Assessing Corporate America’s Opposition to the FASB’s New Stock Options Expensing Policy

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The Financial Accounting Standards Board recently issued Financial Accounting Standard 123(R), which requires the fair value of employee stock options to be reported as an expense on corporate income statements. Mandatory options expensing was first proposed in the early 1990s, and the issue has generated considerable debate since that time. Members of the entrepreneurial and technology sectors have been particularly vocal critics of mandatory expensing and, consequently, FAS 123(R).

Some arguments against the FASB’s new expensing standard are quite reasonable, while others seem less valid. For instance, the valuation methods prescribed in FAS 123(R) are somewhat imprecise. This lends credibility to claims that mandatory expensing will fail to improve the reliability of corporate financial statements and will encourage increased litigation. On the other hand, fears that mandatory expensing will place start-ups at a competitive disadvantage relative to established firms seem overblown, as does the claim that FAS 123(R) will curb the economic benefits associated with the issuance of stock options.

Several years are likely to pass before the true impact of FAS 123(R) is understood. In the meantime, concerned businesses can adapt to the new regime by taking steps to minimize the effect of mandatory expensing on earnings.

I. INTRODUCTION: A BRIEF HISTORY OF THE STOCK OPTIONS EXPENSING DEBATE

On December 16, 2004, the Financial Accounting Standards Board (“FASB”) issued a controversial regulation governing the way U.S. companies account for employee stock options. The new rule, known as Financial Accounting Standard (“FAS”) 123(R), requires the fair value of employee stock options to be reported as an expense on corporate income statements. Mandatory options expensing was first proposed in the early 1990s, and the issue has generated considerable debate since that time. Members of the entrepreneurial and technology sectors have been particularly vocal critics of mandatory expensing and, consequently, FAS 123(R).

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stock options awarded to employees to be reported as an expense on corporate income statements.²

More than a decade of debate over the merits of options expensing preceded the adoption of this standard. The FASB first proposed mandatory expensing of stock-based compensation in the early 1990s, but a forceful and effective lobbying effort by the business community³ resulted in the 1995 implementation of a less-stringent policy known as FAS 123.⁴ This standard permitted firms to choose between two methods of accounting for options. The first approach called for companies to report the fair value of options awarded to employees as an expense, thereby reducing net income.⁵ The second allowed firms to avoid showing options expenses on their income statements. Instead, it required firms to provide financial statement footnotes estimating the extent to which option awards would decrease earnings per share.⁶ Naturally, the vast majority of U.S. companies chose the latter method because it did not reduce reported profits.⁷

Flexible accounting rules such as FAS 123 have contributed to a significant increase in the use of options as a form of compensation. The magnitude of this increase becomes apparent when examining the changes to compensation of executive-level employees. In 1992, stock options accounted for twenty-seven percent of the compensation received by the CEOs of America’s 250 largest companies.⁸ Ten years later, options comprised sixty percent of CEO pay.⁹ Initially, the rising popularity of options was viewed as a positive development. In theory, stock options gave corporate managers greater motivation to maximize profits and increase shareholder wealth and more closely aligned the interests of executives with shareholders.¹⁰

Unfortunately, this theory did not always hold true. An unprecedented wave of corporate fraud at firms like Enron and WorldCom revealed the downside of options and other forms of stock-based compensation. Executives receiving massive option awards had

⁵ Id. at 4.
⁶ Id. at 4-5, 14-15.
⁷ Kevin A. Hassett & Peter J. Wallison, A Troubling Requirement, 27 REGULATION 52(Spring 2004).
⁹ Id.
¹⁰ Gary S. Becker, Options Are Useful – But Only If They're Used Right, BUS. WK., Aug. 5, 2002, at 26.
tremendous incentive to increase their firms’ stock prices, and some of them used unethical and illegal means to inflate share values long enough to exercise their options and realize huge gains. In the process, they compromised the long-term viability of their companies and destroyed billions of dollars in shareholder value.

The arguments proffered by critics of option-based compensation are bolstered by a Boston Consulting Group (“BCG”) study that revealed a link between corporate fraud and excessive use of options. It found that the value of the stock options granted to the CEOs of public companies where fraud occurred was 800% greater than the value of the options awarded to the CEOs of comparable firms that did not engage in fraudulent activities. Of the factors examined in the BCG study, the value of stock option awards showed the strongest correlation with instances of fraud.

