

Jo the CEO's options

Fasten your seatbelts. This is an accountant's explanation of why accountants think options should be counted as a corporate expense

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No issue has bred more tension in the uneasy relationship between accountants and their clients than how to account for executive stock options. At one extreme is the view expressed by Ken Hugessen on this page last Friday that "... stock options don't directly cost the business. They cost the shareholders by way of dilution ..." At the other is the strongly held but often inarticulate opinion that all the costs of outstanding options should go through the income statement. Neither extreme is even close to what accountants are actually proposing. So, to try to clarify things, I am going to do something that is unusual in articles on accounting for stock options. I am going to talk about accounting.



An illustration of a person writing at the desk of Jo The CEO, Owner, Worker.

An income statement registers revenues and expenses only if they stem from transactions with parties other than the firm's owners, the shareholders. Interest is an expense because bondholders aren't "owners," whereas dividends are distributions of earnings to owners, not expenses. A CEO who owns shares or stock options in the company is actually two people for accounting purposes: an employee (an "outsider") and an owner. Not even an Einstein could fathom the accounting for executive stock options without keeping this distinction in perspective.

So, when a company awards Jo the CEO some stock options, accountants track the implications with one camera that focuses on Jo's worker half. They ask: How much did the firm give her in exchange for her services as a worker? Since they only measure this expense once, they turn this first camera off right away and train a second camera on Jo's owner half to track what happens if she later exercises the options or walks away when they expire worthless.

This second camera doesn't register any expense when Jo exercises her options because it sees this as being merely a transaction among owners. Jo's owner half is like a warrant holder who can buy the company's stock cheap. No one proposes recording expenses

when warrant holders exercise their warrants. It would be equally inconsistent to recognize an expense when Jo exercises her options. As Ken Hugessen rightly put it, such transactions merely "... cost the shareholders by way of dilution ..."

Of course, Jo benefits by getting cheap stock and her transaction dilutes the ownership interests of shareholders other than Jo. It even dilutes Jo's own equity as a newly admitted shareholder because each share will be worth less than it would have been worth had she not exercised the options. But no expense appears on the income statement. Rather, from now on, the company's net income will be a bit less than it would have been had it sold shares at market value instead of selling them to Jo at the lower exercise price. So accounting is like a black hole: The company's lifetime net income will be lower because Jo got cheap stock.

The following simplified example illustrates these ideas numerically. On Jan. 1, a firm's non-dividend-paying stock is selling for \$30 and the one-year default-free interest rate is 4%. The firm grants Jo 100 options to buy shares on Dec. 31 at a strike price equal to \$30 ("at the money"). With a one-year term to expiry and an annualized volatility of 30%, each option is worth \$4.11 according to a binomial tree model, which accountants accept as a basis for option valuation. The worker camera snaps a compensation expense of \$411. To balance the picture, it adds the 100 warrant-like securities Jo got to owners' equity, under the caption "Contributed Surplus -- Stock Options." Since we only measure this expense once, on the day Jo Worker got her options, we turn this camera off for the rest of the year.

On Dec. 31, we turn on the Jo Owner camera. Say the stock price has plummeted to \$10. Jo refrains from exercising the options; they expire worthless. Accounting then transfers the \$411 into permanent Contributed Surplus. Jo is no longer a warrant holder; she has "contributed" her estimated productivity for the year to the firm "for free." But retained earnings continues to reflect the \$411 deduction for compensation expense.

Say the stock price soars to \$50 by Dec. 31. Jo exercises the options at \$30. The company gets \$3,000 cash from her and gives her 100 shares worth \$50 each. Jo becomes a shareholder, giving up the warrants she held for the year. The firm adds the \$411 estimated value of Jo's productivity to the \$3,000 cash proceeds, recording new common stock equal to \$3,411. In other words, the company effectively sells Jo 100 shares of stock in return for \$3,000 cash plus 100 warrants that were carried at \$411. As before, retained earnings continues to reflect the \$411 expense.

In the second case, shareholders other than Jo may lament the fact that the company sold stock to Jo for \$30 when it could have sold stock on the open market for \$50, especially since the stock price may have risen for reasons that had little to do with how well Jo performed over the past year. But accounting doesn't recognize opportunity costs. Only if (by coincidence) the stock had been selling for \$34.11 at the end of the year would Jo Owner's profit be equal to Jo Worker's compensation.

As intended, I've only sketched how the accounting works. If you don't like it, ask yourself if it's because you don't buy accountants' depiction of Jo Worker and Jo Owner. If that's the case, you have a much bigger issue with accounting than accounting for executive stock options. Also, there are many interesting issues relating to how Jo Worker might try to inflate the stock price and pocket the spoils as Jo Owner, but that governance issue is much broader than accounting.

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