Shareholder Letters: Accounting Themes

Stock options are an expense

Berkshire letters: 1992, 1998, 2007

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What the Letter Says

> *"How many legs does a dog have if you call his tail a leg? Four, because calling a tail a leg does not make it a leg."*
>
> Warren E. Buffett, 1992 letter

- Key letters: 1992, 1998, 2007
- Course fit: ACC250 Ch11 · ACC531 — · Difficulty: Intro

Step 1: Grant-date Fair Value

- **Stock option**: the right to buy shares at a fixed price.
- Its **fair value** at the grant date is estimated with a model.

EX. Options worth $12 million granted Jan 1; they vest evenly over 4 years.

Step 2: Expense over the Vesting Period

$12 ÷ 4 years = $3 million each year.

Dec 31:	Compensation Expense (+E)	3	
	APIC (+SE)		3

- Net income ↓ $3; cash: no change.

Step 3: Before and After 2006

	Before 2006	Since 2006
Expense for options	Usually $0	$3 per year
Net income	Higher	Lower by $3

- U.S. GAAP (SFAS 123R) has required option expensing since 2006.

Back to the Letter

- Buffett (1992): “How many legs does a dog have if you call his tail a leg? Four.”
- If options are not compensation, what are they? If compensation is not an expense, what is it?
- Buffett (2007): “Decades of option-accounting nonsense have now been put to rest.”

Questions

1. A company grants employees options with a total fair value of $12 million that vest evenly over 4 years. How much compensation expense does it record each year ($ millions)?
2. Recording stock-option compensation expense...

   A. affects only the cash flow statement

   B. lowers net income but uses no cash

   C. lowers cash and net income

   D. raises net income

Sources

- Warren E. Buffett, 1992 letter (berkshirehathaway.com/letters)
- Warren E. Buffett, 1998 letter (berkshirehathaway.com/letters)
- Warren E. Buffett, 2007 letter (berkshirehathaway.com/letters)
- Reading packet and question sheet for this theme

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