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Reference No. 1102-001 Accounting for Stock-Based Compensation

Director of Technical Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Enclosed are my comments on Stock-Based Compensation.

I focus on some issues that are not discussed in either the $\underline{\text{Invitation to}}$ Comment or the financial press. I believe these issues should be addressed by the FASB in its deliberations.

Keep up the good work.

Sincerely,

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Employee Stock Options: Why Not Tell the Full Story in One Statement?

In the financial press discussion of accounting for stock options, a basic assumption is that a corporation's owners are sacrificing a portion of the firm's future earnings stream as a result of stock option grants. Thus dilution is expected to occur. Retroactively determining what the owners have actually sacrificed is impossible because it can never be known what the future earnings stream would have been had no stock options ever been granted. The corporation's owners could be worse off, not impacted, or better off as a result of stock option grants—all depending on the value created by the stock option holders. Thus there may not actually be a sacrifice and thus not a true "cost of stock options" from the perspective of looking at the postgrant actual earnings stream. If it is impossible to retroactively determine if a sacrifice has occurred, it is illogical to try to determine an assumed sacrificial amount at the stock option grant date. Attempting to do so is flawed from the beginning because doing so assumes that a sacrifice occurs—when it may not actually occur.

Undeterred by this reality, many call for some measure of sacrifice to be reported as stock option compensation expense in the income statement. In studying this issue, accountants have devised four methods of determining the so-called cost of stock options. Three of the methods are intrinsic value based because they measure the extent to which the option is "in-the-money." Each of the three intrinsic value methods compares the exercise price to the market price at a particular date. The first method uses the date of exercise—it often results in a huge cost amount (the Internal Revenue Code requires the use of this method for determining tax-deductible amounts for the cost of stock options). The second method uses the date of grant—it almost always results in a zero cost (this method is set forth in Accounting Principles Board Opinion No. 25 and is used by the vast majority of companies). The third method uses the date when the option vests-it results in a cost amount that is somewhere in between the amounts derived under methods 1 and 2 (this method is favored by the International Accounting Standards Board in its present deliberations). The fourth method is an "opportunity cost" method set forth in Financial Accounting Standards Board No. 123, and it usually results in widely substantial varying cost amounts—all depending on certain factors (such as past stock volatility) that pertain to a specific company. This fourth method is the one that the FASB is now seriously considering making mandatory (it presently being optional).

Surprisingly, what is missing from the stock option discussion is that the method required by the Internal Revenue Code for tax-reporting purposes often results in an enormous financial benefit to the stockholders. Furthermore, this financial benefit could be far greater than any calculated cost of stock options obtained under the other three methods.

Unfortunately, this financial benefit is not readily apparent because the financial benefit is not reported in the income statement. The financial benefit is reported, instead, in the statement of changes in stockholders' equity as an addition to Additional Paid in Capital (APIC), as is required under current financial reporting standards, hereafter GAAP. Thus the income statement reports the cost of stock options, and the statement of changes in stockholders' equity reports the income tax benefit of stock options. Apparently because of this omission from the income statement, this financial benefit is not considered an integral part of the stock option controversy.

For the nine years 1994-2002, Microsoft Corp. reported in its income statements (1) no amounts for employee stock option compensation [Microsoft used method two as described above], (2) income before income taxes of \$69 billion, (3) income tax expense of \$23 billion, and (4) net income of \$46 billion. Thus based on the amounts reported in its income statements, Microsoft appeared to have had a 33% effective tax rate (\$23B/\$69B) for these years. In its statement of stockholders' equity for these years, however, Microsoft reported an increase in its APIC account of \$15 billion from income tax benefits relating to employee stock options. Thus \$15 billion of its \$23 billion of reported income tax expense was never paid to the federal government—only \$8 billion was paid. The rationale for treating the \$15 billion as both a tax expense and a direct addition to APIC (a pro forma "paper entry" involving no cash inflow or outflow) is the presumed desirability of presenting a "normal relationship" between income tax expense and pretax income in the income statement. Consequently, a pro forma artificiality is achieved in the income statement at the cost of portraying the true economic reality of the situation

For Microsoft to have reported \$15 billion of income tax benefits, Microsoft had to have taken \$43 billion of income tax deductions for employee stock options (\$15 billion tax savings divided by the 35% statutory federal income tax rate equals \$43 billion of allowed income tax deductions). Thus \$43 billion of Microsoft's pre-tax income was effectively shielded from federal corporate taxation—enabling Microsoft to retain \$15 billion cash that otherwise would have been paid to the federal government. Of course, this means that Microsoft's true effective tax rate was 11% (\$8B/\$69B)—not the 33% rate portrayed in the income statement. To portray in the income statement that Microsoft was effectively taxed at 33% when it was effectively taxed at 11%—over a nine-year period—borders on intentional misrepresentation. Surely this manner of reporting cannot be "transparency," the FASB's often-stated primary objective in financial reporting.

