

**Determinants and consequences of stock option accounting treatment: the expensing debate.****Multi-country evidence:** (DK, US, UK, FR SP).**Description:**

The firm's accounting treatment of stock options has been in and out of focus of the business press for over a decade. The press has rooted for increased transparency, and thereby the expensing of stock options, for some time. Concurrently numerous firms have gone on the record as firmly opposing a mandated move towards expensing, and lobbied in that direction; and most recently, in the United States, we have observed a reversal on behalf of certain of these firms in their voluntary adopting of stock option expensing measures.

However, multidisciplinary academic research over the same time period has not yet conclusively provided a rationale neither in favor of the expensing move, nor against it. Accounting-focused research has but topically examined the question, and the recent papers dealing with the subject remain descriptive, focused on US companies, and of limited scope (Aboody et al, 2004). Corporate governance-focused research has explored the accounting treatment of this form of compensation progressing from a traditional optimal contracting perspective through the so-termed "managerial power approach" (Bebchuck et al. 2002) and, most recently, to the "perceived cost view" (Murphy, 2002) and provided tentative explanations both for and against expensing from the firm's perspective. Tentative testing of the applicability of these approaches both from a theoretical and empirical perspective for samples of US companies also yielded mixed results (Penvern, IB master thesis, 2004).

The general purpose of the PhD project will be twofold. Firstly it will aim to continue my previous work in examining the determinants and consequences of the accounting treatment of stock options both for Danish and other companies (in the multi-country framework) in asking the following question: "why do companies choose a certain accounting treatment for their stock-based compensation?"

In particular I plan to incorporate as broad data sets as possible and in this sense Denmark represents a perfect case study as there exists unique and comprehensive data sets to work on. This will also incorporate an examination of the role of accounting auditors in the expensing decision; in particular whether they are able to counteract outside pressure exerted on them in their guiding of the company in its accounting decision. Secondly, the PhD project will aim to examine the expensing decision in a more general sense, broadening the focus to other accounting procedures which influence current and future reporting of earnings and other key financial data; in particular this will concern the factors and conditions affecting these choices of accounting procedures. (I cite as an example the treatment of depreciation).

Lastly, I believe it important to note that it is likely that in the United States, stock option expensing could be made mandatory in the very near future. This does not undermine the relevance of the here-exposed project as the examination of the expensing decision, and

thereby attempting to understand it should yield sufficiently broad conclusions that they can be broadened to the expensing decision in a more general sense (cf. the 2<sup>nd</sup> purpose of the PhD project).

**Essays:**

Essay 1: Relevant theory review, the expensing choice in a corporate governance framework and the related accounting treatments

Essay 2: To expense or not to expense, multi-country evidence

Construction of a relevant data set for DK, US, UK, FR SP (perhaps other countries as well). Effect of expensing or not on companies' bottom lines and other relevant variables.

Mirroring of master thesis logic, meaning observe expensing behavior, and related accounting, and attempt to construct data set as before and after expensing. Observe resulting variations in EPS, and attempt to single out factors affecting the expensing decision (size, size relative to peers, industry effects, magnitude of earning variation, capital intensity in industry, annual stock option use, board structure and so on...). Perhaps attempt to filter these out in order to observe potential determinants of the expensing decision, and the related accounting methods.

Essay 3: Determinants and consequences of the accounting treatment of stock options.

Continuation of above work, in the master thesis framework. How do these treatments affect the relevant companies? Aim is to filter out possible influences such as industry, size etc, and thereby determine who expenses, who does not, and why they make that particular choice. I plan to adopt a corporate governance focus. I also find it relevant to attempt to determine whether the accounting treatment is a consequence or a factor and how it comes to play in this problem concerning expensing. Larger question is that of the accounting treatments associated with such high-impact decisions as those that affect current and future earnings (bottom line impact).

Incorporation of a possible study of the pressure exerted on auditors, and associated firms, to adapt accounting treatment to company necessities and current earning necessities. Effects of these pressures on the above-mentioned expensing choice. Examine the role and influence of these auditors on company choices, on legislation also perhaps.

Essay 4: A broader view of the expensing decision: effects of accounting on decisions with high earnings-impact.

Look at other accounting issues that relate to this expensing decision, and that might have been unearthed in the 2 previous essays (for example depreciation). Is it possible to reuse the data set of essays 2 and 3? If not, possible case studies? Restrictive nature of conclusions though.

Attempt to further an answer of the larger question of the accounting treatments associated with such high-impact decisions as those that affect current and future earnings (bottom line impact).

**Bibliography:**

Aboody et Al, "Firms Voluntary recognition of stock-based compensation expense", Journal of Accounting Research, May 2004

Bebchuck, Fried, Walker, "Managerial Power and rent extraction in the design of Executive compensation", Discussion Paper No.366, Harvard, 2002

Murphy, "Explaining executive compensation: Managerial power versus the perceived cost of stock options", the University of Chicago Law Review, 2002

Penvern, "International Corporate Governance: to expense or not to expense? Perspectives for U.S. companies", Copenhagen Business School, IBS master thesis, 2004