COMMENT ON G4+1 POSITION PAPER ON ACCOUNTING FOR SHARE-BASED PAYMENT

The press-release summary of the statement emphasises that one of its main principles is that 'a transaction whereby an entity obtains goods and services from other parties, including employees and suppliers, with payment taking the form of shares or share options issued by the entity to those other parties, should be recognised in the financial statements, with a corresponding charge to the income statement *when those goods or services are consumed*' (emphasis added).

This principle seems wholly correct. And it is the failure of other accounting standards properly to reflect it that, in my view, is one of the main reasons why the FASB's most recent standard, Statement of Financial Accounting Standards No.123: *Accounting for Stock-based Compensation*, was extremely controversial.

Professor Steve Zeff of Rice University (in Cooke and Nobes, 1997) has given a lively account—and commented on the fearful dangers—of how successful economic consequences lobbying by US corporations, reaching a new height in gaining support in the US Congress and in particular from the Senate, forced the FASB to abandon its originally proposed standard on the treatment of stock option compensation in the income statement, even though the Board remained convinced that this was the proper accounting treatment and had the support, *inter alia*, of seventy US accounting academics who wrote to Senator Levin, and of one of the leading US institutional investors (Warren Buffet), who wrote similarly:

'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?' (quoted by Zeff at p.185).

In considering now whether the G4+1 group's proposals are acceptable, perhaps the most important country to understand is still the USA, as the FASB may be hoping to garner international support to strengthen its hand back home. But Zeff's analysis of the US political context of the proposals on accounting for stock options also brings out the need to consider whether the *accounting content* of the proposed standard is reasonable. While it may be indeed be argued that:

> 'Stock options have value; they impose a cost on companies that issue them; and the cost of stock option compensation ought to be charged to corporate earnings' (quoted by Zeff at p.185)

the issue of *when* they should be charged remains unresolved. Here the paradox is that the most valid motive for utilising stock options to incentivise top managers (rather than say performance based remuneration linked to accounting earnings) is that the benefits of the kinds of decisions and efforts they are being encouraged to make will not show up in accounting earnings until long after they have shown up in the price of the company's shares—for example where those managers are developing the intangible factors, or undertaking research and development, crucial to a company's long-term success. This is one reason why such forms of remuneration are so appropriate in high tech start-up

companies and ‘dot.coms’. So, while a proper ‘matching’ would accrue the cost, but not charge the expense against accounting earnings until the expected benefits are also reflected in accounting earnings, it is in relation to areas such as research and development and other ‘internal’ intangibles that conventional accounting standards—in requiring immediate write-off—currently fail most conspicuously through their inability properly to ‘match’ the expense and the revenues.

One beneficial role of issuing executive stock options (provided there is full disclosure) may be to overcome this deficiency of accounting’s content The political lobbying over the unacceptable ‘economic consequences’ for corporations in the US and elsewhere of the FASB’s original proposals (also especially relevant to countries like the UK where stock markets and the growth of high-tech companies are sufficiently developed to make this form of remuneration particularly attractive), may indeed reflect a legitimate concern that proposals—such as the G4+1 group is now adopting—to measure and *charge this cost against earnings* merely exacerbate what is already an inadequate feature of conventional accounting. Standard setters need to undertake a much more radical rethink before attempting to ‘fix’ this particular issue.

Reference:
The Development of Accounting in an International Context: a Festschrift in honour of R.H. Parker edited by T.E. Cooke and C.W.Nobes, Routledge International Studies in Business History, London, 1997, xii + 261pp. (ISBN: 0-415-15528-2).

Comment prepared by:
Professor Richard Macve,
London School of Economics,
London WC2A 2AE, England, UK.
12 September 2000

email: R.Macve@lse.ac.uk