One major reason why Microsoft has so much cash (currently near \$50 billion, which most of us marvel at) is because of the \$15 billion of income tax benefits that it has received from its stock option grants. A similar analysis of Intel Corp. and Cisco Corp.'s financial statements for these years also shows the same enormous benefits to their respective stockholders from employee stock option deductions for federal income tax-reporting purposes. With such substantial income tax savings from stock options, it seems that stockholders should be elated about stock options being granted rather than fretting so much about potential dilution. It is not unreasonable to conclude that the \$15 billion of tax savings either substantially negates, negates, or more than negates any dilution effect the Microsoft's stockholders might have expected when the stock options were granted.

The FASB is nearly finished with its deliberations on which particular method to use for determining the cost of stock options. Accordingly, the most we can hope for at this point is that the FASB requires the enormous tax benefits that result from employee stock options be reported in a more forthright and telling manner so that stockholders may see the full picture in a single financial statement. Two suggested alternatives to the current GAAP treatment are discussed next.

The first alternative would be to reduce the amount reported for income tax expense (which amount is presently calculated without the tax deduction for stock options) by the amount of the tax benefit. (In Microsoft's case, the reportable income tax expense would be \$8 billion—not the pro forma \$23 billion it actually reported.) Thus this \$43 billion so-called "permanent difference" between financial reporting and income tax-reporting would be treated the same as all other such tax benefit differences are treated—that is, the tax benefits are reported as a reduction of income tax expense in the income statement. The advantage to this approach is that it results in reporting the proper income tax expense amount in the income statement for calculating the true effective tax rate.

Furthermore, current GAAP requires that the notes to the financial statements display a reconciliation of the *statutory* income tax rate to the *effective* income tax rate (the *effective* tax rate is calculated using the tax expense reported in the income statement). Because the tax benefits from stock options are *not* reported in income tax expense under current GAAP, the stock option tax benefits cannot be included in this reconciliation. In Microsoft's case, the reconciliation (cumulatively for nine years) identifies the items that make up the 2% difference between the 35% *statutory* income tax rate and the apparent but false 33% *effective* income tax rate—even though Microsoft's true effective tax rate was 11% for this period. Thus for firms that are receiving major tax benefits from stock options, these reconciliations are downright misleading because they do not depict a reconciliation to the true *effective* tax rate.

Under the proposal given above, the reconciliation for Microsoft would have had to explain the items that make up the 24% difference between the 35% statutory income tax rate and the true 11% effective income tax rate. Of this 24% difference, 22% pertains to stock options, and the remaining 2% pertains to other items. If corporations having stock option tax benefits desired to present a false picture in the income statements of both the taxes they must pay and their true effective tax rates, they could not have asked for or received more from the accounting rule-makers than the current rules that exist under GAAP.

A second alternative to current GAAP is to (1) report the tax benefit as a separate line item immediately below the income tax expense amount (as presently calculated) and (2) label the tax benefit as "federal government subsidy income resulting from the stock options." Reporting the tax benefit in this manner would result in substantially greater transparency.

In substance, all special tax breaks to corporations are government subsidies and should be reported as such—prominently. It is for convenience only that such federal subsidies are administered through the tax code. If no federal corporate income tax existed and if the federal government wanted to give special breaks to corporations to encourage certain behaviors, the government, instead, would have to administer such subsidies through the Department of Commerce. Upon receiving cash subsidies from the Commerce Department, corporations would have to report subsidy income separately in their income statements. (State and local governments routinely report the various subsidies they receive from the federal government as subsidies separately in their operating statements.) Reporting federal government subsidies as separate line items in corporate income statements is not without precedent. For instance, U.S. airlines that received federal government stabilization subsidies as a result of the September 11, 2001 terrorist attacks reported those subsidies as such on a separate line in their income statements.

