Why should the FASB require the expensing of options if it has no idea how it should be done?

A Troubling Requirement

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SINCE THE ENRON COLLAPSE IN MID-2002, the Financial Accounting Standards Board (FASB) has been pressed to require that companies include the hypothetical expense of their employee stock options in their financial statements. Many lawmakers and commentators on financial matters have argued that employee stock options are a form of compensation, and the failure to show the cost of those instruments results in misleading financial reports.

Prior to the renewed interest in this question, the applicable rule — embodied in Statement of Financial Accounting Standards (SFAS) 123, issued in October 1995 — required that the hypothetical compensation cost of employee stock options should be recorded at "fair value" as an expense in corporate income statements.

"Fair value" is a term of art in accounting that refers generally to the price at which a willing buyer and willing seller would trade an asset. In recent years, accounting theorists have encouraged the use of fair value estimates for assets and liabilities, replacing valuations previously based on cost. Under SFAS 121, fair value can be established with reference to a market price for an asset or a liability, or — in the absence of a market — through reference to markets for similar items or "option pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis."

Because there is no reference market for employee stock options, SFAS 123 offers companies two ways of presenting their financial reports under Generally Accepted Accounting Principles (GAAP):

Option-pricing model SFAS 123 originally referred to Black-Scholes and a "binomial model" as types of options pricing models that could be used for estimating the fair value of its options. In this case, the options' estimated value, as established by those models, was to be deducted as an expense in computing the company's earnings per share.

Intrinsic value method This method consists of determining the difference between the option strike price and the value of the underlying shares on the date of grant. In most cases the numbers are the same, so the intrinsic value method results in no options expense in the computation of earnings per share. However, if a company chooses the intrinsic value method, it is required by SFAS 123 to show, in a footnote to its financial statements, the hypothetical or pro forma effect on earnings per share of the issuance of the options using Black-Scholes or the binomial option-pricing model.

Since 1995, most companies have chosen to use the intrinsic value method for establishing the fair value of their employee stock options, and have used the Black-Scholes options-pricing model for making the required pro forma disclosure in the footnotes to their financial reports. Accordingly, the earnings per share of U.S. public companies, for the most part, have not reflected the hypothetical or fair value costs of their employee stock options. Instead, this has been disclosed in the footnotes to their financial statements.

Responding to the calls for expensing stock options, the FASB readily and promptly agreed that stock options are a form of compensation and that SFAS 123 should be modified so that the value of those options would be included as an expense in computing a company's earnings per share. Initially, the FASB seemed to believe that this could be done rather easily through use of the Black-Scholes or binomial models. But as they have gathered more information on the accuracy and effectiveness of those models — particularly Black-Scholes — the FASB has

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appeared to back away from mandating the use of any particular model. In a meeting on September 10, 2003, the Board reaffirmed its determination to require the expensing of options in financial reports issued in 2005 but removed the reference to Black-Scholes or the binomial method from SFAS 123. In doing so, the Board stated that "the use of any specific option-pricing model would not be precluded."

This suggests that the FASB is prepared to require that employee stock options be expensed without actually designating the valuation method that should be used. In light of the uncertainties associated with all existing options-pricing models, one can see how the FASB might adopt that approach. The Black-Scholes model, which the Board specified as one of the acceptable methods in 1995, has been shown to have significant deficiencies for valuing long-term instruments such as employee stock options. For example, one recent study concluded that Black-Scholes systematically overvalues options while another found that, *ex ante*, Black Scholes numbers did a poor job of predicting *ex post* realized costs. That is because Black-Scholes is unsuitable for valuing instruments — such as employee stock options — that are subject to a wide variety of contractual conditions and vesting arrangements, and have extremely long durations. Moreover, as Charles Calomiris and Glenn Hubbard discussed in their 2003 paper "Options Pricing Models and Accounting Practice," there is significant uncertainty about the proper formula or method for valuing employee stock options. Drawing on the discussion in John Campbell, Andrew Lo, and Craig MacKinlay's 1997 book *The Econometrics of Financial Markets*, Calomiris and Hubbard document that uncertainty concerning the proper model for determining the underlying asset price is so high among financial economists that ever more complicated and opaque methods — such as kernel density estimation and neural networks — have been utilized to provide a more accurate picture of the value of options. If financial economists are still uncertain about how to value the options, the FASB will undoubtedly have difficulty specifying a method. The essential difficulty is that there are many competing valuation candidates — each with pros and cons — that produce widely varying results depending on the specific circumstances of individual firms.

