Stock Options Expensing

Is a Classic American Market Tool at Risk?

Are stock options still a compensation tool that captures the spirit of American entrepreneurship, or have they become a form of looting by unscrupulous corporate executives?

Since the collapse of Enron, the pure intent of America's corporate executives has fallen under suspicion and stock options have become the new symbol of corporate greed. The hotly debated issue of stock options expensing reflects this crisis of confidence. Proponents of expensing call it a necessary accounting reform, but opponents say it is retribution.

Proposed accounting reforms center around the true nature of stock options. Are they still a compensation tool that captures the spirit of American entrepreneurship, or have they become a form of looting by corporate executives?

First created in the early 1970s, stock options have become the most significant compensation tool used to lure and retain key executives. At the end of 2001, 90 percent of large U.S. companies issued stock options and more than 10 million American workers received them as part of their pay, a tenfold increase over 1992, according to the National Center for Employee Ownership. Stock options account for almost 60 percent of CEO pay, according to compensation consultants Pearl Meyer & Partners.

And since granting options has little to do with how much a company can afford to pay today, the sky is the limit for executives who have learned to cozy up to compensation committees, rather than shareholders.

The most appealing — albeit most controversial — feature of stock options for corporate America is that they function as a promise of payment, but never have to be listed as an expense on corporate earnings reports, as long as the exercise price is fixed at the prevailing market price.

If and when those options are exercised, the employee payment for them becomes an influx of cash for the company, and at the same time, the company can take the difference between the strike price and the market price as a tax deduction. Handing out enough stock options could mean paying no taxes at all, because companies whose tax liability is erased through stock options expenses may not be subject to

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the corporate alternative minimum tax.

Most companies are comfortable with this *pro forma* measure of profits, which excludes the costs of stock options, restructuring, amortization, etc. Approved stock option plans must be explained in a footnote to expense reports.

This footnote disclosure method has become all-important to expensing opponents, who argue that it provides sufficient information about a company's financial state. But footnotes are tricky to read and may not provide shareholders with a clear picture. And it was only at the end of 2001 that the Securities and Exchange Commission (SEC) began to require the disclosure of all employee stock options plans, not just those that have been officially approved by shareholders.

In the Money

Because of their incredible appeal, stock options have become an obsession for many corporate executives, who fixate on day-to-day and week-to-week fluctuations in stock prices, waiting for the golden moment when they can cash in.

In January, investors in the Oracle Corporation took issue with chief executive Larry Ellison when he cashed in about 23 million company shares, averaging at 23 cents each, for a paper profit of nearly $700 million. A month later, the company issued an earnings warning.

Economists would call this an example of "asymmetric information," when the seller has more information than the buyer, a situation that does not promote efficient market dynamics.

Executives have figured out ingenious ways to drive up stock prices with carefully timed management decisions that have little to do with the future welfare of the company. Cutting back on hiring, research and development, or other investments drives up the stock price artificially, but postpones potential profits. In this sense, stock options are driving the markets, instead of the other way around.

Managerial focus on the short term is at complete odds with the original intent of granting options — to give employees a stake in the company so that they will work harder to make it profitable, the theory being that such a stake would tie the interests of management to the interests of the shareholders. But it hasn't exactly worked that way.

Companies often re-issue ("reload") executive options at a higher strike price, so that options that were underwater will now suddenly have value. Some executives are offered short cycle options, or options that vest upon grant. But these sweet deals are not usually available to the average employee, and are rarely put to shareholders votes.

Touching on this point in his annual letter to shareholders of Berkshire Hathaway in 2001, investor Warren E. Buffett wrote, "To their shame, these business leaders view shareholders as patsies, not partners."

Facts and Figures About Stock Options

- Eighty-two percent of companies offering options give incentive stock options; 18 percent offer non-qualified stock options
- About 53 percent of companies grant stock options to all employees (at information technology companies, that figure is 88 percent)
- Sixty-eight percent of companies with fewer than 100 employees give stock options to all employees; 74 four percent of companies with less than $50 million in revenues give stock options to all employees

Source: National Center for Employee Ownership

At Issue: Executive Pay

Executive compensation packages are determined most often by industry standards, instead of according to productivity or profitability. Because the value of stock options is tied increasingly to market swings rather than to a company's intrinsic worth, they have a pure upside with no downside for most CEOs.

Pearl Meyer and Partners reported that the number of options granted by 50 major companies in 2001 was up 12 percent from the year before, but the value of those options fell seven percent in the first eight months of 2001.

Accounting professors at the Wharton School at the University of Pennsylvania determined that in 1980, chief executive pay was about $655,000 in cash and bonuses, with approximately 30 percent of executives receiving stock options valued at around $155,000. In 1994, 70 percent of executives were receiving options as part of their compensation packages, with a mean salary of $1.3 million and mean options grants worth $1.2 million.

