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Letters re: *Another Option on Options*

Who Bears the Cost of Options?

September 10, 2002

Reuven Brenner and Donald Luskin ("Another Option on Options" editorial page, Sept. 3), arguing the case for a particular way of measuring stock options, start with the assumption that it is a foregone conclusion that option grants should be expensed.

Like all arguments being advanced in favor of expensing, this one suffers from a confusion of corporate income and the personal income of shareholders. Accounting standards have always made it clear that the two are separate, and thus the receipt of cash in exchange for stock is never shown as a revenue to the corporation. From this it follows that a reduction of cash received for stock cannot be an expense to the company. The logic of the argument for expensing, apparently, is that the cost of options is analogous to the cost of defaults by customers, in which the disappearance of some of the company's sales revenue is recorded as bad debts expense so as to avoid overstating income. But the two situations are not analogous, because in the case of stock options there is no disappearing revenue, only a reduction of investment by new stockholders.

This is not to deny that stock options represent a cost. It's just that the cost is borne not by the company but by the existing stockholders in their personal holdings, through dilution. This cost is fully reflected under current accounting standards in the diluted earnings per share figure. Placing an options expense in the numerator of the EPS figure while leaving its effect in the denominator would be a clear case of double counting, and would render the diluted EPS figure meaningless.

There is one more reason to resist the options expensing juggernaut. It will sever accounting income from the one thing that gives it its grounding in reality: its ultimate reconcilability to net operating cash flows. Over the life of a corporation net income should be equal to net cash flows exclusive of transactions with stockholders. Any item of income that does not contribute to that reconciliation is bogus on its face. Imagine the uproar, for example, if corporations were booking "revenues" that would never bring in assets to the company. The logical basis for that uproar also applies to the booking of "expenses" that will never call for an outlay of assets by the company, and that is the case with options.

The fact is that a company gives up nothing when it issues options. That is precisely why options are so popular.

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Options Exercise Can Be Both Dilution and Expense

September 17, 2002

In response to the Sept. 10 Letter to the Editor by Prof. Fred Sellers, who takes issue with our Sept. 3 editorial-page commentary "Another Option on Options":

As Mr. Sellers points out, options do not represent an expense beyond share dilution when they are issued. But it is a myth that earnings per share dilution entirely accounts for the expense of stock options when they are ultimately exercised. When a company issues stock at the market price and holds the cash proceeds from the issuance, then, yes, dilution is the only consequence. But as soon as any of the proceeds are spent for costs such as paper clips or executive compensation, then those costs are expenses. It doesn't matter that the money came from issuing stock. When options are exercised, and stock is issued to an executive at a below-market price, it is the precise economic equivalent of issuing stock at the market price and paying the difference to the executive in cash. Options exercise therefore is both dilution and expense.

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(Mr. Brenner holds the Repap chair at McGill University's School of Management. Mr. Luskin is chief investment officer of Trend Macrolytics LLC.)