IS THIS USEFUL?

The debate over whether to expense employee stock options has thus far largely turned on the question of what would be the most useful financial disclosure for investors and whether discouraging the use of stock options would be good economic or financial policy. We believe that the absence of any reliable or accepted method for establishing the value of employee stock options raises two significant issues that undercut the FASB's arguments for its position. First, the absence of any satisfactory method for estimating the value of employee stock options, when combined with a requirement that this uncertain and unascertainable value be included in computing earnings per share, appears to be inconsistent with the principles and objectives of accounting itself and could create considerable legal risks for companies. Second, the absence of any reliable formula for ascertaining the value of employee stock options calls into question whether any fair value analysis is appropriate for use in this context.

Use of fair value estimates as an accounting technique is not without controversy or troubling elements. As shown by the Enron scandal, allowing management to make its own estimates of fair value can have massively adverse consequences for the integrity of financial statements. One of the lessons from Enron is that the rules of accounting and auditing concerning fair value estimates should more effectively restrain management discretion. George Benston, in his Cato Policy Analysis "The Quality of Corporate Financial Statements and Their Auditors before and after Enron," notes, "The Enron experience indicates that… fair values should not be included in financial statements unless they are based on trustworthy information — prices determined by arms-length market transactions." (In other writings, Benston argues that a distinction should be made between revenues and expenses when using fair value accounting, and that it is in accord with the accounting principle of conservatism to use fair value accounting for estimating expenses but not for estimating revenues.) In this case, the FASB seems to be going in the opposite direction — loosening the already weak rules and principles by which fair value estimates are permitted. Indeed, the FASB appears to be on the verge of requiring fair value estimates before there is any known way of establishing reliable estimates.

STOCK OPTIONS

Why the fraud in Enron should have stimulated such interest in accounting for employee stock options is something of a mystery. It is true that Enron, Worldcom, and other companies that appear to have engaged in financial statement manipulation had large numbers of stock options outstanding, and that the executives of those companies profited handsomely from the exercise of options and the sale of the underlying stock before investors became aware of the companies' true financial condition. But there is no reason to believe that stock options, per se, were responsible for the frauds in those cases, and very good reason to believe that stock options helped create a climate that produced the enormous growth and profitability that U.S. companies have experienced over the last 20 years. Options allow firms a unique financial opportunity. They are able to finance their human capital by exchanging options for hours worked by their employees. The alternative, providing cash or stock compensation, would require firms either to access costly external finance or confront employees with an unwelcome tax liability.

If advocates of expensing stock options are taking their position because they believe it will prevent financial manipulation by managements in the future, they are making a serious mistake. It is roughly equivalent to eliminating automobiles in order to prevent highway accidents. The way to prevent managements from manipulating financial statements is to punish those who do. By making stock options less attractive to companies as a way of recruiting, retaining, and incentivizing key employees, the FASB may be tinkering — needlessly and counterproductively — with a mechanism that has contributed substantially to the singular prosperity of the United States.

Indeed, there is currently a great public policy debate about just this point in Washington and before the FASB, with many companies arguing that expensing stock options will reduce their use and thus will have an adverse effect on U.S. economic growth. That is an important point that the FASB and the public policy advocates of expensing should take seriously, but it will not be the focus of this article. Instead, we propose to look at what technology is available for estimating the value of employee stock options and to determine the accounting and other consequences of requiring that options be expensed before a reliable method for establishing their value is available.

Ironically, the Enron affair could as easily be interpreted as requiring that fair value accounting — and hence the expensing of employee stock options — should be significantly pared back. It is doubtful that any of the public proponents of expensing stock options have considered that their advocacy would make some of the Enron abuses more likely to recur.

WHY OPTIONS?

The conceptual roots of the drive to expense employee stock options can be found in the view that, by issuing options, companies are able to avoid the cash expense associated with other methods of employee compensation. A company that might have to pay $500,000 in salary to attract an executive may instead be able to acquire his or her services for half that amount with an offer of stock options. From the employee's point of view, the trade might be worth the difference in cash compensation because she believes that the company has good prospects for substantial share growth. The employee may also believe that she can enhance the likelihood or extent of that growth. In this example, the company has saved a hypothetical $250,000 by issuing stock options that do not appear — as would cash salary — as an expense on its income statement. The income statement, it is argued, thus understates the company's costs in producing its income and overstates the company's real earnings.

