

T H E L O N G V I E W

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Greed vs. Common Sense

The Enron fiasco has shed light on a wider phenomenon. Today many public companies are run by executives for themselves rather than for the owners of the company.

A study of the Roaring 20's, the Japanese real estate mania in the late 1980's or any other asset bubble reveals a slippage in moral standards. Greed leads to dishonesty and mass greed leads to widespread dishonesty. Unlike Ponzi schemes and other easily identifiable scams of the past, however, corporate deceit in the early years of the 21st century has become part of the system.

The Great Millennial Wealth Transfer

The most distinctive characteristic of this era's continuing (yes, continuing) stock mania is the way in which executives of public companies have taken advantage of the accounting rules to transfer huge amounts of wealth from shareholders to themselves. Large companies that have used a combination of stock options and inflated earnings to pick the pockets of their shareholders include Xerox, Lucent, Cisco, WorldCom, Verizon, Qwest, Kmart, AOL Time Warner, Yahoo!, Global Crossing, Tyco and Enron.

Canadians have not been immune to this epidemic. In 2000, Nortel's then highly respected CEO exercised stock options and sold his resulting stock for proceeds in excess of \$130 million. The price of the stock plummeted. And the CEO announced his resignation. Shortly afterwards the CEO of JDS Uniphase cashed out his stock options to the tune of more than \$150 million and other senior executives of the company pocketed over \$100 million from their options – all before the collapse of the stock. In the case of both companies the stock price dropped by more than 90% from its peak. Billions of dollars of shareholders' savings were lost.

There's No Accounting for Options

It's hard to imagine that a financial disaster of this magnitude could be caused by something as obscure as the rules accountants follow with respect to stock options. However, we believe this is the case.

A stock option is a right to buy shares some time in the next, say, ten years at today's market price. Options which guarantee an employee all the upside and none of the downside for an extended period have a lot of value. Through the use of derivatives, that value can be turned into cash the day the option is granted. As you might guess, the value to the employee is equal to the cost to the company and its shareholders of receiving less than market value for the shares when the option is exercised. And, as you might also guess, options are awarded in stunningly disproportionate amounts to the most senior executives.

Because of a gaping hole in the accounting rules, the grant of stock options to employees is not treated as a compensation expense. So expenses are understated and profits overstated.

The overstatement of profits naturally leads to an increase in the price of the stock and – because of the leverage built into the options – massively increases the option value. Presto! Senior executives become rich.

Andrew Smithers, a highly regarded U.K. economist, has estimated that, if options had been properly accounted for, the year 2000 profits of the companies in the S&P 500 would have declined by about 20%, and the profits of the information technology companies in the S&P 500 would have dropped by more than 67%.

Creative Accounting

But that's only the beginning. Perhaps most insidiously, the existence of stock options increases the incentive to find *other* methods of elevating the stock price. The more options management have, the greater the incentive to fabricate earnings.

Over the past few years public companies have often predicted a quarterly earnings number high enough to keep the stock moving up and have then worked backward to create it. Management have increasingly directed the attention of investors to numbers such as earnings before interest, taxes, depreciation and amortization (EBITDA) or some other earnings measurement

– often described as pro forma earnings – which inflates revenue or avoids the deduction of expenses deemed unusual or unsightly.

There are of course occasions when companies should provide, not just income calculated in accordance with generally accepted accounting principles, but earnings that have been adjusted to reflect real ongoing profits. However, over the past few years, many of the earnings adjustments have been entirely artificial.

For example, companies have often taken excessive write-offs designed to boost future reported profits. This practice has been followed by most of the companies mentioned earlier. Another technique practised shamelessly by GE and IBM, among others, is to assume unrealistically high future investment returns on pension fund assets. These assumptions inflate the company's reported earnings – often substantially.

Neither the companies' auditors nor the research analysts employed by investment banks have chosen to blow the whistle on these practices. Both derive their livelihood – directly or indirectly – from the continuing patronage of senior management. And human nature is such that we are not inclined to bite the hand that feeds.

The situation has become so extreme that rating agency Standard and Poor's recently announced that in future it will recalculate a company's "core earnings" to properly reflect expenses such as stock options, restructuring costs and pension fund contributions. It's interesting to see that, where the accountants, investment banks and regulators have failed to insist on honest financial reporting, an independent company has stepped in to fill the void.

We're All Part of the Problem

What is most amazing about stock option accounting is how accepted it has become by just about everyone.

The more people that benefit from stock options, the less likely it is that anyone will draw attention to what is actually happening. Often options are granted not just to management but to the directors of the company. Today almost all CEO's and directors of public companies – including some of North America's most respected business people – have become part of the problem.

