Commentary

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BUFFIN PARTNERS INC. INVESTMENT AND ACTUARIAL RESEARCH

Requiem for Stock Options

The Microsoft decision to end its use of stock options as employee compensation marks a major turning point as the post-bubble world seeks to establish a new sense of rational and ethical corporate behavior. The basic false premise that stock options were justified, on the grounds that they provided an incentive that aligned management's self-interest with their fiduciary responsibilities to shareholders, has been laid to rest with the arrangement for currently worthless outstanding Microsoft options to be bought out by JP Morgan Chase.

It is an appalling commentary on corporate ethics that the long-running stock option conspiracy to loot shareholders' equity involved so many corporate executives, legal advisers, accountants, auditors, compensation consultants and others, while the Securities and Exchange Commission stood idly by as this legal but unethical looting took place. Not even in the wildest fantasies of Alice in Wonderland might one have expected to experience the distorted logic that permitted the granting of executive stock options without recognizing their expense as a charge against reported earnings, but nevertheless creating a tax deduction that inflated earnings and consequently aided in producing the stock price bubble that eventually burst.

It appears increasingly likely that awards of restricted stock will supplant the practice of granting stock options as executive compensation. The cost of restricted stock awards is treated as an expense under US accounting rules. The Financial Accounting Standards Board is moving toward implementing rules requiring grants of stock options to be reported as an expense, so that companies will no longer be able to act as though stock options constituted the proverbial "free lunch." Evidently, companies will be faced with a choice of expensing stock options or abandoning the "no-cost" fallacy in favor of a more rational policy of granting restricted stock and recognizing the appropriate costs directly.

Technology leaders such as Cisco, Intel and Oracle adhere to the philosophy of the *Ancienne Regime* and may eventually be forced to abandon their entrenched views as shareholders increasingly insist on higher standards of corporate governance. Once this hurdle has been cleared, the stock valuations of many technology companies will revert to rational levels as the misperception that stock option awards do not have an associated expense that impacts current earnings and stock values is exposed as a canard whose effect has been hidden from view with the consent of willing accomplices in the accounting profession and at the SEC.

It is interesting to note that an equally-weighted portfolio of three stocks, Cisco, Intel and Oracle, would have its 2002 reported earnings reduced by 34% with the expensing of stock options and that the 2002 option-adjusted price/earnings ratio of this trio would be as high as 67, based on current stock prices. What may be less apparent is the relative impact on future earnings of a move to restricted stock awards as compared to expensing the costs of stock options. Evidently, many companies have studied the likely future impact on earnings and have made the reluctant decision to convert from stock options to restricted stock awards before the light of disclosure shines into the dark recesses of corporate accounting that have hidden the truth about the true cost of stock options for so long.

Although stock options enriched many recipients during the 1990's bull market, the tax treatment of options, when exercised, seems in retrospect to be a supreme example of distorted logic. Many unsuspecting management employees experienced the angst of incurring large immediate tax liabilities on option profits when exercising options, even when the profit was unrealized, if the individual elected to hold rather than sell the stock. Many employees who subsequently experienced the post-bubble stock price collapse lived to regret the loss of cash outlay for taxes paid on ephemeral profits at the time of exercise. Incredibly, while the companies had never expensed the cost of granting the stock options, they benefited from the employees' exercise of the options by receiving tax deductions that served as credits to enhance cash flow and earnings. In the case of Microsoft, these tax credits exceeded $5 billion in the year 2000.

The way in which stock options were misused by Corporate America in recent years resulted in situations that created opportunities for diluting stockholder equity and contributed to illusory reported earnings and stock price inflation. Companies were also responsible for the widespread practice of share repurchases to offset the dilution effect. But these share repurchases were typically financed by borrowing that produced a significant leveraging effect on balance sheets and capital structure. Financial historians in future years will undoubtedly shake their heads in disbelief that the whole 1990's stock option fantasy world was somehow allowed to happen. Microsoft is to be lauded for beginning a process that may eventually enable us to chant "Requiescant in Pace" for stock options.

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