This is a fairly straightforward idea, and has been the basis of testimony to Congress by members of the FASB on why they believe the expensing of options is necessary. But as a concept, this approach has significant flaws.

First, companies offer a number of intangible and unrecorded inducements to employees that may also have the effect of lowering the employers' salary obligations. Companies that are leaders in their industries — large, profitable, and stable — may not have to pay as much for their executive talent as start-ups or companies in need of turn-around. The career risks associated with joining large and stable companies are lower than the risks of joining start-ups, and it is likely that the executives recruited to start-ups can command higher salaries because of that risk. The cash savings realized by the large and stable companies is every bit as real as the cash savings realized through the issuance of stock options, but no one is suggesting (yet) that it be valued and treated as an expense.

The same is true for companies located in or near communities with good schools, transportation, housing, and cultural facilities. All of those are inducements to employees that might lower the companies' salary obligations, but they are not treated as expenses that companies would otherwise have had to pay if they were not so favorably located. Indeed, many companies move to places where they can more easily recruit executive or scientific talent, and the costs of the move are not treated as an employee expense even though its principal purpose was to recruit management or research talent that would have cost considerably more to lure to less favorable venues.

That is especially true if options are an effective compensation device for encouraging retention, which is often cited by managers as a key reason for their use. Employee turnover is costly to a firm in many ways, and an option may lower those expected future costs. In addition, firms with higher retention rates may be more attractive workplaces, lowering the required level of cash compensation that must be offered to lure desirable employees to a firm.

Because the theory is framed in terms of the value of the options in reducing the salary costs of the employer, it is not clear that some objective valuation for the options — their estimated fair value — is truly ascertainable. Fair value, by definition, is what a willing buyer and a willing seller would pay for the asset, and that is what was supposed to be measured by Black-Scholes or the binomial method. But that is not the value of the option to the employee. One reason is that the employee, in most cases, is not able to sell the option, so there is a liquidity discount that would be appropriate in valuing the option. But there are other reasons, too. A willing buyer and a willing seller would have to be considered diversified in their holdings of securities such as options. The employee is unlikely to be diversified, and thus the option represents a greater risk (the risk of non-diversification) to him than to the willing buyer — another reason for a discount from whatever value is established by Black-Scholes or some other model. On the other hand, as just mentioned, an employee may find a firm that relies more heavily on options to be a more attractive workplace.

Finally, and perhaps most significant, the employee is entering into an employment relationship with the company and will have an opportunity to affect the value of the option that the hypothetical willing buyer in an arms-length market transaction will not have. Thus, the employee may believe that her efforts on the part of the company will increase the value of the option and the underlying stock, and for that reason it is possible to argue that the option is worth more to her than it would be to a willing buyer.

A GOOD DETERMINATION

All this suggests that using an option-pricing formula such as Black-Scholes — even assuming that it is capable of producing an accurate value for options with the characteristics of employee stock options — is not likely to establish a fair value for the instruments. If, in fact, the underlying accounting reason for expensing employee stock options is to capture the amount by which a company reduces its salary costs through use of options, that result cannot be achieved by determining the price at which a willing buyer and a willing seller would transact. In this sense, in light of the definition of fair value used in accounting texts, employee stock options are just not suitable for fair value treatment.

To be sure, the FASB takes the position that the value they want companies to expense is not the value of the option to the employee, but the amount that the option would fetch if it could be sold to a willing buyer instead of awarded to the employee. Although this approach creates a somewhat more objective standard than attempting to measure the value to the employee, it bears no real relationship to the theoretical basis for seeking to capture and expense the cash savings of the employer. At best, the price that a willing buyer would pay is a weak surrogate for what the option is worth to the employee. So, we have in the end a requirement to use an inadequate option-pricing model in order to determine the value of what is in any event only a shadow of the actual thing we are trying to measure. It is hard to imagine a weaker case for the use of fair value accounting.