The debate over options expensing, which was relatively quiet for several years in the late 1990s, intensified following the corporate scandals of 2001. Proponents of mandatory expensing urged the FASB to revise FAS 123, claiming that a new standard was necessary to improve the clarity of corporate financial reports and discourage the excessive use of options. Just as they had in the early nineties, members of the business community fought back. They vigorously defended the use of options and argued that mandatory expensing would be impractical due to a lack of reliable valuation models. This time, however, corporate America’s arguments did not persuade accounting regulators. As a result, mandatory expensing became a reality with the adoption of FAS 123(R).

The FASB’s decision to require that the fair value of options be reported on corporate income statements has not ended this debate. The issue of expensing continues to generate significant discussion, particularly in the entrepreneurial and technological sectors. This Note adds to the discussion by explaining the requirements of FAS 123(R), evaluating the appropriateness of the FASB’s options expensing policy, and examining how firms can adapt to the new standard.

11 Id.
12 Id.
13 Id.
14 See Zvi Bodie, Robert S. Kaplan & Robert C. Merton, For the Last Time: Stock Options Are an Expense, HARV. BUS. REV., March 2003, at 63, 68 (arguing that the practice of disclosing the cost of stock option awards in footnotes distorts financial statements).
15 See id. at 71 (arguing that, in the absence of mandatory expensing, companies are encouraged to award stock options rather than alternative forms of compensation).
16 Johnson, supra note 1, at E1.
II. AN OVERVIEW OF FAS 123(R)'S REQUIREMENTS AND THE RATIONALE FOR ITS ADOPTION

The Securities and Exchange Commission ("SEC") possesses statutory authority to establish financial accounting and reporting standards for public companies under the Securities Exchange Act of 1934.\textsuperscript{17} The SEC delegates much of this rulemaking authority to the FASB, a private sector regulatory body that oversees the accounting industry.\textsuperscript{18} Once the FASB establishes standards, the SEC assumes responsibility for enforcement.\textsuperscript{19} Consequently, the adoption of FAS 123(R) amounted to a federal mandate requiring firms to report the fair value of employee stock option awards.

FAS 123(R) was phased-in during the second half of 2005. For public companies with $25 million or more in annual revenue, the new options expensing standard became effective during the first quarterly reporting period after June 15, 2005.\textsuperscript{20} Public firms with less than $25 million in annual revenue were not required to comply until the first quarterly reporting period beginning after December 15, 2005.\textsuperscript{21} Nonpublic companies also were permitted to delay the expensing of options until the fiscal year beginning after December 15.\textsuperscript{22}

A. Calculating the Fair Value of Stock Options under FAS 123(R)

As firms begin complying with FAS 123(R), they face the challenge of calculating the fair value of options awarded to employees. Because there is no market for trading employee stock options, firms must use complex mathematical formulas to determine the options expenses that appear on their income statements. FAS 123(R) does not require companies to use a specific formula to estimate the fair value of their option awards.\textsuperscript{23} Instead, it identifies six variables that must be included in any valuation model. These variables are: (1) the exercise price of the option; (2) the expected term of the option; (3) the current price of the underlying

\textsuperscript{18} Id.
\textsuperscript{19} Id.
\textsuperscript{20} Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 123 (revised 2004): Share-Based Payment, at 25 (Dec. 2004). FAS 123(R) became effective for "public entities that do not file as small business issuers" during the first interim or annual reporting period that began after June 15, 2005. Id. A small business issuer is defined as an entity that has annual revenues of less than $25 million; is a U.S. or Canadian issuer; is not an investment company; and, if the entity is a majority-owned subsidiary, is owned by a parent company that is also a small business issuer.
\textsuperscript{21} Id. at 26.
\textsuperscript{22} Id.
share; (4) the expected volatility of the price of the underlying share for the expected term of the option; (5) the expected dividends paid on the underlying share during the expected term of the option; and (6) the risk-free interest rate for the expected term of the option.\(^{24}\) The Black-Scholes formula and the “binomial” model, two of the best-known option pricing methods, incorporate each of these variables, and FAS 123(R) specifically mentions them as valuation models that satisfy the FASB’s requirements.\(^{25}\)

Of the six variables, the expected price volatility of the underlying stock is probably the most difficult to accurately quantify. Past share price volatility is often used to predict future volatility, but this approach is of little help to firms that do not have publicly traded stock or have been publicly traded for a very short period of time. FAS 123(R) addresses this problem by permitting such firms to estimate the volatility of their shares using the historical price volatility of other companies in the same line of business.\(^{26}\)

