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## Hi-Tech Options Myths

The battle lines are drawn on the debate over expensing options and rhetoric on the issue should only increase as FASB proceeds towards mandated expensing. Of important note is the fact it is an extremely vocal, organized and well-financed minority that opposes the expensing of options: the tech industry, the venture capitalists who back them and the politicians who receive large contributions from them. All have clear biases for keeping the status quo in place and fear losing the proverbial 'free lunch' that options represent. The Wall Street Journal has showcased editorials by Andy Grove, Harvey Golub and most recently David Pottruck, arguing against FASB's initiative to properly recognize options as an expense. But expecting these three executives opine, in an unbiased manner, on the options expensing debate is like asking a jackpot winner to expound on the evils of gambling-its not going to happen.

For anyone who has done in-depth research on this topic and has a modicum of intellectual honesty, the conclusion is quite clear: options, due to their favorable accounting treatment, systematically overstate every facet of a company's financial statements. Earnings are overstated because the current accounting "cost" of options when granted at-the-money is exactly zero, despite having very real economic value to the recipient and attendant cost to the issuing firm's shareholders. Cash flow from operations is enhanced by reduced compensation expense and the tax benefit recognized upon the exercise of options. Lastly, the balance sheet is buttressed by the cash flow benefits just mentioned, plus the strike proceeds collected when options are exercised-in essence an evergreen equity offering at below market prices. strength of many tech balance sheets can be traced to this prolific issuance of equity from options. One software CFO admitted, off the record, that "the accounting for options is garbageit's better than a free lunch. I get to collect the strike proceeds. I get the tax benefit and I don't have to record an expense." It is glaringly obvious why this issue is so important to the tech industry and why their lobbyists and executives have descended upon Washington like a swarm of locusts. Silicon Valley's disingenuous arguments against the appropriate expensing of options are predictable and largely representative of the tech industry's self-serving position. It is time to debunk some common options myths perpetuated by the tech crowd and their paid lackeys.

Poptions do not directly align the interests of management with shareholders. Those who perpetuate this fallacy ignore the asymmetric return profile of options, which is akin to that of a lottery ticket. Returns are leveraged on the upside and 100% on the downside. As a result, options can incent imprudent risk-taking, especially when combined with short vesting periods. Restricted stock grants with long vesting periods provide a much tighter alignment of interests as Brian Hall, of Harvard Business School, argues in his study, "Incentive Strategy II: Executive Compensation and Ownership Structure." He details the myriad of problems attendant with options use and explains why plain-old stock is a "more efficient" equity motivator. Despite the clear benefits of using stock instead of options, he concludes "that the uneven accounting treatment of compensation is creating a value-destroying bias in favor of options and against cash, stock and other forms of equity pay." Accounting is supposed to measure results, not drive sub-optimal operating decisions. The post-bubble decline in the stock market has also prompted many heavy options issuers to exchange out-of-the-money options for new options issued at much lower strike prices. Many also employ the "6 and 1" loophole that allows these effective repricings to avoid being recognized as an

- expense. These exchanges provide clear evidence that options are often a "heads you win, tails I lose" proposition for shareholders. Lastly, the recent tax code change has removed the disincentive for paying dividends. Unfortunately, since initiating or increasing a dividend mathematically reduces the value of employee stock options, the interests of shareholders and employees are actually *mis*-aligned on this important capital allocation decision.
- The diluted share count <u>does not</u> capture the real economic cost of options. Diluted share count only measures the historical options liability at a particular point in time. It does not appropriately reduce the earnings stream being capitalized to reflect use of options as compensation. Enron's Jeffrey Skilling admitted the accounting benefits of using options during his congressional testimony, "you issue stock options to reduce compensation expense and therefore increase your profitability." Those who continue to perpetuate this fallacy should read, "The Economic Dilution of Employee Stock Options: Diluted EPS for Valuation and Financial Reporting" (Core, Guay & Kothari), which concludes that the current treasury stock method "systematically understates the dilutive effect of outstanding stock options, thereby upwardly biasing diluted EPS."
- Deptions often do not promote outright stock ownership. Most companies grant options annually to their employees and, according to the book "In the Company of Owners," the vast majority-an estimated 90%-sell their stock immediately after exercise. This is typically for diversification reasons, which defeats the purported purpose of building a direct ownership stake. Many firms even offer a "cashless exercise," which allows employees to receive their net option gains without ever having to open their own checkbook. Proxy statements detail the "amount and nature of beneficial ownership," but if you subtract "shares subject to purchase options exercisable within sixty days," the real underlying share ownership of executives is usually pathetically low-especially for tech firms. Restricted stock grants more efficiently promote outright stock ownership, but are underutilized due to their less favorable accounting treatment.
- Expensing of options will not cause Silicon Valley's level of innovation to grind to a halt. It will simply put their businesses on a level playing field, in terms of accounting, with those that pay cash or restricted stock or virtually any other form of compensation that is expensed. What it will end is the charade of inflated financial results that enriches VC's and employees at the expense of unwitting investors. The recent linking of domestic tech jobs to expensing options is tantamount to political "extortion," according to corporate governance expert Nell Minow. Paul Miller, an accounting professor at the University of Colorado argues further, "The techie's argument is bankrupt, it's saying the only way we can maintain our competitiveness is through organized misrepresentations in our financial statements." The fact that the International Accounting Standards Board recently mandated options expensing starting January 1, 2005 renders this tech argument moot.
- ➤ Options are most definitely a form of compensation. To argue otherwise is absurd. As Coke's CFO stated, "there's no doubt that stock options are compensation, if they weren't, none of us would want them." There has been a massive shift towards equity pay over the past 2 decades for most top executives and "bonus changes are in the rounding error relative to annual changes in stock and option holdings" according to Brian Hall. The recondite