Nevertheless, it is still possible for accounting theorists to argue that an employee stock option has some value — i.e., its value is not zero — and good accounting practice should recognize a value of some kind, if only to vindicate the traditional accounting concept of conservatism. But this would be correct only if it is consistent with other principles of accounting. It seems likely, however, that a requirement for expensing options would call into question a number of other accounting concepts — particularly the requirements for reliability, consistency, and comparability

RELIABILITY The Statement of Financial Accounting Concepts No. 2, published by the FASB in 1980, defines reliability as "The quality of information that assures that information is reasonably free from error and bias, and faithfully represents what it purports to represent." We have already noted above that the fair value of an employee stock option — i.e., its effect in reducing the cash compensation obligations of an employer — can never be measured by a formula that attempts to estimate the price that would be paid by a willing buyer to a willing seller. Thus, the option's estimate of value is not one that "faithfully represents what it purports to represent." In fact, it is at best a very rough theoretical measure of what it purports to represent, which is the amount by which a company's cash compensation obligations are reduced by the issuance of employee stock options.

Indeed, the FASB has received a large number of comments from business organizations to the effect that the Black-Scholes method of estimating the fair value of options overstates option values. The January 31, 2003 comment of the Business Roundtable is typical. The group noted that the fair value methodology under consideration by the FASB does not recognize a number of characteristics of employee options, "all of which reduce their value: (1) non-exercisability before vesting, (2) truncated term if employment terminates after vesting but before exercise, (3) inability of employees to hedge their option position or use their options as collateral, (4) ordinary income taxation of gains at exercise, and (5) for some companies' grants, black-out periods, holding periods, ownership requirements, non-compete provisions, and 'claw-back' provisions."

Acknowledging that the FASB believes that the standard of measurement should be the value of the option if it had been sold to a willing buyer, the Roundtable was still concerned that no model currently in existence could measure what an employee stock option would be worth in a hypothetical market. "Before deciding whether to propose changes to U.S. accounting standards for employee stock options," the Roundtable cautioned, "we believe the FASB should determine whether the 'fair value' of employee options, as measured by adjusted option-pricing models, reasonably estimates the foregone cash the company could have received from selling options *with the same terms* to the market."

The Roundtable's comment makes clear that the accounting concept of reliability would be violated through use of any known options-pricing model. None of them take adequate account of the many ways in which the value of employee stock options can be diminished by contractual terms that would affect the price at which a willing buyer and a willing seller would transact.

Quite apart from that deficiency, even without the manifold contractual terms that alter the value of an employee stock option, there is no options-pricing model currently in existence that clearly gives the best possible assessment of the value of options across all firms. Because of those factors, whatever number is ultimately developed would have to be little more than a guess, and thus would not "faithfully represent what it purports to represent."

Reliability is also called into question by the FASB's failure to prescribe a model. That opens the possibility of management manipulation, also a factor in assessing reliability. Benston, in his Cato paper, notes that in order to be of value to investors, financial statements must be based on "trustworthy" numbers. "Unfortunately," he writes, "a financial report based on fair values can rarely be achieved within the requirement that the numbers also be trustworthy. It is often said that that there is a tradeoff between trustworthiness and relevance, but information is relevant and useful for decision-making to the degree that it is accurate and unbiased (where the bias is not known). Therefore, trustworthy numbers are more relevant than fair values that are much more subject to managerial manipulation than are historical costs." Accordingly, at least with respect to the standard of reliability, a fair value established for employee stock options through use of a faulty model, or one subject to management manipulation, would be less useful than no valuation at all.

It is also important to note that the FASB has itself pointed out that, with respect to fair-value estimates, "the more market inputs, the more reliable the estimate," and that "reliability encompasses representational fairness, neutrality, and verifiability." It is doubtful that a number derived from a wholly artificial model, which contains assumptions about an unknown future and is subject to management bias in the choice of the model utilized, meets any of those tests.

To be sure, defenders of the FASB's position have argued that employee stock options certainly have some value, and failure to include that value in the computation of earnings per share is inherently misleading. But that is only a partial answer. The assets that Enron's management vastly overvalued probably also had *some* value. One of the arguments against fair value

accounting is that it allows managements too much discretion in establishing the values of assets and liabilities. In principle, the FASB and the accounting profession should be resisting efforts to break down the standards for how fair value can be established, not requiring companies to include in their earnings per share numbers for which there is no adequate conceptual basis. It is not necessarily an improvement in financial reporting to substitute an arbitrary value when the actual value cannot be ascertained. Doing so impairs the credibility and trustworthiness of the financial statement, and certainly does not meet the accounting test of reliability — i.e., "faithfully representing what it purports to represent."

