Commentary

MAY 2002

BUFFIN PARTNERS INC. INVESTMENT AND ACTUARIAL RESEARCH

Stock Option Awards As Corporate Expense

The debate as to whether executive stock option awards should be treated as corporate expense is not new. In 1993 the Financial Accounting Standards Board (FASB) decided that option awards should be treated as corporate expense. However, lobbying efforts by opponents resulted in the FASB opinion not being implemented.

The debate has resurfaced recently from concerns over reported corporate earnings and stock valuations being overstated due to the non-recognition of executive stock option awards. Authoritative voices are now urging a more realistic assessment of stock option awards. Respected investor Warren Buffet is quoted as saying "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses shouldn't go into calculations of earnings, where should they go?"

Federal Reserve Chairman Alan Greenspan has expressed concern about the use of stock options as executive compensation and has drawn attention to the distortions caused by the failure to expense stock options. A Federal Reserve study shows that if the Standard & Poor's 500 companies had expensed their stock options in 2000, actual operating income would have been approximately 14 percent below that reported. The Fed Chairman has proclaimed that reform of stock option accounting is a top priority.

A significant voice in favor of expensing stock option awards is the Council of Institutional Investors, representing major pension funds, endowments and investment firms. Institutional investors are increasingly concerned about overstated earnings and stock valuations. They want to curb management practices that dilute stockholders' equity such as excessive executive awards inconsistent with management's record of creating shareholder value and re-pricing options to protect executives' vested interests.

Many boards of directors have become aligned with or dominated by company management and have consistently voted to award executive stock options in a manner detrimental to shareholders' interests. Shareholder activists are demanding more accountability from boards, more representation by outside directors and more disclosure of the terms and performance objectives underlying executive stock option awards. As the truth emerges about the impact of executive compensation deals, including interest-free loans to executives to acquire shares, shareholders are expressing outrage at the extent of self-interest of corporate management and the dilution effect of options.

Another influential voice in this debate is the International Accounting Standards Board (IASB). The IASB has concluded that stock option awards should be recognized as an expense in financial statements and is proceeding to secure the cooperation of companies worldwide to adopt this principle. Former Chairman of the Federal Reserve, Paul Volcker, is leading the IASB in its efforts to establish the global standard for expensing stock option awards.

A particular aspect of stock option awards that is being closely re-examined is the tax treatment accorded to companies. Although the companies are not currently required to expense stock options, they generate substantial tax advantages when options are exercised by taking the appreciation in the value of shares awarded as a corporate expense for tax purposes. Senators Levin, McCain and Stark have introduced legislation to deny tax deductions to those companies that award stock options but do not report the awards as current expense in their financial statements.

The debate is not merely an academic discussion of accounting principles, shareholder rights, tax policy and management ethics; there is undeniably a significant political dimension to the debate. Corporations do not hesitate to use their influence through lobbying and political campaign contributions to ensure that lawmakers hear their message. After the FASB decided in 1993 that companies should expense options, Senator Lieberman led the effort to oppose the FASB decision and introduced legislation that the Senate approved to that effect.

A prominent spokesperson in favor of retaining the existing practice of not expensing stock options is Jack Kemp of Empower America. He states that proposed changes would "deny millions of hard-working Americans employed in a broad cross-section of American industries an opportunity to own a piece of the company they are helping to build." He considers that "requiring companies to forecast the future value of their stock and treat the estimated value of stock options as a compensation expense would be a violation of generally accepted accounting principles." He believes the current practice is "fair, simple and accurate and that stockholders and potential investors are not deceived about the dilution effects of stock options when disclosed in a footnote to the financial statement."

Institutional investors and their advisors need to take an objective, fair-minded look at all the issues surrounding the debate on expensing stock options, balance the interests of shareholders and corporate management and permit users of financial reports to rely on them as a true and fair view of the financial operations of the company. Boards of directors need to ensure that their decisions do not attract criticism for failing to represent the interests of shareholders and for favoring unreasonable compensation awards to corporate executives.

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