

STOCK OPTION ACCOUNTING CAN BE MATERIALLY MISLEADING

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Stock options were the fastest growing segment of executive pay in 2000. A survey reported in the *CPA Journal* (May 2001, p. 15) showed that CEO's average total compensation increased 16% in 2000 to \$10.89 million, with an average stock option value of \$6.45 million, representing 60% of total remuneration. Options worth millions of dollars became commonplace. For example, Sanford I. Weill, Citigroup, Inc., had total direct compensation of \$224.4 million, which included a \$196.2 million gain from exercising stock options and a restricted-stock grant valued at about \$2.2 million.

But the bubble burst as the stock market crashed. Many dot-com employees saw their paper fortunes crumble as share price plummeted and bankruptcies multiplied. For example, Steve Jobs, co-founder of Apple Computers, Inc., was awarded 20 million stock options exercisable at \$43.59 a share. With Apple stock selling in the low \$20s, his options are worthless.

Many non-tax, financial people believe that stock options are not deductible on financial statements, but are deductible for tax purposes. Stock options have been called stealth compensation for this reason. However, stock options are more complicated than generally perceived:

deductibility for tax purposes depends upon the type of stock options.

This article discusses both the financial reporting and tax implications of options granted to employees. In the post-Enron environment, the quality of corporate earnings is suspect. Financial statement users should beware that ignoring the value of stock options can result in a misleading appraisal of results of operations. Investors must adopt forensic investing techniques because many companies are engaged in earnings management even under GAAP.

The legendary investor and CEO of Berkshire Hathaway, Warren Buffett, has strongly criticized option accounting. His position was stated succinctly in the 1998 annual report of Berkshire: "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 into the calculation of earnings, where in the world should they go?"

Various Types of Stock Options

There are incentive stock options, nonqualified stock options, and restricted stock options. As Exhibit 1 illustrates, incentive stock options are

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