B. The FASB’s Rationale for Adopting FAS 123(R)

Although the valuation of employee stock options is not particularly straightforward or precise, the FASB concluded that the benefits of requiring firms to expense the fair value of options outweighed the uncertainties associated with the expensing process. In announcing the adoption of FAS 123(R), the board cited three reasons for its new standard. First, it felt that mandatory expensing was necessary to ensure that corporate financial statements more accurately reflected economic reality.\(^{27}\) FASB members were concerned that, in the absence of mandatory expensing, firms were compensating employees with options that had economic value but were not including the cost of such compensation in the calculation of net income. In other words, firms that did not expense employee stock options were overstating their earnings. Second, option expensing was mandated in order to make earnings reports more comparable.\(^{28}\) Requiring all companies to report the fair value of option awards spares investors the hassle of trying to compare a firm that expenses its options with one that does not. Finally, mandatory expensing was adopted in order to bring U.S. standards in line with those of the International Accounting Standards Board, which required option expensing as of February 2004.\(^{29}\)

\(^{24}\) Id. at 42-43.
\(^{25}\) Id. at 41.
\(^{26}\) Id. at 43-44.
\(^{28}\) Id. at ii.
\(^{29}\) Id.
While these are sensible justifications, a fourth factor not specifically mentioned in the text of FAS 123(R) may have had the greatest influence on the FASB’s decision. Proponents of expensing highlighted its potential to discourage massive option grants and thereby reduce the likelihood of scandals similar to those at Enron and WorldCom.\textsuperscript{30} The apparent link between options and fraud resulted in increased support for mandatory expensing as part of a broad regulatory effort to discourage corporate misconduct.\textsuperscript{31}

III. ANALYZING THE MAJOR ARGUMENTS AGAINST MANDATORY STOCK OPTIONS EXPENSING

The debate over stock options expensing continues even though companies are now required to comply with FAS 123(R). Members of the entrepreneurial, venture capital, and technology sectors have been particularly vocal critics of the FASB’s decision to require companies to report the fair value of options as an expense. The critics claim that the new expensing requirements will: (1) impact recently started businesses more harshly than established firms; (2) hurt the U.S. economy by discouraging domestic job creation and reducing the productivity gains associated with stock options; (3) fail to achieve the results predicted by supporters of mandatory expensing; and (4) create additional opportunities for trial lawyers to file class action lawsuits against U.S. companies. As the following analysis shows, some of these arguments are quite persuasive and others are less convincing.

A. FAS 123(R) Impacts Recently Started Businesses More Harshly than Established Firms

Entrepreneurs and venture capitalists cite three ways in which FAS 123(R) will disproportionately harm start-ups. First, they note that start-ups generally are more reliant on stock options to attract talented employees than their larger competitors. Second, they argue that the forced expensing of options will reduce earnings, making it more difficult for young companies to obtain capital. Finally, they suggest that the costs of complying with FAS 123(R) will be much more burdensome for small businesses.

There is no question that start-ups, especially those in the technology sector, have used stock options on a widespread basis. Such businesses tend to be cash-strapped, so non-cash forms of compensation such as options frequently are used to attract and retain talented employees.


\textsuperscript{31} Benjamin A. Templin, Expensing Isn’t the Only Option: Alternatives to the FASB’s Stock Option Expensing Proposal, 30 J. CORP. L. 357, 364-65 (2005).
who would otherwise choose to work for larger firms that pay higher salaries. Today, because FAS 123(R) appears to make options less feasible, the entrepreneurial community fears that it is at a competitive disadvantage relative to larger companies. According to Mark Heesen of the National Venture Capital Association, mandatory expensing means “stock options will be too costly for most young companies to grant to all employees.”

If the high cost of options under FAS 123(R) triggers a widespread reduction in option awards, start-ups presumably will find it more difficult to compete in the marketplace for talent.

Start-up companies that continue awarding options may find it more challenging to raise money in the capital markets. Benjamin Templin, a professor at the Thomas Jefferson School of Law, predicts that young companies that use employee stock options will report lower earnings because of the new expensing requirements, causing their share prices to underperform. Such underperformance will in turn make it more costly for them to raise additional capital. Besides increasing the cost of capital for firms that are already publicly traded, critics of FAS 123(R) claim options expensing may delay or entirely prevent privately-held businesses from going public. The premise of this argument is that the added expense of options will make it more difficult for a firm to achieve the level of profitability necessary for an IPO, forcing greater reliance on private equity, which typically is the most expensive source of capital.

