Deloitte & Touche

Survey on Expensing Stock Options Survey Synopsis

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Deloitte & Touche recently surveyed 120 *Fortune* 1000 companies regarding expensing employee stock options. While a few companies are currently expensing stock options or have plans to do so in the near future, the majority of respondents (53 percent) are taking a "wait-and-see" approach. A significant minority of respondents (35 percent) will not expense options unless mandated by legislation and/or regulatory change.

Nearly one-half of the respondents expressed a strong desire for more clarification and standardization in the methodology for expensing stock options. Others indicated they believe the "cost" of stock options is properly reflected in the calculation of Diluted EPS, where it receives appropriate disclosure and, therefore, did not believe the cost also needed to be included on the income statement.

Most respondents (60 percent) believe that determining the proper valuation for options is the most difficult issue related to expensing stock options. If companies were required to assign a value to their stock options, many would choose the Black-Scholes model, although with some misgivings. Almost an equal number don't know how they would assign a value, again indicating a need for clear direction on this issue.

Interestingly, only a small number of respondents (9 percent) cited the negative impact on earnings as the most significant problem. Despite this, almost one-half of respondents reported that if they had expensed stock options on their most recent earnings statement, such an expense would have reduced earnings by 5 percent or more.

A larger percentage of respondents (21 percent) are most concerned about the impact a possible requirement to expense options would have on their compensation programs. Currently, stock options constitute 75 percent to 100 percent of the respondents' entire long-term incentive programs. One-half of companies report that they would be forced to reduce the number of employees who receive options and/or to reduce the number of options granted. Fully one-third of companies could not yet predict what the ultimate impact might be. Companies are highly likely to substitute three or more types of alternate forms of long-term incentive vehicles, indicating a significant upheaval in executive compensation programs if options were required to be expensed.

The survey results convey an understanding among respondents that the issue of accounting for employee stock options needs to be resolved in a manner that provides clarity and consistency. At the same time, many other events are converging to force companies to reevaluate their use of stock options.

> Dilution and equity overhand concerns were already forcing companies to consider alternatives to stock options. The option expensing debate has merely accelerated the decision-making process regarding alternative vehicles, grant methodology, and participation levels.

> Concurrently, there is something of an option "backlash" among employees who may have only underwater stock options or have faced a tax liability from exercising stock options when the underlying stock subsequently declined in value.

> Many respondents' uncertain growth prospects are fueling a focus on whether measuring relative performance makes more sense than measuring absolute performance, as traditional stock options do.

> Respondents are also considering other ways to restore investor confidence, such as implementing stock retention and ownership requirements.

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