Opinion

Stock

BY JOSEPH D. BEAMS, CPA

The collapse of Enron and scandals at WorldCom and other companies in 2002 led to lost jobs and pensions for many employees and lost savings for investors. The public was outraged, politicians were nervous, and analysts were embarrassed. How could thefts of this magnitude be hidden by accounting practices? Alternative methods of accounting for the same or similar transactions were viewed as part of the problem. The Sarbanes-Oxley Act was passed soon after details of the WorldCom scandal hit the business press, and penalties for insider misconduct were increased. America was tired of once again letting dishonest corporate executives dupe the investing public.

This cry for change created an opportunity for the Financial Accounting Standards Board (FASB) to once again consider requiring public corporations to expense stock options. It began looking at this issue in the 1980s but met overwhelming opposition from both the business community and politicians. In particular, high-tech companies, who often compensate employees with salary packages containing stock options, lobbied Congress to prevent a requirement for expensing stock options. As a result of this effort, Congress threatened to take power away from the FASB if it didn't back off the expensing issue. As a compromise, in 1995 the FASB passed Statement of Financial Accounting Standards No. 123 (SFAS No. 123), "Accounting for Stock-Based Compensation," which allows companies to choose whether or not they want to expense the fair value of employee stock options in their financial statements or continue to follow Accounting Principles Board Opinion No. 25 (APB No. 25), "Accounting for Stock Issued to Employees," and only disclose the effect that expensing would have in the notes to the financial statements. For a time it appeared that the high-tech companies had won. Even though SFAS No. 123 states that expensing the fair value of options is the preferred method, for the next five-plus years, nearly all companies chose not to report stock option expenses in their financial statements. Then came Enron, WorldCom, and a host of other scandals.

In March 2003, the FASB announced that it intended to readdress the issue of accounting for stock options and possibly release an exposure draft before the end of that year. After 20 years, it finally appeared that the FASB would be able to require companies to report the fair value of stock options. Many companies, viewing it as inevitable, began to expense their stock options before a new pronouncement required them to do so. This made a company appear more socially responsible at a time when corporate credibility was being widely questioned. The new exposure draft that requires the expensing of stock options, "Share-Based Payment," was issued March 31, 2004, and the FASB allowed comments until June 30, 2004. Last month the standards setter announced that it would postpone the required expensing of options for another six months.

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THIS TIME IT'S GOING TO BE DIFFERENT

Thus, the rule would take effect in the third quarter of 2005 rather than the first quarter.

But opposition remains strong, and lobbyists continue to pressure Congress to stop the FASB from requiring companies to expense stock options. It has been two years since the Enron and WorldCom collapses, and the anger at corporate malfeasance may be subsiding. In July 2004, the U.S. House of Representatives passed a bill that would prevent the FASB from requiring companies to expense the fair value of stock options. The House bill would only require the expensing of options granted to the top five executives.

Once again it isn't clear whether the FASB will be able to require companies to expense stock options. But this time there's a catch. SFAS No. 123 allows companies to choose whether they will report stock option expenses in their financial statements, but it also says that fair value expensing of options is the preferred method "for purposes of justifying a change in accounting principle under APB Opinion No. 20, 'Accounting Changes.' " Once a company begins to expense its stock options under SFAS 123, it can't switch back to APB No. 25.

Those companies that decided to expense their stock options in anticipation of a new Statement—or simply because they felt it was the right thing to do given the time and circumstances—can't change their minds if a new Statement doesn't appear. Until recently, most companies continued to follow the rules of APB No. 25 and only disclose the effects of fair value expensing of options in the notes, so there was no problem of comparability between companies. Since 2002, many high-profile companies have switched to fair value expensing. Coca-Cola began using this method for its year ended December 31, 2002, and Microsoft followed suit for its year ended June 30, 2004. This could make comparisons between companies even more difficult. The net income reported in Microsoft's income statement reflects $5.7 billion of stock options expense. By contrast, Intel hasn't adopted fair value expensing. For 2003, it had $991 million of employee stock options expense that wasn't included in its income statement and is only reflected in the notes.

In 1995, nearly all companies opposed the fair value expensing of stock options. This was evident because virtually no companies chose to use this method. Now, many have begun to use it and will likely be in favor of requiring all companies to do so. In my opinion, this support, or at least lack of resistance, from companies that have already switched to fair value accounting for their stock options will allow the accounting profession to finally require the expensing of employee stock options. ■

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