In addition to the expenses associated with option awards, companies that continue to grant options are likely to face higher compliance-related expenses because of FAS 123(R). The additional audit fees required to satisfy the FASB’s expensing policy may be significant, especially for small firms that use options liberally. The typical venture-capital-backed start-up is likely to pay $30,000 - $100,000 to auditors and consultants each year in an effort to conform to the new standard. Such high compliance costs are difficult for smaller companies to absorb, increasing the disadvantage they face relative to larger competitors.

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33 Templin, supra note 31, at 399.
34 Id.
35 Id.
following the adoption of FAS 123(R). If compliance-related fees end up being as high as the FASB’s critics suggest, mandatory expensing will create a significant burden for start-ups that award options to employees. Otherwise, it is not clear that FAS 123(R)’s impact will be as negative as the supporters of small business predict.

The argument that mandatory expensing will make small firms less competitive and will increase their cost of capital assumes that options expensing harms a company’s financial condition. In reality, though, the act of expensing options pursuant to FAS 123(R) only changes the appearance of a firm’s financial statements; information that once appeared in a footnote is now a line item on the income statement. Cash flow, which is the ultimate determinant of financial health, remains the same whether or not options are expensed.

The fact that option expensing does not actually “cost” a business any money suggests that investors should not be discouraged from investing in firms that award stock options to employees. Private equity investors who typically provide funding for small businesses are usually savvy enough to recognize this. The same holds true for most of the investors who purchase shares in an initial public offering. Moreover, investor interest in a young company is likely driven by expectations about the future rather than current results. Thus, the entrepreneurial community’s widespread concern about options expensing may be overblown. If audit fees incurred because of FAS 123(R) do not spiral out of control, it appears quite possible that start-ups will be able to continue awarding options without jeopardizing their financial well-being and their ability to raise capital.

B. FAS 123(R) Will Hurt the U.S. Economy by Discouraging Domestic Job Creation and Reducing the Productivity Gains Associated with Stock Options

Critics of FAS 123(R) also contend that the FASB’s new stance on employee stock options will negatively impact the entire U.S. economy. This is based on the theory that mandatory expensing will discourage the

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39 See id.
40 See, e.g., Steve Hamm, Amy Borrus & Mike McNamee, Will Expensing Cost the U.S. Jobs?, BUS Wk, Dec. 22, 2003, at 40 (discussing technology executives’ warnings that options expensing will lead to greater outsourcing); The Economic Impact of Expensing Stock Options, POLICY BACKGROUNDER (Employment Policy Foundation, Washington, D.C.), September 17, 2002, at 4, www.savestockoptions.org/pdf/studies_03.pdf (discussing the potential for reduced economic productivity as a result of mandatory options expensing).
use of options, resulting in the outsourcing of jobs to overseas markets and decreased productivity.

For example, technology firms traditionally have been the biggest users of options. Industry leaders warn that forced expensing will result in an undesirable chain reaction—companies will stop granting options to rank-and-file employees, the employees will demand higher cash compensation in lieu of options, and workforce expansion will ultimately be shifted overseas where skilled workers are available at lower wages. John Chambers, the CEO of Cisco Systems, is among those predicting that mandatory expensing will promote outsourcing. Prior to the adoption of FAS 123(R), he indicated that the FASB’s decision would affect whether his firm decided to grow its headcount in the U.S. or abroad.

Even if mandatory expensing does not cause U.S. firms to hire more workers overseas, opponents of FAS 123(R) claim that discouraging the use of options will have negative consequences for the U.S. economy. Studies suggesting that employee ownership through options has a highly positive impact on individual firms and the national economy support this argument. If options are curtailed because of the burdens associated with expensing, this positive effect may disappear. Research by Joseph Blasi and Douglas Kruse of Rutgers University showed that companies with broad-based option plans increased average productivity six percent faster than firms without such plans. Moreover, the average return on assets at firms with option plans increased sixteen percent more over a ten-year span than the average public company’s return on assets. A study conducted by the Employment Policy Foundation (“EPF”) indicated that discouraging stock options could result in a loss of $2.3 trillion in output over the next ten years. The EPF estimates a reduction in output of this magnitude could cost federal, state, and local governments as much as $563 billion in tax revenue over the next decade.

Similar to the claims that mandatory option expensing will significantly harm small businesses, predictions that FAS 123(R) will be a

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44 Hamm et. al, supra note 41, at 40.
45 Id.
47 Id.
49 Id.
major setback for the U.S. economy may be overstated. Many companies that reduce or eliminate their option programs will likely award alternative forms of equity-based compensation such as restricted stock. Thus, the productivity gains associated with employee ownership are not likely to disappear altogether.

