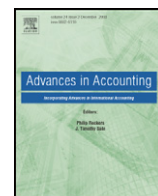




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The impact of SFAS No. 123(R) on financial statement conservatism

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ABSTRACT

SFAS No. 123(R) requires firms to recognize the fair value of stock options as compensation expense over the vesting period of the options. Thus, SFAS No. 123(R) leads to an overall increase in financial statement conservatism. However, it is not known whether SFAS No. 123(R) increases conditional and/or unconditional conservatism. Because the different forms of conservatism have different implications for the quality of earnings, I investigate which types of conservatism are impacted by SFAS No. 123(R) to gain insight into the ramifications of the Standard. I find that SFAS No. 123(R) leads to an increase in both unconditional and conditional conservatism. I additionally find that the Standard causes an increased negative relation between contemporaneous economic gains and income. These findings hold outside of the sample period and under a non-priced based model of conservatism.

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1. Introduction

SFAS No. 123(R), *Share-Based Payment*, requires firms to recognize the fair value of stock options as compensation expense over the vesting period of the options. The debate surrounding SFAS No. 123(R) has been ongoing and contentious. Opponents of SFAS No. 123(R) argue that estimates involved in option pricing will lead to expense figures which are unreliable, and therefore meaningless to investors. Challengers of SFAS No. 123(R) further maintain that the expensing of stock options will slow competition, increase administrative costs, and reduce the overall value of financial statements. Critics additionally fear that SFAS No. 123(R) will lead to the reduction or discontinuation of stock options plans, which in turn will generate even more negative economic consequences. E. Floyd Kvamme of the venture capital firm Kleiner Perkins Caufield & Byers expressed his discontent over the expensing of stock options in a letter to the Financial Accounting Standards Board (“FASB”). He noted: “Although ESOs [employee stock options] have value to the employee, they are not a cost to the company...ESO’s don’t meet the standards for an expense and any attempt to violate those standards and count them as an expense necessarily confuses what is really a (potential) equity transaction with an operating transaction, resulting in financial statements that are misleading, that obscure the true performance of the company... particularly cash flow performance...and that make the Paid in Capital account meaningless.”

While the opposition to SFAS No. 123(R) has been loud and strong, the Standard is embraced by many. Supporters of SFAS No. 123(R) believe that the expensing of stock options more accurately reflects the

economic consequences of compensation, better complies with international accounting standards, and decreases inconsistent accounting treatment across firms. Corporations such as Coca-Cola and General Electric showed their support for expensing stock options by voluntarily expensing the fair value of stock options before the mandatory requirements per SFAS No. 123(R) went into effect. Berkshire Hathaway, Inc. chief executive officer Warren Buffet has long been a proponent of expensing the fair value of stock options. He countered the critics who claim that expensing of stock options will be unreliable due to pricing difficulty by stating: “Some people contend that options cannot be precisely valued. So what? Estimates pervade accounting. Who knows with precision what the useful life of software, a corporate jet or a machine tool will be?...But the inherent uncertainties involved do not exclude companies from making their best estimate of these, or any other, expenses. Legislators should remember that it is better to be approximately right than precisely wrong.” He further expressed his support for expensing stock options by noting: “When a company gives something of value to its employees in return for their services, it is clearly a compensation expense. And if expenses don’t belong in the earnings statement, where in the world do they belong?” The former Securities and Exchange Commission chairman, Arthur Levitt, proved to be in favor of expensing the fair value of stock options. He publicly stated that not fighting for such mandatory recognition was “the biggest mistake I made while I was at the Commission.”

The ongoing debate surrounding the recognition of the fair value of stock options has led to many academic studies. Matsunaga (1995) provides weak evidence of the use of ESOs in the pre-SFAS No. 123(R) period as part of an income management strategy, implying that mandatory recognition of stock option expense will reduce the use of ESOs for certain firms. Dechow et al. (1996) examine the economic consequences surrounding the 1993 *Expose Draft* (“ED”) which initially proposed the recognition of stock option expense. Their results suggest

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that the recognition of stock option expense would not impact the cost of raising new capital. Their results further counter the debt and size hypotheses: they find no evidence that highly levered or dividend-constrained firms were more likely to oppose the ED, use more options, or experience a negative stock price reaction to news increasing the probability of mandatory recognition of stock option expense. [Aboody et al. \(2004\)](#) determine that expenses related to the fair value of stock options are value relevant. They find that stock option expense is deemed sufficiently reliable to be used in firm valuations, and that annual returns reflect stock option expense in a timely manner.

I contribute to the ongoing debates and academic studies surrounding the expensing of stock options by documenting the impact of [SFAS No. 123\(R\)](#) on financial statement conservatism. Because [SFAS No. 123\(R\)](#) leads to greater (more negative) expenses it increases overall conservatism in income. However, it is not known whether the adoption of [SFAS No. 123\(R\)](#) will increase conditional and/or unconditional conservatism. Conditional conservatism represents the timelier recognition of economic losses relative to economic gains. Conditional conservatism is widely considered to be a positive earnings characteristic. Specifically, conditional conservatism is found to increase contracting efficiency and reduce litigation and political costs ([Watts \(2003a, 2003b\)](#)), Unconditional conservatism, on the other hand, is the reduction of income regardless of economic circumstances. Unconditional conservatism is widely considered to be a negative earnings quality. Specifically, unconditional conservatism adds noise to earnings, thereby reducing contracting efficiency ([Ball et al. \(2008\)](#)).¹ Because the different forms of conservatism have different implications for the quality of income, I conduct this study to better understand the implications of [SFAS No. 123\(R\)](#).