accounting for options requires employees to report their options proceeds as "ordinary income on their tax returns," while their employer records this same amount as a "compensation expense" for tax purposes. The only place this expense doesn't show up is in the net income number reported to investors-a patent mismatch. A number of prominent tech executives, including John Chambers and Tom Siebel, are currently working for an annual salary of \$1 and received zero cash bonus according to their most recent proxy statements. Cleary, they are hoping to "get paid" via the massive options grants that each receives on an annual basis. How is an income statement at all reflective of reality, when the total CEO compensation expense recognized in net income is sixty-two cents, after-tax?

- ▶ Broad-based options plans do not create an excuse for avoiding treating options as an expense. The popular "broad-based" argument promoted extensively by Intel attempts to divert attention to executive compensation abuses as the real problem, but this is a separate and distinct issue. Additionally, giving options to lower-level employees sounds altruistic, but is generally misguided. According to Brian Hall, "from the perspective of any one worker in a very large company, the connections between effort and stock price is fairly small and likely to be swamped by other factors." This "suggests the possibility that options are being used too heavily in broad-based compensation plans, perhaps because of the distorted accounting treatment...it seems likely that broad-based option plans are inefficiently substituting for cash-based and other forms of compensation." Again, the current 'free lunch' accounting for options appears to be driving sub-optimal operating decisions.
- ▶ Options are <u>absolutely</u> a real cost to the corporation. Options are granted as incentive compensation and compensation is a cost of doing business. It is easiest to see the real cash cost of options by noting that the tech industry spends billions of dollars each year repurchasing stock in an effort to mitigate the dilutive impact of options and yet shares outstanding continue to grow. Options effectively force companies to sell low and buy high and the cash used to fund repurchases is cold hard cash lost to the company and shareholders.
- Poptions are not impossible to value. Option pricing using Black-Scholes provides a reasonable approximation of the magnitude of value conveyance at the time of issuance. Just because an expense must be estimated, like the value of goodwill, depreciation or loss reserves, doesn't mean it should be ignored. The tech industry claims that there is no accurate way to measure options value for expensing purposes and that Black-Scholes is not reliable. However, when it comes to getting cash to their employees via an options exchange, Siebel, Adobe, Apple and others have no problem employing option valuation methods to value deep out-of-the-money options held by their employees-a blatantly hypocritical position. In the words of Warren Buffett, it is better to be "approximately right than precisely wrong." Recording zero expense for options grants is precisely wrong.

Given the current crisis of confidence, it is both sad and pathetic that the tech industry refuses to do the right thing and reform their egregious options practices. As with any unhealthy dependency, the first step to recovery is admitting you have a problem. Particularly galling is that executives who do not adopt the pro-expensing position are ignoring the explicitly stated desire of investors and standard-setting organizations. The Council of Institutional Investors

voted to back the expensing of options by a 5-to-1 margin. A global AIMR survey found that more than 80% of analysts and portfolio managers believe stock options are a form of compensation that should be expensed. The Investment Company Institute (ICI), which represents 95% of total mutual assets or roughly \$6.5 trillion, has taken the position that "mandatory expense treatment is necessary to ensure full and fair disclosure of issuers' results of operations and financial position." Prominent and highly-respected investors, including Warren Buffett, Chris Davis, Bill Miller and TIAA-CREF are all critics of the current system of accounting for options. Standard & Poors, a completely independent analytic organization, determined that options should be an expense in determining 'core earnings.' Shareholder Services (ISS) has rejected the anti-expensing arguments put forth by the tech industry as "self-serving and transparently false." ISS additionally observes that, "it is clear that end-users of financial disclosure documents-investors, large and small-overwhelmingly support the 'fair value' approach favored by both the IASB and FASB." Alan Greenspan endorses expensing options and former SEC Chairman Arthur Levitt has stated that not pushing through options expensing was the single biggest mistake of his 8 year tenure as Chairman of the SEC. Lastly, standards-setting organizations like the IASB and FASB, both have crystal-clear positions in favor of expensing options. Management teams are hired to run businesses for the benefit of shareholders, and those that ignore the clear will of owners do so at their own peril.

Perhaps the most fascinating aspect of the options debate is that expensing options is just a bookkeeping entry, a non-cash charge like goodwill amortization that tech firms are already so good at pro-forma-ing out of existence. Nothing changes in the actual operations or reported cash flows of the corporation. So why is the tech industry so afraid of this phantom charge? Because it will serve to highlight for less sophisticated investors just how badly they've been getting pick-pocketed. As Brian Hall suggests in his study, the complexity of options valuation and accounting "undermines transparency and lack of transparency facilitates abuse." Greenspan's comments on this topic are also quite revealing: "If investors are dissuaded by lower reported earnings as a result of expensing, it means only that they were less informed than they should have been. Capital employed on the basis of misinformation is likely to be capital misused." Again, it is a biased minority that is against expensing options. Virtually every other interested party, including academics, investors & regulators agree with Warren Buffett's simple "If options aren't a form of compensation, what are they? If Socratic line of reasoning: compensation isn't an expense, what is? And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?" The tech industry is simply afraid of the ugly truth: after taking options into account, much of Silicon Valley's economic miracle is really just a giant wealth transfer machine.

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