Furthermore, it is quite possible that the talk of moving jobs overseas was nothing more than a hollow threat, concocted by corporate leaders who were searching for leverage in the options expensing debate. For example, Cisco’s CEO made his comments about outsourcing in the midst of a last-minute effort to encourage Congress to override the FASB’s expensing requirements. Considering this context, it seems reasonable to conclude that the economic impact of FAS 123(R) may not be as dire as predicted.

C. FAS 123(R) Will Fail to Achieve the Results Predicted by Supporters of Mandatory Expensing

Following the release of FAS 123(R), FASB Chairman Robert Herz stated that the new standard would “provide investors and other users of financial statements with complete and unbiased information.” Fellow FASB member G. Michael Crooch added that mandatory options expensing would improve the “relevance, reliability, and comparability” of corporate financial data. These comments reflect the goals behind the FASB’s decision to require expensing, yet critics of the plan claim it will not enhance the reliability and comparability of financial statements. Critics also argue that mandatory expensing will fail to achieve another objective not specifically mentioned by Herz and Crooch—the reduction of corporate fraud.

1. FAS 123(R) Will Not Improve the Reliability and Comparability of Corporate Financial Reports

Opponents of FAS 123(R) argue that the option valuation models endorsed by the FASB are not designed to price employee stock options and, therefore, do not provide reliable cost estimates for such option awards. Burton Malkiel and William Baumol, professors of economics at

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51 See Hamm et al., supra note 41, at 40.
53 Id.
Princeton University and New York University, respectively, cite the Black-Scholes formula as an example of a popular valuation model that produces suspect results when used to calculate options expenses pursuant to FAS 123(R). This formula, designed to price short-term market-traded options, is a poor predictor of prices when applied to long-term options. This is a significant problem because employee stock options generally have durations of five to ten years, far longer than the six-month duration of a typical market-traded option. Furthermore, employee stock options possess characteristics that should negatively affect price, but these characteristics are not accounted for in the Black-Scholes pricing formula. The inability to exercise prior to vesting and the inability of employees to hedge their options are two such characteristics. All of this leads professors Malkiel and Baumol to conclude that Black-Scholes and similar pricing models do not accurately represent the fair value of employee stock options. Consequently, income statements that include options expenses are not necessarily more reliable than those that do not.

Critics of FAS 123(R) also note that the comparability of the options expenses shown on income statements is undermined by the FASB’s failure to prescribe a specific valuation method and by the significant assumptions that must be made in calculating option values. The lack of a standardized pricing model means that identical firms can legitimately report substantially different expenses if they use different formulas to determine the fair value of their option awards. Likewise, similar firms will report significantly different options expenses if they do not make the same input assumptions when using the pricing models. Unless investors are able to unravel the differences in the valuation methods used and the assumptions made by the firms, it will be difficult to compare their results. The ease with which companies can manipulate their options expenses by changing their input assumptions is already apparent. One of the simplest ways for companies to lower their costs is to reduce the volatility estimates used to value options. In 2004, 210 companies in the Russell 1000 Index trimmed their volatility estimates, lowering their

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56 Id.
57 Id.
58 Id.
59 Id.
60 Id.
61 Hassett et al., supra note 7, at 58.
63 Id.
64 See Elizabeth MacDonald, A Volatile Brew, FORBES, Aug. 15, 2005, at 70.
options expenses by a quarter, or $1.4 billion. It is not yet clear how many companies used this same tactic in 2005, but investment researchers expect that the release of year-end financial reports will reveal widespread adoption of lower volatility estimates.

In addition to reducing volatility estimates, companies also are lowering their reported expenses by accelerating the vesting of options. Between July and November of 2005, the number of firms using accelerated vesting to trim option expenses increased from 234 to 439. Accelerated vesting will likely cut more than $4 billion from these firms' option expenses in 2006 and later years.

The use of lower volatility estimates and accelerated vesting has prompted Bear Stearns analyst Christopher Senyek to agree with critics of the FASB who question the usefulness and reliability of option expenses reported pursuant to FAS 123(R). He refers to such tactics as “smoke and mirrors” and warns “options expenses could be understated for years ahead.”

Overall, the critics of mandatory expensing make a very good point about FAS 123(R)’s failure to significantly improve the reliability and comparability of corporate financial statements. Forcing firms to report option expenses may increase the extent to which income statements reflect economic reality. This increase is relatively small, however, because of the shortcomings of the prescribed option valuation models. It is doubtful that Black-Scholes or other methods designed to price exchange-traded options can accurately value employee stock options, and the flexibility of input assumptions adds to the uncertainty of reported expenses. Until a more precise valuation model is developed and approved by the FASB, the reliability and comparability of options expenses will be somewhat questionable.