CONSISTENCY The Statement of Financial Accounting Concepts No. 2 defines "consistency" as "conformity from period to period with unchanging policies and procedures." That concept would also be violated by an FASB requirement that companies estimate the fair value of their employee stock options before there is in place an agreed technology for doing so. In the minutes of a meeting on September 10, 2003, the FASB made clear that no preferred or accepted method for valuing employee stock options currently exists. The Board deleted the references to Black-Scholes and the binomial method from SFAS 123, and is recorded as deciding that "the use of any specific option-pricing model would not be precluded." The inability of the Board to specify a particular model has significant consequences that will be discussed below under "Comparability," but the absence of any accepted standard or method also has significant consequences for the concept of consistency.

Under the consistency concept in accounting, a company is supposed to report its results from period to period without changing its policies and procedures. This principle works when policies and procedures remain unchanged for extended periods, but it is useless if constant updating and modification is required because of changing accounting rules. The Board's September 10 discussion of company obligations reflects a view of at least some Board members that the technology of options-pricing would improve in the future. For example, according to the minutes, in a discussion of the consequences of permitting the use of models other than Black-Scholes, FASB member Edward W. Trott noted that other models might be developed that would improve on Black-Scholes: "A more robust and dynamic valuation model could incorporate better information and allow for improvement of information and modeling techniques over time."

This view is likely to have been the basis for the Board's decision to reduce the focus on the Black-Scholes and binomial models as the accepted option-pricing technologies. But leaving open the choice of models not only leaves open the possibility of management manipulation in the choice of model, it also creates the prospect that companies will be required to change modeling techniques as the technology improves over time, and this will clearly disrupt consistency of presentation.

More troubling is the position of the company that adopts one method for estimating the value of its employee stock options, but finds as it proceeds from year to year that the standard used by others — perhaps even others in its own industry — has changed. A new method may have been introduced that is deemed superior. Would the company be required to change the pricing model it has been using, and thus change its earnings-per-share computation? If it did this, would it be required to restate its net income and earnings per share for all the preceding years in which it had used the older and presumably inferior model? Later in this article, we discuss the legal implications of such a change, but for present purposes we note only that an evolving standard for what is the proper way to estimate the fair value of employee stock options is a serious threat to the accounting concept of consistency of presentation.

COMPARABILITY The accounting concept of comparability is defined as "the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena." For investors, adherence to the concept of comparability is essential to the process of comparing the financial results of two or more companies. Obviously, GAAP was developed to assure that companies prepare and publish their financial reports under the same set of rules. Without that, it would not be possible to compare one company with another, or even to compare a company's results in one year with those in a preceding or subsequent year.

The possibility that the FASB might require companies to estimate the value of their employee stock options without specifying a particular method for doing so presents a unique challenge to the concept of comparability. In order to compare the GAAP financial results of any two companies, investors will have to understand the options-pricing model the companies used as well as the inputs to that model. That would be a difficult process even if a particular model were specified, because investors would have to evaluate whether the values the company selected for inclusion in the model were appropriate given the company's history and circumstances. The process would be even more difficult if the companies chose entirely different option-pricing models for this purpose.

For example, companies that choose to use the intrinsic value method of estimating the fair value of their employee stock options have been required since the promulgation of SFAS 123 in 1995 to provide supplemental information in the footnotes to their financial statements about the assumptions they use as inputs to the model. Most have used the Black-Scholes model, and their inputs have included assumptions concerning the expected volatility of their stock, the risk-free interest rate at the date of grant, the expected option life in years, and the expected dividend yield on their stock. Several of those assumptions are obviously extremely difficult to estimate and involve unknowable future events. In reviewing various corporate financial reports, it becomes clear that companies chose substantially different estimates of volatility and expected option life. Different choices for those two values can have a major impact on the expense that is attributable to employee stock options.

