

# Options, and the Lying Liars Who Don't Want to Expense Them

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## Introduction

The “debate” concerning the expensing of options somehow manages to continue even though by all rights it should long be over. This short essay reviews the arguments for and against expensing options, coming down entirely, blindingly and whole-heartedly on the side of expensing them, and in fact finding the counter-arguments in most cases either intellectually bankrupt, morally bankrupt, or both. Those making these mendacious pleas for accounting fiction should really be ashamed of themselves.

So why am I writing this essay when the arguments for expensing options are so clear cut and obvious and many others have already written accurate eloquent pieces making the same case? Well, only because the “debate” still rages on and the forces of logic and sense have yet to succeed. I could not resist adding my small voice to the cause. Furthermore, many days still bring the odd editorial in the Wall Street Journal<sup>2</sup>, or an interview on cable news from a tech stock executive, a sell-side shill, a NASDAQ chieftain, a captain of industry, or worst of all, a politician on why options should remain un-expensed. Since this collection of pundits does not seem to mind repeating

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<sup>1</sup> I'd like to thank several anonymous friends for comments on the first draft, but I will not name them for fear their computers will mysteriously stop working.

<sup>2</sup> In the interest of full disclosure I should mention that some months ago the WSJ summarily rejected an editorial shorter, but similar in spirit (if less angry as I had co-authors to calm me down) to this essay written by myself, Rob Arnott (editor of the Financial Analysts Journal) and Bill Bernstein (widely respected author on investments, economic history, and other topics). Truth-be-told they also rejected an editorial by this same trio, and a little known callow fellow of narrow experience named Jack Bogle Sr., responding to the authors of Dow 36,000 who continued to insist that they were right (they weren't, and they shouted fire in a crowded NASDAQ in 1999 to the general public and people should remember that) in their own WSJ editorial. The WSJ also has recently published multiple editorials by another group of their old cronies claiming that this still expensive stock market is actually off-the-charts cheap. I will leave it to you, and posterity, to ask why they publish inane arguments by bubble shills, and not ours. I am obviously biased, but if you want my opinion, the WSJ editorial staff has woefully confused their mission of defending free markets with the goal of propping up expensive ones.

falsehoods, I believe another article repeating the truth should be tolerated. My apologies go out to the many who have already made the following arguments in other venues. I'm not copying you, I'm saying amen to your work. In a more formal setting I'd cite each of you. Suffice it to say that little below is original save the sarcasm.

The bigger question is why do I care so much. Well, like many others I think the 1990s, culminating in the late 1999 / early 2000 bubble blow-off, was not just about valuations soaring to unsustainable heights, it was about truth being shown the door. Now we have to rebuild not just our markets, but also our faith in the system itself. So, what makes this issue so important? Accounting is inherently adversarial, with companies trying, within the rules, and sometimes by influencing the rules, to paint their firms in the best light possible. What makes this any different? Well, it is a matter of degree. There are lines you should not cross, and arguments you should not make. You should not spend lobbying money to get financially addled congressmen to legislate that  $2 + 2 = 17$  in a knowing effort to inflate your stock price, at the expense of anyone buying your shares, and for financial gain for yourself. That is beyond the pale of even an adversarial system. Those who perpetrate it should be met with scorn and anger. As such, I don't think I'm too angry about expensing options, I think everyone else on my side is too calm. Of course, my therapist reminds me that I think that way about many issues.

### Why Options Must be Expensed

Options are something of value (even if out of the money<sup>3</sup>). They are something people want and desire. When you give them away, the company gives away something of value and that is called an expense (sometimes giving away something yields an asset in return and that is called an investment, but this is not one of those times). If it helps to understand this, imagine instead of giving options to executives, the company gave them randomly out as gifts at a shopping mall. Would they be an expense then? The company just took something of value and gave it away, sounds like an expense to me. Now go a step further, and say the company didn't issue new options to give away (which means if they get exercised, existing shareholders get diluted), but rather bought the options in the open market from a broker. For example, say Company A goes to investment banker B and buys for cash \$100,000,000 in out of the money call options on their stock and gives them away to random people. There is no dilution. If those options get exercised shares will change hands and money will be exchanged, but the only effect on the company is the initial outlay of the options cost *in the year* they bought them. If you don't think this is an expense please stop reading and instead concentrate on mastering simpler things. Well, the case of companies issuing options against an implied promise to issue shares to fulfill them if exercised is no different.<sup>4</sup> Options issued are an expense. They are an

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<sup>3</sup> I assume some rudimentary options knowledge in this piece. If you don't have any, that is of course fine, but please don't dare have an opinion on this issue. Unfortunately, this rules out much of the government, media, and half of the tech company CEOs who feel so strongly about it.

