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Strategic Finance; Jun 2003; 84, 12; ProQuest Central
pg. 61

Foes of Stock-Option Expensing Rise Again

➤ NEW ACCOUNTING FOR STOCK options is a controversy that just won't die.

In mid-March, the Financial Accounting Standards Board (FASB) said it was tackling a project to improve the "accounting and disclosures of stock-based compensation." Then, in April, the Board decided unanimously that stock-option compensation does result in a cost that should be recognized in the income statement as an expense.

But once again, opponents—primarily from technology companies and their trade associations—are pulling no punches to stay the FASB's hand. They've formed public policy coalitions to lobby politicians and raise public rhetoric against the required expensing of options. Their reasoning? Expensing of options would put technology companies, many of which rely heavily on stock-option compensation, at a competitive disadvantage and make financial statements more incomparable.

Congressman David Dreier (R.-Calif.) and Congresswoman Anna Eshoo (D.-Calif.) introduced a bill in late March to enhance disclosure of stock-option valuation but not change the accounting. In fact, the proposed legislation would prohibit the Securities & Exchange Commission (SEC) from recognizing any new stock-option accounting for at least three years.

"We're going on the offensive here," Dreier told a news conference. He argued that requiring options expensing would slow the economy by effectively eliminating the use of stock-option compensation. The bill would also require the Commerce Department to study the impact of options on economic growth. A similar bill was introduced in the U.S. Senate by Senators John Ensign (R.-Nev.) and Barbara Boxer (D.-Calif.).

The FASB decides in favor of expensing options compensation, but technology companies get Congress to intervene.

But expensing also has supporters in Congress, including Republican Sen. John McCain of Arizona and Michigan Democrat

Sen. Carl Levin. Thirty lawmakers wrote to the FASB in February urging the Board to require expensing. IMA member Dennis R. Beresford, FASB chairman from 1987–1997, reportedly said it was "terrible" that lawmakers were intervening in accounting rule making. "They should not get involved in this process," he said. "Congress should let the SEC overlook the process and let the SEC step in if FASB is not serving the public interest."

But public policy coalitions such as TechNet and the International Employee Stock Options Coalition (IESOC) say expensing stock options would curtail their use. Net income would plummet for many technology firms expensing stock options, their share value battered and international competitiveness diminished.

"There's a reason that Silicon Valley exists in the United States and not in some other country," noted Rick White, chairman of TechNet and IESOC, at a press conference in April. He said IESOC is studying how Asian competitors would have an advantage in recruiting employees if U.S. companies have to pay a higher cost for offering stock options. "It would be a mistake for us to tie one hand behind their back," White said of U.S. companies, explaining they have attracted workers from around the world with the widespread use of options.

Some opponents of new stock-option accounting say it isn't accounting that has to be revised—it's the structure of stock options. Options, they maintain, are basically a good tool: They align management's and shareholders' interests and offer performance-based compensation. On this premise, economists William Baumol and Burton Malkiel, in a *Financial Times* article on April 4, 2003, outlined five ways to retool options that obviate new accounting *and* restrain stock-pumping financial fraud and short-term gains on options despite poor corporate performance.

"These problems are best attacked directly by making issuance of stock options to management contingent on several provisions," Baumol and Malkiel wrote. "First, their exercise should not be permitted for some substantial period, say, five years; second, options should be performance-based, with their value depending on, say, the company's performance exceeding that of comparable companies; third, grants should be subject to approval by independent directors and shareholders; fourth, executives should be required to hold shares obtained through the option for a substantial period; and, fifth, sale of any shares by top management should be made public promptly."

Furthermore, Baumol and Malkiel reason that expensing options would invite creative accounting of options' valuation as "No one correct method of evaluating the costs of long-term employee stock options exists." Many people complain that Black-Scholes, the valuation method most often used, can produce vastly different costs because some of the underlying variables, such as the company's stock volatility, are subjective. That can lead to manipulation of stock-option costs, says Jeff Rodek, CEO of Hyperion Solutions Corp. Hyperion—a developer of business-management software—reported profits of $15 million in 2002, but, minus the costs of options valued with Black-Scholes, the company would have incurred a net loss of $882,000.

FASB Chairman Robert Herz said the Board has heard extensively from individuals and institutional investors, financial analysts, and many others who have urged it to mandate the expensing of stock-option costs. In addition, the Board believes there's a need for one consistent approach to recognizing these costs.

A renewed public tussle now seems fully under way! ■