Concern over stock options today goes beyond questioning the wholesome motivation of executives. Liberal option grants create an overhang of outstanding shares that dilutes the effect of those already purchased. The average options overhang of the companies in the S&P 500 was 14.6 percent of outstanding shares in 2000, up from 13 percent a year earlier, according to Watson Wyatt Worldwide.

Anti-reformers argue that the dilutive effect of stock options is already noted in footnote disclosures, so new expensing requirements would count them twice.

Another thorny issue in expensing stock options is valuation. The option pricing model devised by economists Fischer Black and Myron Scholes, whose work on the subject earned them a Nobel Prize in 1997, attempts to account for the nature of the option plan — the vesting and exercise period, the volatility

of the underling stock price, etc. But one of the assumptions of this formula is that the options are not taxed.

The Levin Bill

Executive pay seems to be the sticking point, however. Sen. Carl Levin (D-MI) collected research showing that, 10 years ago, CEO pay was 100 times average worker pay. Now, it is 500 times average worker pay.

Levin began analyzing these figures in 1994 when he proposed legislation in Congress that would require more accountability for stock options. The FASB, which in 1972 had opted not to regulate stock options, initially came on board with the bill, but after swift and heavy opposition from its membership, the organization took a formal position against it.

Silicon Valley was up in arms against the bill, led by former Treasury Secretary Lloyd Bentsen and Sens. Joseph Lieberman (D-CT) and Barbara Boxer (D-CA). In the height of the lobbying season, one hundred CEOs from around the country flew to Washington, D.C. to lobby Congress on the issue. Lieberman even proposed a bill that would close down the Financial Accounting Standards Board (FASB).

Those who opposed reform were telling Congress, "If it ain't broke, don't fix it."

The Senate eventually voted 88-9 to recommend against putting stock options pay on the books. In 1995, the FASB settled for a compromise position of requiring stock options to be disclosed in the now-sacred footnote on corporate earnings sheets using Black/Scholes.

The purpose of both new statutory provisions is to ensure that any stock option deduction or credit claimed on a taxpayer's return will mirror, and not exceed, the corresponding stock option expense shown on the taxpayer's financial statement. If no stock option expense is shown on the taxpayer's financial records, there can be no expense taken as a deduction or credit on the taxpayer's return. If a taxpayer declares a stock option expense on its financial statement, then the taxpayer is permitted to claim a corresponding deduction or credit on its return in the same taxable year for exactly the same amount of expense.

— From Sen. Carl Levin's bill, "Ending the Double Standard for Stock Options Act" (S.1940)

Arthur Levitt, chairman of the SEC from 1993 to early 2001, opposed the expensing reforms proposed in 1994, but now supports them. In January, he told the Governmental Affairs Committee of Congress that he spent 50 percent of his first four months at the SEC talking to corporate executives who wanted to keep their stock options pay off the books. One of his greatest regrets from his days at the SEC, Levitt said, was that he didn't do enough to get stock options treated as an expense on a company's financial statements.

Levin has resurrected his legislation and many of those formerly opposed to the bill are now lobbying in support of it. The Levin bill, dubbed the "Ending the Double Standard for Stock Options Act" (S.1940), would not require companies to expense options directly, but it would eliminate tax deductions for stock options *unless* they are expensed on company books. In his comments before Congress, Levin said, "That's tax honesty. That will end the stock option double standard."

The Levin bill is supported by several large institutional investors and pension funds, including the Council for Institutional Investors (CII) in Washington, D.C. CII, an association of 120 pension funds and other financial services firms, opposed the bill in 1994, but now supports it because the size of option programs has exploded in the last decade.

"The Council's policy is broader than the bill, so it would clearly fit within it," said CII's deputy director, Teresa Webb. "Our policy does not say 'give a choice,' we say all options charged. So our policy is furthered by the bill even though it gives a trade off."

The Line in the Sand

Current SEC Chairman Harvey E. Pitt has addressed the issue, not by calling for expensing, but by arguing for more disclosure to shareholders.

"Making equity incentive compensation available to management is in the interest of shareholders," Pitt said in April. "Companies should be required to make full disclosure and submit such plans to a shareholder vote as a fundamental first step." Pitt also said that option grants should be decided by a board of outside directors and should be tied to long-term performance.

With major accounting reforms in the wind, republicans in Congress, led by Marge Roukema (R-NJ) have already proposed a 60 percent budget hike for the SEC. Opponents such as Sen. Phil Gramm (R-TX) have characterized the legislation as a tax bill that attempts to usurp the FASB's rulemaking authority.

Detractors of the Levin bill argue that the kind of accounting changes it would require could reduce average corporate earnings by at least 10 percent while increasing accounting costs by up to 40 percent. They also say that small companies will be the hardest hit by the legislation because stock options are the only way to attract top talent from very lucrative spots. The National Venture Capital Association has stated that any reduction on earnings reports will make it more difficult for companies to attract capital.