<sup>4</sup> It is no different in terms of current expense, but going forward it is different as the shareholders remain "short" the option in the case of a direct grant (and future fluctuations of the option value matter). In the case where options are bought in the open market any fluctuations going forward are between the employees with the options, and whoever took the other side in the open market.

expense in a house, they are an expense to a mouse, they are only not an expense if you're a louse.

Now that this has (again) been proven beyond a reasonable doubt, we can move on to eviscerating and ridiculing the specific arguments against options expensing. I apologize in advance that many of the arguments that follow are similar or overlapping.

#### False Reason Not to Expense: Options Values Are Difficult to Calculate

Yes, there are definitely some issues regarding valuing executive stock options. The justly famous, and reasonably accurate for its purpose, Black-Scholes options pricing model is generally geared to short-term options, with fully rational exercise policies (not all employee stock options are rationally exercised), and constant volatility. In broad generality, for several reasons, Black-Scholes probably overprices executive stock options.

This is a ridiculous reason not to expense options. First, many, if not most, accounting numbers are subject to wide bands of error (anyone ever hear of depreciation, or its tricky pal amortization, or even more apropos to unexercised options, typical finger in the wind guesses of bad debt expense or goodwill?). There is little evidence options are more dicey than many other parts of financial statement analysis. Second, many methods have been developed, by academics and practitioners, to correct some of the deficiencies of the Black-Scholes model for this purpose. Third, and most important, there is only one non-negative option value we know is demonstrably false, zero. Saying we can't calculate options values accurately, so let's choose the one and only value we know for a fact can't be right, is nuts. "...Gregor Samsa awoke one morning ... transformed in his bed into a monstrous insect..." is the start to a more realistic, and more uplifting story than those telling this yarn. If you want to use some fraction of the Black-Scholes price, or argue for a conservative model, then that is a legitimate subject for debate. But, zero is just a provably insane choice.

Finally, if option values really are way too difficult to calculate accurately (which they are not), then options should not be used at all for compensation. Is it prudent to pay people with a currency whose value we cannot even estimate?

#### False Reason Not to Expense: They Have No Value When Issued

Yes, they do (see above for calculating that value). If the options have no value when issued then I assume the executives would be happy to just give them to me. No? Really, how interesting. I could go on about this one, as it has been said many times (really, I know that is hard to believe). It callously and consciously relies on people misunderstanding present value and probabilities.

### False Reason Not to Expense: This Stuff is Already Reported in the Footnotes

So we should bury the truth and lie on the front page in bold type? How about we switch the order? I know, radical idea.

### False Reason Not to Expense: The Options Are Worth Less to Executives As They Are Not Diversified

Here is how this argument goes in more detail. Since executives end up concentrated in their own stock, executive stock options are worth less to them than their open market prices, as they are forced to own a concentrated and risky portfolio. This is probably true, however, that is just a downside to using options as compensation, not a reason to avoid expensing them. Since when does a company calculate expenses based on the value of their payment to the vendor not themselves? If a company paid for its widgets, but the widget company found U.S. currency just didn't work for them, is the expense gone? No, it isn't.

### False Reason Not to Expense: Options Values Must be Periodically Recalculated if They Are Expensed

Yes, if issued, and not purchased in the open market, the options are a contingent liability of the corporation. When first issued the company has handed something away of value, and that is an expense. If those liabilities change in value, it should hit both balance sheet and income statement and involves some ongoing work. Too bad. We have accountants and computers, pads and pencils, and loads of coffee percolating just to do this kind of thing, and it's already being done all the time for all sorts of things other than options. "Gee we'd have to change these numbers once a quarter and that would be exhausting" is not a reason to lie about today's expenses. "We are too lazy to expense options" is quite an uninspiring battle cry.

