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Accounting for Options

By Joseph E. Stiglitz

Déjà vu. The post-Enron imbroglio over stock options is a reminder that history—if forgotten—does indeed repeat itself. Eight years ago, while serving on President Clinton's Council of Economic Advisers, I was involved in a heated debate over information disclosure. The Financial Accounting Standards Board had proposed a new standard that would require firms to account for the value of executive options in their balance sheets and income statements.

> *We need to restore faith in company balance sheets.*

When FASB made its proposal for what would have clearly been an improvement in accounting practices, Silicon Valley and Wall Street were united in their opposition. The arguments put forward then are the same as those put forward today, and they are as specious and self-serving now as they were eight years ago.

Outrageous

The most outrageous argument—but the one that had the greatest impact—was that disclosing the information would adversely affect share prices. That is, if people only knew how much their equity claims on the firm could be diluted by options, they would pay less for their shares! True, and that is precisely why the disclosure is so important. Markets can only allocate resources efficiently when prices accurately reflect underlying values, and that requires as good information as possible. If markets overestimate the value of a particular set of ventures, resources will mistakenly flow in that direction. This is partly what caused the dot-com and telecom bubbles. Irrational exuberance played its part, but so too did bad accounting—i.e., distorted information.

To be sure, information will never be perfect and asymmetries of information are pervasive. But one of the key insights of the modern theory of information is that participants do not always have an incentive to disclose fully and accurately all the relevant information, and so it is important to have standards.

This is where the second specious argument enters: Critics of FASB's proposal claimed that it is impossible to value options accurately, and accordingly, it would be misleading to include the options within the standard accounting frameworks. To better understand the falsity of this argument, let's take a closer look at how stock options really work.

The basic economics of stock options are simple. Issuing stock options does not create resources out of thin air. Executives like stock options because they have value. But the value, however measured, comes at the expense of other shareholders. The right of managers to buy shares is the right to dilute the ownership claims of existing shareholders. When markets work well—when information is good—the market will value today the issuance of a right to dilute, even when that dilution may never occur, and if it does occur, would happen sometime in the future.

The existing owners of the firm will participate less in the upside potential of the market than they would have in the absence of the options. In principle, they can calculate the circumstances when the executives are likely to exercise their options, and therefore can calculate the diminution in their potential gains from owning shares in the company. That is why when this information is disclosed in ways that can easily be understood by investors, it will lead to a fall in the company's share price.

Making such calculations, however, is not easy or costless. In principle, each shareholder could go through each of the items in the firm's accounts to construct his own "estimates" but that would be a foolish waste of resources, and the transaction costs would put a major damper on capital markets and the market economy. That is why we have accounting standards. Such information is like a public good: Better standards—more transparency—lead to better resource allocation and better functioning markets; and if participants have more confidence in markets, they will be more willing to entrust their money to markets.

Which brings us back to the argument that it is "impossible" to value options. Companies do, of course, have ways of calculating the value of options and do it themselves all the time for their own internal planning purposes.

As for the question of whether an estimate based on a publicly-disclosed formula would be misleading, because it is only an *estimate*, that is true of many line items that are central to our accounting frameworks, such as depreciation. Calculations about the value of options would be just as, or even more, accurate than standard depreciation estimates are of the market value of the declines in asset values that come with use and obsolescence—something which is a line item on every accounting framework in corporate America and most of the world. Of this much we can be sure: zero, the implied valuation used by companies now when describing the cost of options in their balance sheets and income statements, is a vast underestimate.

Those who argue against including options within the standard accounting frameworks try to have it both ways: They believe that market participants are smart enough to read through dozens of footnotes to figure out the implications of options for the value of their shares, but so dumb that they would be misled by the more accurate numbers that would be provided under the reform proposals, and unable to redo the calculations themselves.

Transparency

There is one more reason for the U.S. to be resolute in improving our accounting standards by including better accounting for options. During the East Asia crisis the U.S. preached the virtues of transparency but then refused to do anything about regulating the murky world of offshore banking. America also preached the virtues of our accounting standards only to find that the world was laughing at Enron and Arthur Andersen. Tightening our rules on accounting of options would signal that the U.S. is serious about openness, serious about improving its accounting standards—despite the special interests opposed to changes—and willing to learn from its mistakes.

Many of the same forces that allied themselves in the 1990s against changes in accounting for options are now trying to suppress this attempt to make our market economy work better. In the earlier episode, the National Economic Council, the U.S. Treasury, and the Department of Commerce intervened in what was supposed to be an independent accounting board, and put pressure on FASB to rescind its proposed regulations. They won, and the country lost. Today, there is a risk once again of political intervention. At least this time, the voices of responsible economic leadership, such as Alan Greenspan, are speaking out. I only hope that this time they will succeed.

Mr. Stiglitz, a professor of economics at Columbia, served as chairman of the Council of Economic Advisers during President Clinton's first term. He was awarded the 2001 Nobel Prize for Economics.

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