Stock options are an expense

Letters: 1992, 1998, 2007 · Difficulty: Intro

Summary

For years, companies did not record an expense when they paid employees with **stock options**. Buffett argues options are compensation, compensation is an expense, and an expense belongs in net income, even when its exact amount is hard to estimate. U.S. GAAP has required option expensing since 2006.

1992 letter

In effect, the attitude of both managements and their accountants toward these liabilities was "out-of-sight, out-of-mind." Ironically, some of these same managers would be quick to criticize Congress for employing "cashbasis" thinking in respect to Social Security promises or other programs creating future liabilities of size. Managers thinking about accounting issues should never forget one of Abraham Lincoln's favorite riddles: "How many legs does a dog have if you call his tail a leg?" The answer: "Four, because calling a tail a leg does not make it a leg." It behooves managers to remember that Abe's right even if an auditor is willing to certify that the tail is a leg. * * * * * * * * * * * * The most egregious case of let's-not-face-up-to-reality behavior by executives and accountants has occurred in the world of stock options. In Berkshire's 1985 annual report, I laid out my opinions about the use and misuse of options. But even when options are structured properly, they are accounted for in ways that make no sense.

The lack of logic is not accidental: For decades, much of the business world has waged war against accounting rulemakers, trying to keep the costs of stock options from being reflected in the profits of the corporations that issue them. Typically, executives have argued that options are hard to value and that therefore their costs should be ignored. At other times managers have said that assigning a cost to options would injure small start-up businesses. Sometimes they have even solemnly declared that "out-of-the-money" options (those with an exercise price equal to or above the current market price) have no value when they are issued.

Oddly, the Council of Institutional Investors has chimed in with a variation on that theme, opining that options should not be viewed as a cost because they "aren't dollars out of a company's coffers." I see this line of reasoning as offering exciting possibilities to American corporations for instantly improving their reported profits. For example, they could eliminate the cost of insurance by paying for it with options. So if you're a CEO and subscribe to this "no cash-no cost" theory of accounting, I'll make you an offer you can't refuse: Give us a call at Berkshire and we will happily sell you insurance in exchange for a bundle of longterm options on your company's stock. Shareholders should understand that companies incur costs when they deliver something of value to another party and not just when cash changes hands.

…

Rather, these costs should be estimated by honest and experienced people and then recorded. When you get right down to it, what other item of major but hard-to-preciselycalculate cost - other, that is, than stock options - does the accounting profession say should be ignored in the calculation of earnings? Moreover, options are just not that difficult to value. Admittedly, the difficulty is increased by the fact that the options given to executives are restricted in various ways.

These restrictions affect value. They do not, however, eliminate it. In fact, since I'm in the mood for offers, I'll make one to any executive who is granted a restricted option, even though it may be out of the money: On the day of issue, Berkshire will pay him or her a substantial sum for the right to any future gain he or she realizes on the option. So if you find a CEO who says his newlyissued options have little or no value, tell him to try us out.

1998 letter

(He still tr avels coach and quotes Ben Franklin.) Nor does it indicate any shortcoming in General Re's accounting practices, which have followed GAAP to the letter. Instead, the pro-forma adjustment came abou t because we are replacing General Re's longstanding stock option plan with a cash plan that ties the incentiv e compensation of General

Re managers to their operating achievements. Formerly what counted for these managers was General Re's stock price; now their payoff will come from the business performance they deliver. The new plan and the terminated option arrangement have matching economics, which means that the rewards they deliver to employees should, for a given level of performance, be the same.

But what these people could have formerly a nticipated earning from new option grants will now be paid in cash. (Options granted in past year s remain outstanding.) Though the two plans are an econo mic wash, the cash plan we are putting in will produce a vastly different accounting result. This Alice-in-Wonderland outcome occurs because existing accounting principles ignore the cost of stock options when earnings are being calculated, even though options are a huge and increasing expense at a great many corporations. In effect, accounting principles offer management a choice: Pay employees in one form and count the cost, or p ay them in another form and ignore the cost.

Small wonder then that the use of options 14 has mushroomed. This lop-sided choice has a big downside for owners, however: Though options, if properl y structured, can be an appropriate, and even ideal , way to compensate and motivate top managers, they are more often wildl y capricious in their distribution of rewards, inefficient as motivators, and inordinately expensive fo r shareholders. Whatever the merits of options may be, their accounting treatment is outrageous. Think for a moment of that $190 million we are going to spend for advertising at GEICO this year.

Suppose that instead of paying cash for our ads, we paid the media in ten-year, at-the-market Berkshire options. Would anyone then care to argu e that Berkshire had not borne a cost for advertising, or should not be charged this cost on its books?

…

Charlie and I, however, have trouble being philosophical about unrecorded costs. When we consider investing in an optionissuing company, we make an appropriate downward adjustment to reported earnings, simply subtracting an amount equal to what the company could have realized by publicly selling options of like quantity and structure. Similarly, if we contemplate an acquisition, we include in our evaluation the cost of replacing any option plan. Then, if we make a deal, we promptly take that cost out of hiding.

Readers who disagree with me about options will by this time be mentally quarreling with my equating the cost of options issued to employees with those that might theoretically be sold and traded publicly. It is true, to state one of these arguments, that employee options are sometimes forfeited — that lessens the damage done to shareholders — whereas publicly-offered options would not be. It is true, also, that companies receive a ta x deduction when employee options are exercised; publicly-traded options deliver no such benefit. But there's a n offset to these points: Options issued to employees are often repriced, a transformation that makes them much more costly than the public variety.

It's sometimes argued that a non-transferable option given to an employee is less valuable to him than would be a publicly-trade d option that he could freely sell.

2007 letter

Our yearend liability for this exposure was recorded at $1.8 billion and is included in "Derivative Contract Liabilities" on our balance sheet. The second category of contracts involves various put options we have sold on four stock indices (the S&P 500 plus three foreign indices). These puts had original terms of either 15 or 20 years and were struck at the market.

…

Before that rebuke the FASB had shown the audacity – by unanimous agreement, no less – to tell corporate chieftains that the stock optio ns they were being awarded represented a form of compensation and that their value should be recorded as an expense. After the senators voted, the FASB – now educat ed on accounting principles by the Senate's 88 closet CPAs – decreed that companies could choose between two methods of reporting on options. The preferred treatment would be to expense their value, but it would also be allowable for companies to ignore the expense as long as their options were issued at market value. A moment of truth had now arrived for America's CEOs, and their reaction was not a pretty sight.

…

It turned out that for many CEOs even the low road wasn't good enough. Under the weakened rule, there remained earnings consequen ces if options were issued with a strike price below market value. No problem. To avoid that

bothersome rule, a numb er of companies surreptitiously backdated options to falsely indicate that they were granted at current market prices, when in fact they were dished out at prices well below market.

Decades of option-accounting nonsense have now been put to rest, but other accounting choices remain – important among these the investment-return assumption a company uses in calculating pension expense. It will come as no surprise that many comp anies continue to choose an assumption that allows them to report less-than-solid "earni ngs." For the 363 companies in the S& P that have pension plans, this assumption in 2006 averaged 8%.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 1992, 1998, 2007 (berkshirehathaway.com/letters). Excerpts © Berkshire Hathaway Inc., all rights reserved; reproduced in part for non-commercial teaching. "…" marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Berkshire Hathaway Inc.