### False Reason Not to Expense: If Tech Companies Have to Expense Options It Will Destroy Them

Well, it is just not true. Expensing stock options won't kill tech. Though, frankly, if it did then they should die. "If we had to report our true earnings nobody would invest in us" is not a reason to grant an exemption from reality. In fact, it's insulting.

Though I doubt it would occur, if the tech industry would be smaller if it reported the truth to its investors, than it should be smaller. In fact, if this reason not to expense was valid, why make tech companies acknowledge other expenses in full? It's no different. Instead of letting them lie about options, how about a law that tech companies only have to report expenses every other month?

I guess one might argue that by not expensing options, we encourage their usage, and somehow entrepreneurship in general. And, in some Keynesian "trick the people" fashion, this is a good thing. Well, again, if this is the goal, truthful accounting and an

honest subsidy for entrepreneurship seem preferable to “hey, let’s just let them lie about earnings”. Also, if this is the noble goal behind not expensing options, one doesn’t have to sing the Internationale to marvel at the irony that the clearest consequence of this humanitarian gesture is to incredibly enrich a handful of managers (often not the creative entrepreneurs) at existing large tech companies.

I believe technology companies are too healthy and strong, and their executives too smart and energetic, to need to rely on false accounting to be successful. It is a pity that they disagree (or pretend to).

#### False Reason Not to Expense: They Involve No Current Outlay of Cash

Granting options involves no current outlay of cash. True. So what. Issuing a promissory note to pay for the commissary donuts (note the cadence) also involves no current outlay of cash, and that is an expense (and a pretty big expense at any firm I’d work at). Even simpler, paying with a credit card doesn’t move the expense into the future.

#### False Reason Not to Expense: It is Really a “Re-allocation” Through Dilution Not an Expense

While this is only a slightly different version of the prior point, it gives me the chance to type some more.

One really silly version of this argument states that dilution is a “personal” thing between the new shareholders (management) and the old shareholders, and not a subject for the firm’s accounting. I’m not even sure what this means, but if instead of expensing options, firms want to issue a prominent special notice detailing how much they’ve “personally” screwed their existing investors per share on a forward basis, I might be alright with it, if only for the honest humor. I love a good “PNOIS” (prominent notification of investor screwage).

#### False Reason Not to Expense: They Might Never Be Exercised

Yet another version of “they have no value today” just phrased differently (sorry, this comes up a lot). This one is particularly insidious because it intentionally preys upon the misunderstandings of finance common to the general public (and, you know, Congress). Option valuation (Black-Scholes or otherwise) methods are exactly about determining what they are worth when issued based on the fact that they may or may not be worth something (or may be worth a ton) down the road.

To give an example of how silly this argument is, say I’m a company and I go to my widget supplier and say “instead of paying you now, let’s agree to a deal where next year I pay you 3 times the normal amount if a coin flipped then comes up heads, but nothing if it comes up tails.” Did I just eliminate all expenses this year? Is there no expense this year and only an expense next year if heads comes up? Nope. The basic principle of

accrual accounting is to recognize expenses when they occur. A reasonable estimate for expense this year is 1.5 times normal levels<sup>5</sup> under the scheme above (and, by the way, that's how we'd know it was a bad deal!). Black-Scholes valuation, or anything like it, is basically carrying out a very similar exercise for stock options, looking at future payoffs and probabilities and estimating today's economic expense.

#### False Reason Not to Expense: Options are Only Exercised During Good Times for the Company

This one is also insidious (sorry, my thesaurus is broken) and comes up again and again in options "analysis" of all kinds. The idea is that you don't care about issuing options, because they're only exercised (diluting existing investors) when times are good, so no one really cares as you are rolling in it anyhow.

First, it's a complete red herring as why does this matter to the question of whether options have value when issued and are thus an expense or not. Second, investors presumably buy stock because they think it will rise over time, the fact that you give up a portion (sometimes substantial) of that rise appears to be a real cost. Nope, this one's a big load.