This example even assumes that the model chosen is correct. In practice, the underlying assumption that the share price follows a geometric Brownian motion has been demonstrated

time and again to be a crude simplification. As Calomiris and Hubbard explained, even relatively small errors in the modeling of the serial correlation of returns over time can lead Black-Scholes estimates to be off by a factor of two. Small errors are highly likely given the volatile nature of stocks, and option models have not held up particularly well when confronted with the empirical data. David Bates, in his 1995 paper "Testing Options Pricing Models," reviews the empirical literature and concludes that "substantial biases have been found in implicit volatilities from stock and stock index options." Those problems suggest that reasonable and well-trained options practitioners might go about the valuation process in different ways, choose significantly different models, and arrive at significantly different values.

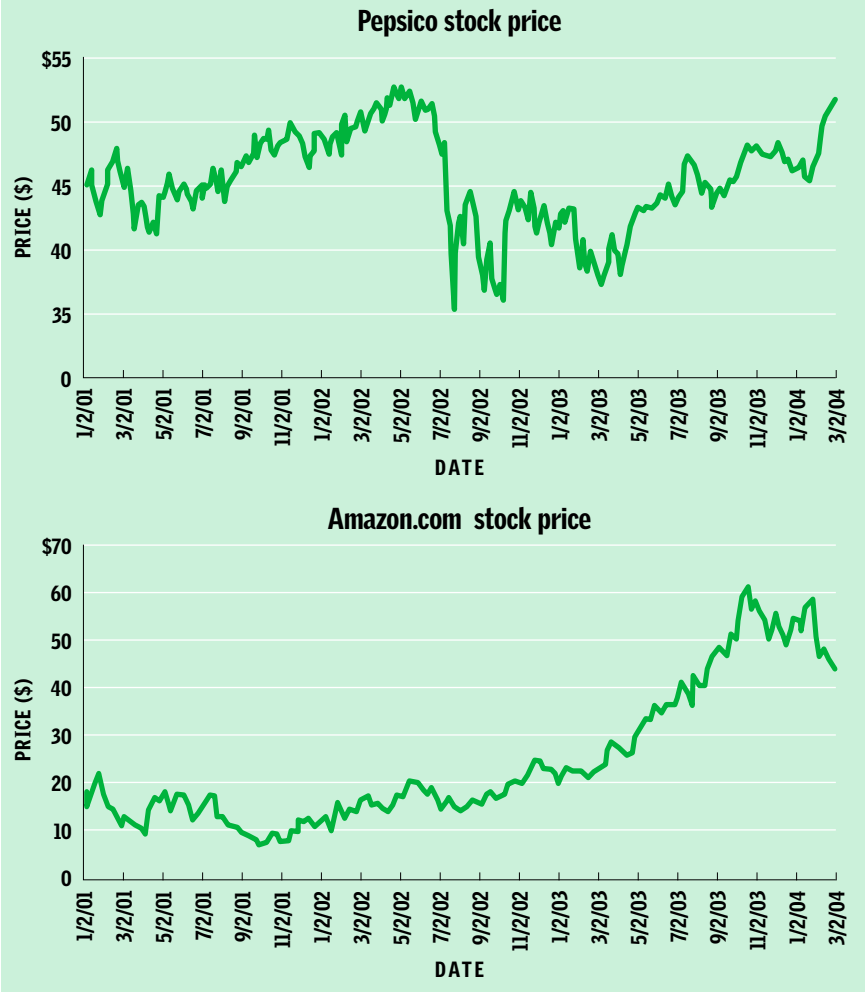
Under the circumstances, it would be important for investors to be able to assess the appropriateness and validity of the inputs selected by any two companies they wish to compare, but it is very difficult for them to do so. Assuming both companies use the Black-Scholes model, the investor might understand how the model works, but be unable to determine whether the input assumptions were reasonable. It would be a still harder task if the companies did not even use the same model — a possibility that is suggested by the FASB's recent decision that "the use of any specific option-pricing model would not be precluded."

Two simple examples can help emphasize how significant those issues may be. Figure 1 provides stock charts for Amazon.com and Pepsico. The Amazon chart looks like the data generating process might well have the form of a random walk with drift, aligning with the assumptions of the Black-Scholes model. If one used data from 2001 to make an assessment of the likely future trend and volatility of the stock price, then one would have made a reasonable projection of the path of the stock's price in 2002. Aside from all of the special issues such as non-transferability, etc., a valuation model based on a random walk (Brownian motion) assumption might well have provided an answer in 2002 that was accurate. However, the Pepsico chart, which is fairly typical, tells a completely different story. Pepsi's stock appears to have periods of quiescence followed by periods of high volatility (conditional heterosckedasticity). If one based one's projections of trend and volatility on the period from April 2001 to April 2002, then one would have wildly misstated the path and volatility of the share price subsequently. Parameters that one might plug into a simple option formula would have changed dramatically, as would the value of forward looking options.

