same as reporting on the P&L and Balance Sheet. Relegating an item of economic significance to the footnotes would distort the financial statements. Analysts will also find it difficult to make inter firm comparisons.

It is true that the diluted EPS, after taking it account the impact of the issue of ESOPs, is reported. But costs enter into a GAAP based, diluted EPS calculation only when the current market price exceeds the option price. Thus fully diluted EPS numbers still ignore all the costs of options that are nearly in the money or could become in the money if the stock price increased significantly in the near term.

Moreover, relegating the impact of options to an EPS calculation would distort the measurement of reported income. Fundamental productivity and profitability measures such as return on capital and return on investment and economic value added, are based on accounting income.

If fully diluted EPS is the right way to disclose the impact of share options, the accounting rules for situations where companies issue common stock to pay for services or assets should also be changed. Currently, when these transactions occur, the cost is measured by the fair market value of the consideration involved. Why should options be treated differently?

Fallacy 4: Expensing stock options will hurt young businesses.

One of the arguments against expensing options is that entrepreneurial firms will find it difficult to attract and retain talent. Lack of cash, however, need not be a stumbling block when it comes to compensating people. Instead of issuing options directly to employees, companies can issue them to underwriters and use the money to pay employees. In fact, this might be more beneficial to companies as markets seem to value the options more than the employees.

Instead of giving an accounting subsidy, a better approach might be to allow startups to defer a percentage of their total employee compensation for some years. This way, companies would get the benefit of not having to report a portion of their compensation costs, no matter what form that compensation might take.

What will expensing involve?

The benefits for a company from issuing stock options occur over a period of time, in the form of increased cash flows generated by its motivated employees. As per the matching principle, costs must be recognized at the same time as revenues. In the case of options, the best way to write off the expenses might be a straight line amortization method applied over the vesting period.

In addition to being reported on the income statement, the option grant should also appear on the balance sheet. At the time of the grant, the cost of the option should be reported as paid in capital. On the asset side of the balance sheet, a pre-paid compensation expense entry can be made.

Should the company make adjustments after the grants have been issued? Employees may leave the company and forfeit their options. Does it mean that the compensation expense should be adjusted downwards? But such an argument would also mean that when the share price increases, the expense should be marked upwards.

Options are definitely an effective way of attracting and retaining talent and aligning the interests of managers and owners. But we cannot justify the argument that options should not be expensed. Accounting standards should not be used to distort executive compensation by subsidizing one form of compensation relative to others. Companies should choose compensation methods according to their economic benefits and not based on the accounting treatment.