#### False Reason Not to Expense: They Do Not Ever Involve a Cash Outlay, Even At Exercise, Only a Dilution

Executives exercising options receive shares from the company for cash that's always less than what those shares are worth. Other equity holders are benefited by the cash inflow, but lose by the fact that they own less of the company. In aggregate the other shareholders are hurt by the amount the shares are worth more than the cash the executives paid for them. Dilution is real, painfully real, and the fact that they take investors' share of the company rather than cash out of their pocket is a very silly reason to think option expense isn't real.

#### False Reason Not to Expense: They Are Only an Expense When Cash is Spent at Time of Exercise to Prevent Dilution

This is hilarious when considered after the last one. Many firms don't like the appearance of dilution, so when executives exercise their options and thus dilute shareholders, the firms spend real cash to go into the open market and buy back shares to stop the dilution. At that point it is pretty obvious that there is a cash expense, and some quasi-reasonable people have said, "ok, when this happens, we'll acknowledge it's an expense, but otherwise no." These people are really not so reasonable.

These are wholly disconnected transactions joined only by a commonality of confusion. Just because a company goes into the open market and pays the going price for shares, does not change whether options had a value when issued or when exercised. It's a completely cosmetic transaction where companies decide that their investors would be

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<sup>5</sup> Ignoring things like risk aversion and present value.

pissed off to be diluted, but somehow won't be if they have the same shares of a company with less cash. It changes nothing, and certainly not when and whether options should be expensed.

### False Reason Not to Expense: Only The Options of The Richest Executives Should Be Expensed

This is really an aside but it actually made the Wall Street Journal editorial page recently. Hey, I'm a free market capitalist (who happens to think free market capitalists are the ones who should be the most critical when the system is not working), but if socialism is your bag, good luck comrade. However, let's separate socialism from accounting. If you want to encourage more even pay throughout the firm, and want to hurt companies for paying top executives too much, then I personally think you are Trotsky and should stop right now, but that's just my opinion. It has very little to do with whether options should be expensed (again, I think perhaps they should). Also, if you want to punish firms for paying top executives too much, why on Earth stop at options? Come on comrade, you must think big! Seeing as this has nothing at all to do with expensing options, why not only make firms expense the salaries of their top 5 executives. Everyone else is free! It's exactly the same thing, and just as unrelated to the discussion at hand.

### Two Ironies Before Parting

Of course, one irony is that, after all the drang noch osten, perhaps the side of right will indeed prevail, and options will have to be expensed. But alas, Wall Street's sell-side analysts might simply choose to focus on "earnings before options expense", and it will all be for naught (at least for a while). We have seen much worse before. They say sunshine is the best disinfectant, and that's true, but Wall Street has some powerful window shades called pro-forma.

The related and grander irony is that none of this should matter to investors. The information is currently there in the footnotes, and we're not talking about changing anything real, just about whether companies have the right to lie loudly on the top line, when the truth is already there now for anyone willing to spend 10 minutes with a financial statement. Even the weakest form of market efficiency (often called the "if only we are all not complete morons" form) says that making them tell the truth in the top line can't matter if we all had easy access to the truth the whole time (and this issue has been publicly known for at least a few years).

So, will changing this matter? Who knows? It might not matter as Wall Street might continue to find a way around it, and it might not matter as investors might have already accounted for it and we're all arguing about a point made moot by an efficient market. However, cockeyed idealist that I am, I still think making a public statement that truth matters, and conscious attempted manipulation won't be tolerated is important. Also, footnotes are great, but would it really hurt to make the truth as accessible and obvious as possible?

## Conclusion

There are legitimate arguments about how to go about expensing options, and the issues are not all easy. What formulas to use and how often to update the values are points for debate. However, there are no arguments for ignoring these expenses, and for thus intentionally understating the P/Es of companies with large options programs, or the market in general.

Seldom are there bright line tests dividing right and wrong in an area as nuanced as finance. This is one of those rare cases. Options should be, and must be expensed. If they are not, we've knowingly chosen a falsehood over truth – and done so in the most callously public fashion after much debate, hand-wringing, and lobbying. That would be bad. Options are a canary in our coal mine. If the canary dies, or survives FASB but is ignored by Wall Street, watch out.