FIGURE 1

Past and Future

Recent trends for Pepsico and Amazon.com stock.



Over time, the profession may converge to a model of the data-generating process and the option itself that does not vary so significantly across time and firms. While this is consistent with the idea that option-pricing technology will improve over time — a notion that seems to underlie the Board's determination to proceed — it creates a highly uncertain landscape for both companies and investors. With a wide variety of option-pricing models in use, investors will be unable to make effective comparisons of bottom-line GAAP results.

LEGAL RISKS As discussed in many of the comments to the fasb, and in the balance of this article, neither of the two models that the Board initially seemed to endorse — the Black-Scholes and binomial models — has been found effective. Instead, the Board has decided not to endorse a particular model, but to leave the choice up to companies and their auditors. This state of affairs creates a serious legal risk for both companies and auditors to which the Board seems oblivious. In the absence of a designated and approved method for valuing employee stock options, companies will have to make choices, not only about the model to be used, but the various inputs

that the model requires. Those choices can have a substantial impact on the reported earnings of a company, and that in turn can leave companies open to class-action lawsuits by disgruntled shareholders.

As an example, consider a company that chooses a model and makes input assumptions that reduce its reported earnings by five percent each year for a 10-year period. At the end of that period, looking back over the actual experience of the company, one of the following becomes clear:

- The expense it charged to earnings was less than what its options-pricing model would have required if the inputs to the model had borne a closer resemblance to its actual experience.
- The options-pricing model it used was less accurate than other models that were available at the time it adopted its model.
- The technology for options-pricing had evolved over the 10-year period, so that the company's model — at the state of the art when adopted — had been superseded by superior models.

Any of those facts will expose the company to lawsuits based on the allegation that its earnings were overstated over many years. Shareholders who purchased shares during this period might have a cause of action based on the company's failure to correctly calculate its employee options costs.

While it is true that the securities laws require some demonstration of *scienter* — intent to mislead — before liability will attach, in the real world companies are constantly challenged with lawsuits on facts far flimsier than those recited above. And they are frequently driven to settle the suits because of the drain on management time, the adverse publicity the suits produce, or the fact that large corporations are generally unsympathetic defendants in jury trials.

Circumstances might be considerably different if the FASB were in a position to specify an options-pricing model that would be acceptable for all companies. In that case, the company would at least have the defense that it did not adopt a particular model in order to achieve favorable earnings results. However, it does not appear that the FASB is able to specify an options-pricing model, and instead will leave it to companies to select or develop their own models. In a sense, that is the worst of all possible worlds for public companies. They are required to estimate an important component of their earnings per share — the most sensitive element of their financial reports — and yet they are left without any sense of how to do it. That situation creates low-hanging fruit, ripe for plucking by the class-action bar.

CONCLUSION

In summary, it seems clear that the FASB has no idea how companies might be able to establish the fair value of employee stock options. But the Board is nevertheless proceeding down the path toward requiring the expensing of options. In part, this may be the result of political pressure that originated with a misreading of the Enron and Worldcom debacles. The responsible course, consistent with the accounting concepts of reliability, consistency, and comparability, would be for the Board to wait until it or some other entity has created a model for pricing employee stock options that is generally recognized as "faithfully representing what it purports to represent." To do less would open up a Pandora 's Box of potential lawsuits and expose firms to vexing terrain that may adversely affect both the quality of their financial reports and the results of their operations.

In this light, it is worth noting that the current system of disclosure has much to recommend it. Given the uncertainty associated with estimating the fair value of employee stock options, it seems appropriate that disclosure occur in the footnotes to the financial statements rather than in the computation of net income. In this case, investors who are interested in what effect a company's employee stock options might have on its earnings per share can see an estimate in the footnotes, but because of the uncertainty associated with the estimate, companies will not be distorting their earnings per share with a weakly derived number. That seems a sensible compromise — until the FASB is able to settle on an adequate and reliable method for ascertaining the fair value of employee stock options. R

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