Stock options essay

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Many years ago stock options were rarely used as incidental benefits for top executives. Nowadays, compensating employee whit stock options has become an increasingly common practice.

Before the year 1996, only the intrinsic value method was used to record these transactions. This method distorted the issuer's reported financial condition and results of operations, which could lead to inappropriate decisions taken by investors.

Followed by the increased use of employee stock options and the surrounding controversy of its recording method, on the year 1996 the fair value method was introduced to be used as an alternative to the intrinsic method and on 2004 the intrinsic value method was completely discontinued. The Fair value method represent a better approach to the benefit of financial statements users given its many advantages.

Employee stock options allow employees to purchase shares of their company's stock at a " strike" price set by the company.

The employee must exercise the right to purchase these options within a specified period of time also established by the company. Usually the strike or grant price is the market price of the stock at the time the option is granted. There is usually a minimum waiting period during which the employee must remain employed by the company before the individual may exercise the option, this period is also referred to as the " vesting" period. The average vesting period is usually 3 years after the time of grant.

Employee stock options works as compensation for employees in two ways.

Sometimes employees are willing to accept lower wages or salaries with the expectation that the value of their stock will grow in the market and they will be able to sell these options in the future to compensate for the sacrifize. In other cases, stock options are just an additional benefit that makes working for a particular company more attractive. From the employer's point of view, options are used as a tool to attract and retain their key employees, since these options most vest over several years before they can be executed.

Moreover, for key executives with capability of making strategic decisions, stock options are used as an incentive tool by making them act in the best interest of the company and the posterior appreciation of their own stock.

That is why the practice of compensating chief executive officers whit stock options have greatly increased over the years. Before 1996, only the intrinsic-value method was used for stock options. Intrinsic value, defined by FASB, is the amount by which the market price of he underlying stock exceeds the exercise price of an option. Under the intrinsic value-based method, compensation cost is the excess of the quoted market price, at the grant date or another stated measurement date, over the price the employees must pay to acquire the stock. Due to the market price of the stock at the grant date being less than or equal to the stock option price generally, this would result in stock-based compensation cost being recorded at zero.

1)(apb opinion 25/desktop) The fair-value method, originally described in the Statement of Financial Accounting Standards No. 123 – Share-Based Payment, was introduced in 1996, and until 2005, companies had their

choice as to which standard to follow. Since usually the intrinsic-value method has no impact on company income in financial reports, most companies chose the intrinsic-value method.

Thus, accounting rules for financial statements allowed an understatement of compensation expenses and a corresponding overstatement of company profits. In December 2004, the Financial Accounting Standards Board (FASB) issued a new standard— Statement of Financial Accounting Standards No 123 (Revised)— for companies that requires them to value employee stock options using a fair-value-based method at the time they are granted and to record this value on financial reports as a compensation expense over the period of vesting.

In the case of an employer that gives a stock option to its employees with a vesting period of 3 years, one-third of the value calculated at time of grant is expensed for each of the next 3 years. The fair value of an option grant ideally would be based on the observable market price of the option or of one with similar terms and conditions.

As the market price is not usually observable, fair value measurement techniques use option-pricing models—such as a Black-Scholes model, a Monte Carlo simulation technique, or a lattice model to determine a fair value of an option—that is, one that accounts for factors such as the stock price at the grant date, the strike price, the expected life of the option (that is, the expected period of time between the grant date and the exercise date), the volatility of the underlying stock and the expected dividends on it, and the risk-free interest rate over the expected life of the option.

Assuming that the fair-value option –pricing model determines the company’s total compensation expense to be $300, 000, then this company will expense $100, 000 each of the following three years. The 2004 requirement eliminated the use of the intrinsic- value-based method and thus addressed users’ and other parties’ concerns of financial statements distortions by requiring an entity to recognize the cost of employee services received in share-based payment transactions, thereby reflecting the economic consequences of those transactions in the financial statements.

By requiring the fair-value method for all public entities, this new FASB Statement eliminates an alternative accounting method and this way improves the comparability of reported financial information. The Board believed that similar economic transactions should be accounted for similarly and so share-based compensation transactions whit employees should be accounted for using one method.

This way, users of the financial information should not have to deal with the confusion of having to figure out which method is being used for the statement they are reviewing, and can easily and compare it whit those of any other company. This statement also results in greater international comparability in the accounting for share-based payment transactions.

In February 2004, the International Accounting Standards Boards (IASB), whose standards are followed by entities in many countries, issued International Financial Reporting Standard (IFRS) 2, Share-based Payment.

IFRS 2 requires that all entities recognize an expense for all employee services received in share-based method that is similar in most respects to

the fair-value-based method established in Statements 123 and the improvements made to it by this Statement. Converging to a common set of high-quality financial accounting standards for share-based payment transactions whit employees improves the comparability of financial information around the world and makes the accounting requirements for entities that report financial statements under both