2. FAS 123(R) Will Not Reduce the Incidence of Corporate Fraud

According to the National Center for Employee Ownership, the number of companies providing options for rank-and-file workers may decline by as much as one-third in coming years due to the institution of mandatory expensing. Many proponents of FAS 123(R) see this as a positive development that will eventually reduce the incidence of corporate fraud. Critics of the FASB, however, argue that changes in the way that companies account for options will not materially affect the incidence of

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65 Id.
66 Sasseen, supra note 62, at 34.
67 Id.
68 Id.
69 Id.
70 Simon et al., supra note 50, at D2.
71 Sahlman, supra note 54, at 96.
fraud. One reason for this is that option grants for executive-level employees are likely to remain quite common even if option awards for rank-and-file workers are dramatically reduced. 72

Harvard Business School Professor William Sahlman argues that the potential for corporate fraud will not decline even if executives stop receiving options. He believes that all performance-based compensation systems have the potential to encourage cheating. 73 Thus, the incentive to engage in corporate fraud is likely to remain if companies provide high-ranking employees with alternatives to options such as restricted stock. According to Professor Sahlman, “Only ethical management, sensible governance, adequate internal control systems, and comprehensive disclosure will protect the investor against disaster." 74

This point is well taken. Corporate fraud is far more attributable to executives who lack integrity than the options held by those executives. Even if one assumes that stock options create incentives to engage in fraudulent activities, FAS 123(R) is not necessarily a viable solution to this problem. Mandatory expensing may encourage smaller option awards, but if it also results in larger grants of restricted stock, integrity-challenged corporate executives will still have considerable incentive to manipulate stock prices.

D. FAS 123(R) May Result in Increased Litigation

The flexibility of option pricing models and the uncertainty of the expense figures they generate have fueled speculation that FAS 123(R) will result in increased litigation. Craig Barrett, the CEO of computer chip maker Intel, predicts that “a rule that requires the expensing of stock options when no one knows how to do it accurately” will be a boon for trial lawyers. 75 Barrett's concern is that FASB has mandated options expensing without providing a specific method for calculating such expenses, making it easy for plaintiffs to allege that a company misstated its earnings.

In the process of valuing its option awards, a company has to make two fundamental decisions that leave it vulnerable to shareholder lawsuits. First, a firm must decide to use a particular options pricing model. As time passes, shareholders may allege that the chosen model is less accurate than other models available to the firm and is resulting in misleading statements of earnings. 76 Second, a firm must decide how to apply the chosen pricing model. This involves making a series of input assumptions so that the

72 Simon et al., supra note 50, at D2.
73 Sahlman, supra note 54, at 95.
74 Id.
76 Hassett et al., supra note 7, at 58.
model can place a value on options. The inherent uncertainty of these assumptions creates an opportunity for shareholders to file lawsuits claiming that the firm is manipulating input values in an effort to lower its options expense and inflate net income.\textsuperscript{77}

Larry Ribstein, a professor at the University of Illinois College of Law, believes such lawsuits are likely once shareholders and plaintiffs’ attorneys begin analyzing how companies calculate their options expenses. According to Ribstein, “Recording the expense of options is not entirely straightforward and, arguably, is more confusing than simply disclosing the amount of options in footnotes to financial statements . . . If the disclosure rules are unduly complex or unclear, firms might face a risk of securities fraud liability, which could discourage the use of options.”\textsuperscript{78}

Even if shareholders have little chance of prevailing in court by claiming that a firm used inappropriate options expensing methods to misstate its earnings, aggressive plaintiffs’ attorneys are not likely to be deterred from filing such lawsuits when there is the potential to settle out of court. This is why Intel’s Barrett and other business leaders are concerned about the legal ramifications of FAS 123(R). Companies often settle seemingly frivolous claims in order to avoid the distractions and negative publicity associated with lawsuits, and the FASB’s relatively vague guidelines for options expensing appear to give trial lawyers another opportunity to extract settlements.\textsuperscript{79}