So the issue is where best to report the tax benefits that often results from stock options. The current accounting treatment is more concealing than revealing. Either of the above two alternatives to current GAAP would be a major step toward achieving substantially greater transparency. (The second suggested approach is strongly preferable to the first suggested approach as it better reflects substance over form.)

Another reason major reason exists for discarding the present manner of reporting these stock option tax benefits outside the income statement (and using one of the two suggestions discussed above). It would eliminate the nonsensical and often enormous disconnect that now occurs between the reported net income in the income statement and the reported cash flow from operating activities in the cash flow statement. Under current GAAP, cash flow from operations is always higher than net income by the amount of the stock option tax benefit. Thus in Microsoft's case, its cash flow from operations was automatically \$15 billion more than its net income over the nine years because of stock option tax benefits. This disconnect occurs because the \$15 billion tax benefit is reported as an addition to APIC rather than in the income statement (as either a subsidy or reduction of income tax expense). To eliminate the disconnect that occurs under current GAAP, the cash flow statement would have to reflect both (1) a \$15 billion outflow from operations (for payment of income taxes that were not paid) and (2) a \$15 billion financing activity subsidy inflow. It would be far better, however, to change current GAAP, as suggested earlier, than to eliminate the disconnect in this manner, which would only expand the existing pro forma manner of reporting.

Reporting under this second approach would also result in enormous social transparency because it would forthrightly reveal both (1) which corporations are receiving special tax breaks (often referred to as "corporate welfare") and (2) the dollar amounts of those tax breaks—currently estimated at roughly \$100 billion annually. (A recent study of the 10,000 largest U.S. corporations showed that their combined effective federal tax rate for 1999 was just 20%—15% below the 35% statutory tax rate.) Of course, reporting all federal subsidies in such a prominent manner might be too much transparency for corporate managements, which undoubtedly, would prefer to not prominently display such tax breaks.

Aside from financial reporting issues, all of this raises an interesting question. Why are three of our most successful companies ever (Microsoft, Intel, and Cisco) effectively being given such enormous tax subsidies and thus have such low *effective* tax rates (roughly 11%)—especially when such sizeable federal annual operating deficits are occurring.

For those who might wonder at the rationale of Congress for allowing such gargantuan income tax deductions for stock options (\$43 billion for Microsoft over the nine years) and their resulting gargantuan tax subsidies, do not try to make sense of it. To accept that tax deduction amount as being economically valid would mean that Microsoft's management intended to bestow upon its employee stock option holders 63% of its post-grant pretax earnings of \$69 billion. Common sense dictates that this can hardly be the case. For Microsoft to report a zero cost of stock options over nine years for financial reporting and to simultaneously be allowed a \$43 billion tax deduction for stock options defies logic.

One can only imagine the howls of protest that would ensue from corporate managements if Congress were to propose that the stock option deduction for tax-reporting purposes could be taken only if the amount was expensed for financial reporting purposes. Obviously, the manner of calculating stock option expense for income tax-reporting purposes makes little sense—other than to enrich corporations. Hopefully Congress will restudy its current income tax rules for calculating stock option deductions and consider substantially reducing or ending these enormous subsidies. Microsoft, Intel, and Cisco will manage to get by just fine.

If the FASB were to require more prominent disclosure of these tax benefits, the greater transparency would shine a light on subsidies in general and possibly result in pressure being able to be brought on Congress to evaluate and justify these subsidies.

That \$43 billion of Microsoft's financial reporting pretax income was untaxed at the corporate level over nine years also considerably lessens the weight of the arguments of those who rail at the perceived inequity of double taxation of corporate income. Without question, double taxation does not occur for large portions of the pretax incomes of Microsoft, Intel, and Cisco and other companies that receive substantial tax deductions from stock option grants as a result of a nonsensical and indefensible method allowed in the Internal Revenue Code.

Another matter that is never considered as an integral part of the stock option controversy is the dilution suffered by (or the accretion that accrues to) the stockholders when stock options are exercised at a price that differs from the book value per share—which almost always occurs. Why be concerned with only the dilution of the future earnings stream? In the vast majority of cases, the exercise prices are higher than the book value per share. As a result, the stock option holders who exercise suffer dilution (their interest in the new net assets of the firm are less than the amount of money that they paid to exercise the stock options). Simultaneously, the remaining stockholders have accretion (their interest in the existing net assets increases because the book value per share has risen). The dilution or accretion of the interest in the existing net assets is the one thing that can be easily and indisputably calculated. Why should this dilution or accretion be ignored if the objective to find the true sacrifice?

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