I find that [SFAS No. 123\(R\)](#) leads to an increase in both unconditional and conditional conservatism. Thus, the impact of [SFAS No. 123\(R\)](#) on the quality of earnings, in terms of conservatism, is mixed. I additionally find that [SFAS No. 123\(R\)](#) causes an increased negative relation between contemporaneous economic gains and income. This finding suggests that [SFAS No. 123\(R\)](#) lowers the quality of income, as it may cause investors and researchers to conclude the firms are underperforming in times of economic prosperity.

Due to the unique circumstances of my sample period, 2006–2007 (a period of economic decline), I examine the impact of implied stock compensation expense outside of my sample period, and my findings hold. Additionally, due to the documented mechanical relation between option pricing and stock prices ([Aboody \(1996\)](#)), I conduct my tests using a non-priced based model of conservatism. Again my results hold. To provide a complete picture of the impact of [SFAS No. 123\(R\)](#) on financial conservatism I further examine whether the impact of the Standard varies in the cross-section. The cross-sectional tests show that my main results are not driven by either size or industry.²

The remainder of the paper is outlined as follows. [Section 2](#) summarizes the accounting treatment for stock option compensation. [Section 3](#) presents my testing methods. [Section 4](#) describes the data. [Section 5](#) outlines the main results. [Section 6](#) discusses additional tests. [Section 7](#) concludes.

2. Accounting for stock option compensation

The original guidance for accounting for stock options was provided in 1972 via [APB Opinion No. 25, Accounting for Stock Issued to Employees](#). Per [APB Opinion No. 25](#), firms were required to report compensation expense due to stock options in an amount equal to the excess of the stock price at the grant date over the exercise price. This

¹ In circumstances where unconditional conservatism is known, it may be reversed by a rational agent, thereby rendering it neutral.

² As explained in [Section 6](#), these variables are chosen because smaller firms and certain industries (i.e. human capital intensive industries) rely more heavily upon stock options as compensation, relative to other firms.

method is referred to as the “intrinsic value method.” Because most options have an exercise price at least equal to the grant date stock price, it was uncommon for the intrinsic value method to result in an expense.

In 1995 the FASB issued [SFAS No. 123, Accounting for Stock-Based Compensation](#). Per [SFAS No. 123](#), the fair value of stock options was determined using an options-pricing model. Stock compensation expense was then determined by amortizing the fair value of the options over the vesting period. This method is referred to as the “fair value method.” As originally issued, [SFAS No. 123](#) was a voluntary measure. A company could choose to either (a) report stock compensation expense determined per the fair value method in its income statement, or (b) report stock compensation expense determined per the intrinsic value method in its income statement as well as report stock compensation expense determined per the fair value method in its footnotes. Because stock compensation expense per [SFAS No. 123](#) is typically greater (more negative) than stock compensation expense per the intrinsic value method, firms mostly chose to continue applying the intrinsic value method, and only disclosed the impact of fair value reporting in their footnotes.

[SFAS No. 123](#) was revised in December of 2004. The revised statement, [SFAS No. 123\(R\), Share-Based Payment](#), supersedes [APB Opinion No. 25](#) completely. [SFAS No. 123\(R\)](#) requires all companies to include the impact of fair value reporting for stock option compensation in their income statements directly. As such, [SFAS No. 123\(R\)](#) leads to an increase in overall financial statement conservatism. The purpose of this paper is to more fully examine this impact.

3. Testing methods and predictions

In order to investigate the impact of [SFAS No. 123\(R\)](#) on financial statement conservatism, I employ the following piece-wise regression model introduced by [Basu \(1997\)](#)

$$NI_{i,t} = \alpha_0 + \alpha_1 DRET_{i,t} + \alpha_2 RET_{i,t} + \alpha_3 DRET_{i,t} * RET_{i,t} \quad (1)$$

where $NI_{i,t}$ is net income per share for firm i for year t divided by the price of firm i stock at the beginning of fiscal year t , $RET_{i,t}$ is contemporaneous 12-month cumulative stock returns for year t less the corresponding CRSP equal-weighted market return, and $DRET_{i,t}$ is an indicator variable equal to one when $RET_{i,t} < 0$, zero otherwise.

In [Eq. \(1\)](#) economic events are captured by returns. The relation between contemporaneous economic gains and income is represented by α_2 , while the relation between contemporaneous economic losses and income is represented by $\alpha_2 + \alpha_3$. Conditional conservatism implies that economic losses are incorporated into income in a timelier manner than economic gains. The presence of conditional conservatism is represented by a positive and significant α_3 coefficient estimate. Unconditional conservatism, on the other hand, implies that income is decreased, regardless of contemporaneous economic events. Unconditional conservatism is represented by $\alpha_0 + (\alpha_1 * \text{loss frequency})^3$.

I conduct this analysis as an exploratory study; I am agnostic as to the predicted outcome. On one hand, [SFAS No. 123\(R\)](#) may lead to an increase in conditional conservatism, as [Bens et al. \(2002\)](#) find that there is an economic loss associated with employee stock options: to avoid dilution caused by employee options, firms buy back outstanding shares. Funds allocated to buy back shares cannot be spent on higher net present value opportunities. On the other hand, [SFAS No. 123\(R\)](#) may lead to an increase in unconditional conservatism, as the [SFAS No. 123\(R\)](#) related expenses will occur regardless of whether the firm experiences an economic gain or loss. It may also be the case that both forms of conservatism are simultaneously increased. Because of the conflicting theories I do not provide signed hypotheses; instead I

³ Loss frequency is the average of $DRET_{i,t}$.

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