Time will tell whether predictions of increased litigation are correct, but the FASB’s critics have a good point. The flexibility and uncertainty of the expensing process create plenty of room for second-guessing, and trial lawyers are adept at using complex regulatory regimes to their advantage. Interestingly, the business community made similar predictions when the Sarbanes-Oxley Act passed in 2002.\textsuperscript{80} Now, four years later, those forecasts appear increasingly accurate. An overwhelming majority of the 176 class action lawsuits filed in 2005 accused companies of violating Sarbanes-Oxley. Eighty-nine percent alleged misrepresentations of financial documents and eighty-two percent alleged false forward-looking statements.\textsuperscript{81}

Both Sarbanes-Oxley and FAS 123(R) create significant disclosure requirements for U.S. corporations. Consequently, it is not unreasonable to expect trial lawyers to challenge companies’ options expensing methods

\textsuperscript{77} Id.
\textsuperscript{79} Hassett et al., supra note 7, at 58.
just as they are currently questioning firms’ conformance to the standards imposed by Sarbanes-Oxley.

IV. EMPLOYEE STOCK OPTIONS IN A POST-FAS 123(R) WORLD

Whether or not they want to, companies must face the reality of mandatory options expensing. Many firms have responded to the FASB’s new expensing requirements by dramatically scaling back the number of options they award. However, the investment industry’s reaction to mandatory expensing suggests such drastic changes may not be necessary. Instead, companies should adjust to FAS 123(R) by finding legitimate ways to reduce their reported option expenses and considering alternative forms of incentive compensation.

A. The Initial Reaction to FAS 123(R): Corporate America Is More Concerned About Mandatory Expensing than Wall Street

The arrival of mandatory options expensing has coincided with a notable decrease in the number of corporations using stock options to compensate employees. A survey conducted by Lehman Brothers found that companies in every industry awarded fewer stock options in 2005.82 The survey results suggested that the use of option compensation will decline in 2006, as well.83 This trend appears to be motivated by three primary factors – the negative perception associated with lower earnings, the costs of regulatory compliance, and the threat of lawsuits due to the inherent uncertainty of expense calculations.

The diminishing popularity of options is readily apparent at America’s largest firms. Companies included in the Standard & Poor’s 500 stock index issued $80 billion in stock options in 2002. Ira Kay, head of the compensation consulting division of Watson Wyatt Worldwide, predicts this figure will fall by fifty percent by 2010 as firms scale back eligibility for option awards.84 All told, up to forty percent of publicly held companies are reconsidering broad-based option plans, and more than thirty percent may discontinue their option plans within a few years.85

The move away from options is particularly evident in the technology sector, where companies traditionally have been very generous in granting options to employees. Half of the technology firms participating in a study by consulting firm Towers Perrin indicated that they were planning to reduce the aggregate number of stock options awarded

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83 Id.
84 Simon et al., supra note 50, at D2.
during 2005. A Deloitte & Touche survey of the technology industry yielded similar results; it found that sixty percent of participating firms were planning widespread reductions of option grants.

While corporate America appears wary of options following the adoption of FAS 123(R), Wall Street analysts and institutional investors, the most frequent users of financial statements, seem far less concerned about the impact of mandatory options expensing. The addition of charges for options will depress earnings, but it is not clear that stock prices will follow suit. According to Credit Suisse accounting specialist David Zion, the earnings of the companies in the Standard & Poor’s 500 will decrease an average of three percent following the adoption of FAS 123(R)-compliant accounting practices. The sectors of the economy that use options more extensively will have a more pronounced decrease. For example, Goldman Sachs analyst Rick Sherlund predicts that the earnings of software firms will decrease an average of twenty percent during fiscal 2006.

Although corporate bottom lines will shrink because of options expensing, the impact on stock prices following the implementation of FAS 123(R) may be relatively minimal. Most firms have not included options expenses in their income statements until recently, but they have provided estimates of such expenses in the footnotes to their financial statements. Thus, analysts have been able to evaluate the financial impact of employee stock options for quite some time. As a result, many market experts argue that the new expensing standard is a non-event because option costs are already factored into stock prices. A Towers Perrin study that tracked the share prices of 335 companies that voluntarily expensed options between April 2, 2001, and August 14, 2003, supports this argument. The study showed that the average stock price of firms announcing decisions to

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89 Id.
92 Id.
expense options did not vary significantly from the movement of the 900 companies making up the S&P 500 and MidCap 400 indices.93

B. Learning to Live with FAS 123(R)

A company that continues granting options can minimize the pain of complying with FAS 123(R) by taking steps to limit the cost of its options program. For example, a firm can reduce the exercise period on the options it grants to employees.94 By reducing the traditional ten-year exercise period on an option five years, a firm reduces the accounting charge associated with the option as well.95 This is because the term of an option is a mandatory component of pricing models.96 The downside of reducing an option grant’s exercise period is that doing so also reduces an employee’s incentive to stay with the firm.

