Exploring the nexus between stock options and corporate accountability

Shagoofa Khan
Daksha Baxi
Chartered Accountant

Granting stock options to employees evolved as one of the methods to inculcate high employee involvement in the company by making them participate in the ownership of the company. More recently, the Information-technology companies used equity compensation for attracting and retaining talent in their companies. However, the tech. meltdown and the fall of corporate giants in the US has forced the regulators the world over to think hard
Grant of stock options has also witnessed positive impact on the overall performance of the granting company since :

* Employees think and act like owners — use their talents and energies to enrich themselves and their co-workers;
* Owners achieve liquidity and are able to attract collaborators;
* Company becomes more productive and competitive.

This article attempts to discuss some of the issues relating to stock options, highlighting its relationship with accounting, expensing and corporate governance. A detailed discussion on the use of various types of equity compensation and its treatment in the books of a company is outside the scope of this article.

Relationship between corporate governance and stock options :
Corporate governance can be broadly understood to be a set of relationships between a company and

* Its Board;
* Its management;
* Its shareholders; and
* Other stakeholders.

Corporate governance aims at fixing liability and determine accountability of the management of the company towards all the company's stakeholders. It assimilates business ethics and social responsibility as a necessary extension of the Company being a part of the system.
In India, corporate governance is enforced through a series of disclosures (as envisaged under the Companies Act, 1956 and the listing agreement) and standards of internal management (i.e. quality and independence of the board of directors, audit committee requirement, etc.). Though still in the nascent stages in India, the proverbial Laxman rekha between corporate governance and corporate mis-governance is transgressed by the management by way of :

* Tricky accounting;
* Insider trading;
* Risky ventures;
* Related party transactions;
* Possible promoter abuses;
* Formation of hidden mono-polies;
* Bribes and payoffs to government officials; and
* Transfer pricing and sham transactions.

Under corporate governance norms, the emphasis is on transparency and disclosure of decisions that will have impact on the financial statements of a company, and hence have a

bearing on the investment decisions of the shareholders. Disclosure in relation to compensation to employees of a company assumes significance in this context.
Employees, especially executives (CEOs/CFOs) are privy to inside information, gathered as part of daily work routines. Stock options to such employees provide incentive for their complicity in manipulating the compilation and presentation of financial data, resulting in inflated stock prices. Further, to the extent that stock options are a form of employee compensation and are not reflected in the books as such, the profits of the company are exaggerated. This results in an untrue picture of the personnel cost of the company.

Expensing stock options :
What and how to expense ?
As per the Securities and Exchange Board of India ESOP Guidelines, 1999, 'value' of stock option would be the difference between the market price on the date of grant and the exercise price of the option, or the fair value of stock options, computed using the Black-Scholes Formula or such other binomial function. Listed companies are required to expense this value over the period of vesting of the stock options. Currently, there is no such expensing requirement for unlisted companies.

Why expense ?
Arguments in favour of expensing stock options :
* Regardless of the scheme, stock options are a form of 'employee compensation' by nature and must be expensed;
* Such expense erodes the distributable profits and consequentially affects the company's earning per share;
* Grant of stock options results in an opportunity cost to the company which is equivalent to the discount at which the employees are granted the option, compared to the market price of the shares;
* Since, stock options are aimed at aligning the interest of the employees with that of the shareholders by way of improved performance of the employees resulting in better stock price performance, cost of such capital appreciation needs to be accounted for;
* Last but not the least, as experience has shown, incentive to manipulate accounts can be checked if the company is made to take a hit on its bottom line.

Arguments against expensing stock options :
* There is no actual cash outflow to the company at the time of grant or exercise of stock options — loss cannot be brought on the books merely on 'opportunity cost' basis. It cannot accurately be stated that stocks purchased by the employees would have actually been subscribed to by general public at the market price and as such the company may not incur a loss;
* Existing valuation models prove inadequate to quantify the actual cost to the company;
* Although, stock options may be in the form of 'incentive plans', no asset (i.e. goodwill or human resources) is brought on the books which in turn is written off over its useful life;
* Quantifying and expensing, even if possible, will not per se address the imbalance between employee and investor interests.

Accounting treatment of stock options in the US :
Stock options are used most extensively in the US. Ac-cordingly, US has already introduced standard accounting practice for recording stock options. Companies are required to expense stock options, using either the Financial Accounting Standards Board Statement 123 ('FAS 123') or the Accounting Principles Board Opinion 25 ('APB 25') read with Inter-pretation No. 44 on APB 25. Despite these standards, the investors have been taken for ride by ingenious accounting practices by US corporates. Thus, it is only natural that we should examine the US account-ing practices in this regard and its development till date.

APB 25 :

APB 25 establishes the generally accepted accounting principles for measuring the amount of compensation to be recorded in a company's books in relation to employee stock options.

For the purposes of APB 25, stock options are classified as compensatory or non-compen-satory. Broadly speaking, com-pensatory stock options are options granted to employees in recognition of past services of such employees and con-sequently need to be accounted for in the books as compensa-tion. Non-compensatory stock options would have characteristics such as grant to non-employees, options linked to future perfor-mance benchmark et al. Such stock options are not construed to result in compensation expense. A detailed discussion on the parameters on which this classification is based is beyond the scope of this article.