Accounting reform legislation put forth by the Bush Administration does not call

for expensing, but President Bush has suggested that *exercised* options be added to the number of shares outstanding when calculating a company's per-share earnings.

The stock options issue has become the first public dispute between Bush and Federal Reserve Chairman Alan Greenspan, who says that stock options are unarguably a replacement for cash compensation and current accounting for them has created "perverse effects" on the quality of corporate disclosure.

Regarding his suggestion about expensing, President Bush told the *Wall Street Journal* in March, "Alan Greenspan is very smart. I hate to get into a debate with him, but my view is that it achieves both objectives. One, what are the true earnings of the company? And two, what is the dilutive effect of options 'in the money'? We may perhaps get to the same end that he is trying to achieve, and that is a full accounting of options."

U.S. Chamber of Commerce Vice President Bruce Josten said that stock options and 401(k) pension plans have enabled more people to have a stake in the American dream, and criticized the "hyperactivity" of the congressional debate over the issue. But groups like CII argue that it is the average employee, whose retirement funds are tied to stock options more than ever before, who may stand to lose out on that dream.

Several major accounting firms now support the expensing of options. A September 2001 survey conducted by the Association for Investment Management and Research reported that 80 percent of U.S. financial analysts also support expensing.

The International Accounting Standards Board in London (IASB), the international equivalent of the FASB, favors expensing of stock options. IASB is developing international standards for global corporations, and corporate lobbyists are already rallying in opposition.

FASB is waiting for IASB to take the lead on the issue, according Robert H. Herz, who became FASB chairman on July 1. Herz, a former IASB member, has said, "There is an overall commitment to try to converge standards across the world and FASB is part of that movement." FASB will study any draft accounting rules from the IASB to determine if they are an improvement to existing FASB standards.

The Options Aura

While reformers argue that expensing stock options will eventually help to eradicate some of their overuse and abuse, opponents fear that expensing options is tantamount to taking them away because they will become too costly to offer in the generous quantities to which CEOs have become accustomed. Thus, a unique fixture in the American capital markets will be wiped out.

The reality of the entrepreneurial effect of stock options is in dispute, however.

Theoretically, they are a great motivator of employees. Or, so said Tyco International spokesman Brad McGee in April when the company announced the spin-off of its financing unit, which cost several thousand employees their unvested stock options. Most

of those options were underwater, anyway, but top employees at Tyco have already been granted new options — just above the current market price — which will continue to vest as the spin-off goes forward.

A Merrill Lynch survey of 32 high-tech companies found that options disproportionately benefit executives of larger corporations and that the impact of not expensing them like other forms of compensation was substantial.

"The general view is that smaller, cash strapped companies must use stock options to lure talent," the study says. "We were surprised that smaller companies showed a lower median tax benefit per employee than the biggest names."

If the flexibility and overwhelming profitability of options attract the top talent in corporate circles, then putting any kind of restrictions on them will inevitably hamper innovation, some argue. In fact, expensing opponents say that the entire future of American technological advancement is at risk if stock options rules are tightened, because it was options that got Silicon Valley off the ground in the first place.

Stock Options Tally Sheet

FOR Stock Options Expensing:	AGAINST Stock Options Expensing:
Warren E. Buffett	Association for Financial Professionals
Council for Institutional Investors	President Bush
Alan Greenspan	Financial Executives International
IASB	Senator Joe Lieberman
Senator Carl Levin	National Venture Capital Association
Arthur Levitt (former SEC chairman)	Harvey Pitt (SEC Chairman)
Senator John McCain	U.S. Chamber of Commerce
80 percent of U.S. financial analysts (Association for Investment Management and Research)	

Solutions

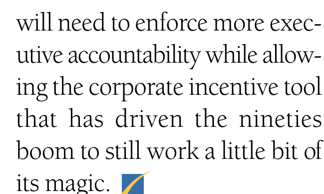
Giving shareholders more say seems to be the popular route to take in the way of stock options reform, or at least it is the less painful alternative. More disclosure means more work, but pro forma expensing would basically stay the same.

Other solutions to fix the problem would be to restrict the number of options awarded and to regulate how they can be exercised. Along the lines of SEC chairman Pitt's suggestion, some economists have noted that options could be tied to a benchmark index, such as the S&P 500, and executives would have to show that their company's share value beat that market index. That way, executives cannot be rewarded for market shifts outside their control.

Yet another solution would be to get more plain vanilla stock into the hands of corporate executives. And perhaps make them pay for it, some reformers say.

Expensing opponents are nervous that the Levin bill may actually go through this time because the gross misuse of accounting practices demonstrated by Enron has most people hungry for reform. Admittedly, there are shareholders that would balk at any accounting or tax reforms that might stem the tide of soaring profits.

Any successful reforms will most likely find a middle ground that reins in the current stock options bonanza to manageable levels. Such a resolution will need to enforce more executive accountability while allowing the corporate incentive tool that has driven the nineties boom to still work a little bit of its magic.



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