Stipulating the maximum gain employees can realize on options can minimize the accounting charge resulting from option awards.97 Like reducing the duration of options, placing a ceiling on gains somewhat undermines the rationale behind granting options. However, firms make this trade-off if they want to provide options to their employees without incurring burdensome options-related expenses.

Firms that decide to reduce or eliminate their options programs can reward employees with other forms of performance-linked compensation. Many companies have decided to grant shares of restricted stock to employees instead of options. Microsoft is perhaps the most prominent firm to take this step.98 Restricted shares are outstanding shares of a company’s stock that are subject to forfeiture and cannot be sold for a certain period of time. Employees who leave a firm prior to the expiration of the forfeiture period lose ownership of their restricted shares. Grants of restricted stock create incentives similar to those created by stock options. They tie an employee’s compensation to company performance and give the employee incentive to stay with the firm until the forfeiture period lapses.99 In the past, restricted stock awards were relatively rare because, unlike options, they had to be expensed. Now that the playing field has leveled, they are becoming more common. The advantage of awarding restricted

93 Id.
95 Id.
96 Id. at 4.
97 Id. at 6.
98 Lavelle, supra note 82, at 12.
stock instead of stock options is that the reported expense tends to be lower and is easier to calculate than the expense associated with options.\textsuperscript{100}

\section*{C. A Look at the Future}

As firms begin complying with FAS 123(R), the realization that stock option expensing is here to stay has fueled a search for more user-friendly option valuation models. Thus far, the SEC has rejected proposed alternatives to the guidelines set forth by the FASB. Nevertheless, the agency appears willing to consider suggestions for making options expensing a more straightforward process.

Much of the effort to find alternatives to the Black-Scholes and binomial methods has focused on the development of a market-based pricing system. Financial experts have argued that options expensing is fraught with uncertainty largely because there is not a market that can establish the true value of employee stock options. Cisco Systems, one of the leading grantors of stock options, sought regulatory approval for a possible solution to this problem in May 2005.\textsuperscript{101} Cisco’s proposal, developed by investment bank Morgan Stanley, called for the creation of a market for derivative securities linked to employee stock options.\textsuperscript{102}

Cisco’s plan failed to win the approval of the SEC, but the rejection was not a complete loss for the critics of FAS 123(R)’s approach to options expensing.\textsuperscript{103} In his response to Cisco’s proposal, SEC Chief Accountant Donald Nicolaisen did not reject outright the possibility of using financial derivatives to price options.\textsuperscript{104} Moreover, the SEC’s decision was accompanied by pledges from agency officials to engage in a broader dialogue with companies and investors about improving the options valuation process.\textsuperscript{105} Thus, there is reason to believe a more reliable alternative to current options expensing methods will eventually be developed and approved.

\section*{V. CONCLUSION}

It will likely be several years before the impact of FAS 123(R) is fully understood. This new regulation certainly has shortcomings, yet the business community may not have as much reason to fear mandatory expensing as some have suggested. Even though options expenses reduce a

\textsuperscript{100} \textit{Supra} note 83, at 6.
\textsuperscript{102} Id.
\textsuperscript{104} Id.
\textsuperscript{105} Id.
company’s reported net income, such expenses do not alter the financial condition of the firm. This is because options expensing is an accounting function that does not actually cost the firm any money. Studies showing that stock prices generally do not react when firms begin reporting options expenses reveal the minimal financial impact of mandatory expensing. This suggests that companies should not be concerned that the reduction in net income will hinder their ability to raise capital.

Nevertheless, FAS 123(R) has notable flaws that may overshadow the benefits of increased disclosure in the long run. The option valuation models prescribed by the FASB were not designed to price employee stock options. As a result, they are difficult to use and yield results that are not always reliable. Moreover, the complexity of the valuation process is likely to result in significant audit fees and other compliance-related costs for firms that continue to award options. Finally, mandatory expensing is likely to encourage increased litigation because the uncertainty of the expensing process makes it relatively easy to allege that a company misstated its option costs.

Despite these shortcomings, the SEC firmly backs FAS 123(R). Companies are recognizing this and learning to live with mandatory expensing. Some are replacing their option awards with alternative forms of incentive compensation; others are adjusting their option plans in order to reduce reported expenses; and virtually all of them are hoping for the development and approval of a simpler, more effective valuation process. The emergence of such a model might be the key to finally ending the options expensing controversy.