Under APB 25, the most significant factor in determining and recognising compensation cost is the 'measurement date.' Measurement date is the first date on which both the number of shares and the option or purchase price, if any, are known. Typically, the measurement date in case of 'fixed option grant' would be the date of grant, since on this date, both the number of shares and the option price are known. On that date, the compensation is measured as the excess of the fair market value of the stock on that date over the purchase price. This is referred to as the 'intrinsic value'. As most options are granted with a purchase price equal to the then fair market value of the stock, most stock option grants do not involve any compensation expense under APB 25 even though the stock may increase in value after grant. Till the components (i.e. number of shares and purchase price) for determining the compensation cost are known, the grant of stock options is as good as an 'off balance sheet' transaction.

FAS 123 :

FAS 123 deals with accounting of grant of stock options to employees as well as to non-employees. The definition of measurement date under FAS 123 is the earlier of (i) the date of a 'performance commitment,' or (ii) the date at which the non-employee service provider's performance is complete. A measurement date will occur on the earlier of these dates, notwithstanding the fact that on such date the terms of an equity instrument may depend on other events that have not yet occurred. Prior to the occurrence of a measurement date, compen-sation expense should be measured at the then current 'fair value' of an equity instru-ment on each interim financial reporting date until the measurement date.

Under FAS 123, 'fair value' of an option is estimated using an option pricing model (such as the Black-Scholes or binomial model) that takes into account the following factors :

* Exercise price;
* Expected life of the option;
* Current price of the underlying stock and its expected volatility;
* Expected dividends on the stock; and
* Risk-free interest rate for the expected term of the option.

A company may elect to apply FAS 123 to its employee stock options, in addition to its non-employee stock options. Once a company elects to apply FAS 123, it is not permitted to switch back to APB 25. Even when a company elects to account for stock options under APB 25, it is required to compute and disclose in its financial state-ments, by way of a footnote, the compensation cost of its stock options (whether employee or non-employee) as calculated under FAS 123. Such footnote should include income statement disclosure and earnings per share.

Recent developments :

In July 2002, Coca Cola an-nounced its decision to expense all stock options as per the fair value method as envisaged under FAS 123 so as to bring its earnings in parity with economic realities. In the past, Coca Cola had applied APB 25 read with Interpretation 44 for accounting of its stock option plans. Accordingly, no compen-sation cost had been recognised, as discussed earlier under APB 25 analysis. Amazon and General Motors have also voluntarily decided to charge their stock options to the profit and loss accounts. The recently enacted Sarbanes-Oxley Act addresses the issue indirectly by requiring the certification of financial reports by CEOs and CFOs for their accuracy.

The Financial Accounting Standards Board in the US has issued an exposure draft on 'Accounting for stock-based compensation — transition and disclosure, an amendment to FAS 123'. This proposed statement seeks to amend FAS 123 to provide for alternative methods of transition for a voluntary change to the 'fair value' method of accounting for stock options. Additionally, it seeks to amend the disclosure requirements of FAS 123 to include disclosures about method of accounting used and the ef-fect of the method on the re-ported results. The new amended standard would be mandatory from the accounting year 2004.

Indian scenario :

In India, stock options issued by listed companies are regulated by the SEBI ESOP Guidelines, which was expected to usher better corporate governance. The disclosures and the compliance requirements under the SEBI ESOP Guidelines are quite elaborate. They require complete disclosure with respect to the options granted, including the pricing formula, options vested, options exercised, the number of shares arising as a result of the exercise of options, options lapsed, variation of terms of options, money realised by exercise of options, the employee-wise details of the options granted and the diluted earnings per share pursuant to the issue of shares on the exercise of the option calculated in accordance with the International Account-ing Standard 33.

Such disclosures are required to be made in the Directors' Report. Companies like Infosys, Wipro and Satyam state, by way of a note to the accounts, the possible impact on the company's earn-ing per share if the stock options were expensed out.

However, there are no provisions in the SEBI ESOP Guidelines for ensuring their enforceability, nor any transition provisions for unlisted companies in regard to stock options issued prior to listing. Further, as far as 'non-variable' plans, (i.e. plans in which both the number of shares and the purchase price are known at the grant date) are concerned, the intrinsic value method as laid down by the SEBI ESOP Guidelines may be sufficient. However, when 'vari-able' plans (subject to performance vesting) are issued by the company, then the intrinsic value method may be inadequate since at the date of grant the number of shares to which the employee will be entitled will not be known. Black-Scholes formula or other binomial function has also been pre-scribed as an alternative for determining 'fair value' for accounting. Issues like granting stock options through a trust route too need to be addressed so that there is no possibility of not accounting for stock options expense.

Conclusion :

The relationship of stock options and corporate governance is much beyond the accounting of stock options. It is certainly a starting point and the Institute of Chartered Accountants of India needs to bring out a standard for expensing stock options so as to complement and achieve the effectiveness of the elaborate disclosure require-ments under the SEBI ESOP Guidelines.

To conclude, the following statement of Warren Buffet aptly summarises the debate on expensing of stock options : "If options aren't a form of compensation, what are they ? If compensation isn't an expense, what is it ? And, if expenses shouldn't go under calculations of earnings, where in the world should they go ?"