The only companies in the S&P 500 that properly account for stock options are Boeing and Winn-Dixie Stores. Given the pressure to cheat, the CEO's of these two companies deserve the Congressional Medal of Honour. In Canada, the recent announcements by The Toronto-Dominion Bank and Bank of Montreal that they will henceforth treat options as a compensation cost places them almost alone among the larger TSE companies.

Legislative Reform Is Possible

The accounting profession has long known that stock options should be expensed. In 1993 the Financial Accounting Standards Board (FASB) in the United States recommended that the cost of options, calculated using the Black Scholes option pricing formula, be recorded as an expense on a company's income statement. The reaction of management – particularly management of high tech companies – was quick. Strong lobbying resulted in Congress stepping in to prevent any change in the accounting rules.

But the battle has been rejoined. In the United States (although not in Canada) a company can, at the time options are exercised, deduct for tax purposes the difference between what the company would have received if the stock had been issued for its then market value and the lesser proceeds received from the optionholder (i.e. the cost to the company referred to earlier). As a result of Enron and other recent scandals, a bipartisan Senate bill (with the snappy title the “Ending Double Standards for Stock Options Act”) proposes that in future a company's reported income must include a deduction for stock option expenses equal to the tax deduction. Among others, Alan Greenspan and Warren Buffett have spoken in support of the bill.

Vociferous opposition has again been mounted by the beneficiaries of stock options. A powerful interest group, which calls itself the International Employee Stock Option Coalition, includes the Business Roundtable (CEO's of American's 200 largest companies), the U.S. Chamber of Commerce and the National Association of Manufacturers. These major contributors to political campaigns have even managed to persuade President Bush to speak out briefly against reform.

Greed and dishonesty are rarely seen as such by those who benefit from them. Corporate CEO's claim that many of the world's biggest and most successful technology companies were built by granting employees stock options in lieu of paying hard-to-find cash. They neglect to point out that the same result

could have been achieved by issuing stock rather than options – or by honestly recording the cost of the option grants.

Let's be very clear about one thing. The argument is not about the *use* of options – or any other compensation system. It is simply about whether you should properly account for them. The succinct case against allowing companies to grant valuable stock options to senior officers and directors without recording it as an expense is that this constitutes a significant misrepresentation.

Critics of the bill also argue that the effect of changing the rules would be that public companies would report lower earnings and the resultant stock price decline would negatively affect investors. We agree that the market price of many companies' shares would drop. Nortel's stock traded at over \$120 in 2000 and now trades below \$6. Had Nortel reported its earnings accurately in 2000, fewer investors would have lost some of their life savings. Artificially high reported profits resulted in a misallocation of capital and ultimately the collapse of profitability. Free markets cannot allocate capital efficiently if people act on false information.

Charles Munger, the Vice-Chairman of Berkshire Hathaway, has recently commented that “fools and knaves, like those at Enron, will always be with us and will be particularly active where big money can be made -- for instance in reporting ever-higher earnings. Therefore accounting rules must make it very difficult for fools and knaves to fake profits.” Amen.

Directors' Liability is Now an Issue

Even if the accounting rules are not changed, the decision to exclude the cost of stock options from the calculation of a company's earnings is no longer straightforward.

Directors and senior officers of a company have a legal duty to act in the best interests of the shareholders. In the case of public companies this includes a specific statutory duty to disclose information about the company and its business which would reasonably be expected to have a significant effect on the market price or value of the stock. It is hard to understand how, by consciously choosing not to disclose a material expense, the directors are complying with the law or acting in the shareholders' interest.

In the wake of Enron, the legal landscape has shifted in the direction of shareholders. Charles Niemeier, Chief Accountant for the SEC Enforcement Division stated in February that management and directors of public companies cannot hide behind generally accepted accounting principles. They are obliged to go further and ensure that the overall impression created by the accounting rules properly portrays the underlying economics. Mr. Niemeier said that, after ensuring that the financial statements reflect generally accepted accounting principles, management should go through two further tests in determining whether financial disclosure is sufficient. “Does the overall result violate the accounting principles on which the rule is based; and does the result *mislead investors as to a material issue?*”

Executives and directors of companies whose stock has dropped precipitously are increasingly finding themselves on the wrong end of a class action. Today any management or board of directors that elects to inflate profits by excluding option costs from the calculation of the company’s earnings may be inviting a shareholder suit.

Time to Speak Out

It is not an exaggeration to say that the much publicized corporate dishonesty of recent years has seriously undermined public confidence in free market capitalism.

Legislators and regulators can fix the rules. But, faced with an extraordinarily well financed pressure group defending the status quo, they are unlikely to do so unless more influential people support reform.

Carl Jung reminded us that “we live not only our own lives but, whether we know it or not, also the life of our time”. We can each add to or take from that larger life. We can elect to stand up for the truth or to keep our heads down. It is time for thoughtful and conscientious business people to speak out.