

T H E L O N G V I E W

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The Amazing Stock Option Bubble

When future generations speak of the reason for the next major market correction, we suspect they will point not to an increase in interest rates or the Internet stock price phenomenon, but rather to the amazing stock option bubble of the late 1990's.

Management Overstating Profits

This bubble has been caused by company management using stock options to overstate profits.

A stock option is simply a right given to an employee to buy a number of treasury shares of a company any time in the next five or ten years at today's market price. CEO's inevitably say that stock options are granted to enable the company to attract and retain the best employees.

The true cost to the company of a stock option is the difference between the amount received by the company when the employee eventually exercises the option and the greater amount that the company would have received if it had issued the shares at the market price at that time. And the value received by the employee is, not surprisingly, equal to the cost to the company.

However, because issuing shares is thought to relate to the capital of the business rather than its operations, this very real compensation cost does not have to appear on the company's published income statement. The result is that profits are overstated. Put bluntly, the accounting rules permit management to cook the books.

Stock Options Are a Cost of Doing Business

Managers who are also option recipients have been heard to say that stock options exercisable at the market price on the date of grant are not a cost to the company because they have no value when they are issued. You don't have to

reflect on this very long before realizing that these stock options, which guarantee the holder all of the market price upside and none of the downside for the next five or ten years, do have a very real value the moment they are granted. To quote Warren Buffett, “If options aren’t a form of compensation, what are they? If compensation isn’t an expense, what is it? And, if expenses shouldn’t go into the calculation of earnings, where in the world should they go?”

A Straight-Forward Alternative

If you still harbour any doubt whether stock options constitute a cost, consider a straight-forward alternative used by some companies. These companies pay employees a cash bonus based on the stock price appreciation. In other words, these companies do not require the employee to exercise the option to buy shares and then sell the shares at a gain. They simply pay cash equal to the amount of the notional gain. This cash bonus is treated as an expense for accounting purposes. And this expense is fully deductible for tax purposes, whereas a Canadian company receives no tax deduction for the cost of a stock option. Think about it. This alternative results in less cost to provide the same after-tax benefit to the employee. So why don’t all companies choose this full disclosure route?

Accountants Have Backed Down

Most of the debate about how to account for the cost of options has taken place in the United States. In 1993 the U.S. Financial Accounting Standards Board (*FASB*) suggested recording the cost of options on the income statement. This suggestion caused a major outcry, particularly from the option millionaires employed by high-tech companies. In Silicon Valley, people actually took to the streets, staging what the media dubbed “the Rally in the Valley”. *FASB* backed down, deciding that the option cost would not have to be expensed and that the only disclosure required would be a footnote to the financial statements. In Canada, the Canadian Institute of Chartered Accountants does not require even a footnote.

An Old Debate

The debate about stock options is hardly new. Benjamin Graham, the father of value investing, wrote a parody press release in 1936 (yes, that’s 63 years ago) announcing that in the future U.S. Steel would pay 100% of wages and salaries in the form of stock options. The result would be to eliminate the payroll cost and massively increase earnings. Consequently, there would be a sharp increase in the market price of the shares, “making the readily realizable value

of these options greatly in excess of the present cash wages they will replace". Graham would be astonished to discover the degree to which his parody has become reality.

Problem Now Acute: Some U.S. Profits Overstated by Half

While this issue has been around for many years, it is only in the past few years that the problem has become acute. Smithers, a British research firm, has recalculated the profits of 145 large U.S. corporations to include the costs of options, and found that profits for 1998 were overstated by about 50%. Studies by Sanford Bernstein, an American investment firm, of U.S. companies in the technology and health care sectors reached a similar conclusion. In the case of some companies the total value of stock option costs is truly staggering. Microsoft announced profit of \$4.5 billion in 1998. According to Smithers, if the cost of options awarded that year, plus the change in the value of outstanding options, were treated as an expense, Microsoft would have incurred a loss in excess of \$15 billion (no, that's not a misprint). No prize for guessing what effect a reported loss of that magnitude would have on the price of Microsoft stock and, consequently, on the value of the options granted to Microsoft executives.

This raises an insidious collateral issue. If you are a manager with stock options, it is very much in your interest to report earnings that increase steadily quarter over quarter, so as to maintain a high price for your stock. And stock options are not the only area of accounting where the rules leave room for the manipulation of profits.

Other U.S. companies that would have incurred dramatically reduced profits in 1998 had their full compensation costs been expensed include Intel, Cisco and Merrill Lynch. The Merrill Lynch example is perhaps the worst. Investment bankers are supposed to police the system on behalf of their clients – not take advantage of the investing public.

Canadian Companies Also Overstating Profits

While stock option excess is not as extreme in Canada, it certainly exists – and the problem is worsening. Canadian companies whose reported profits for the past few years would have been reduced had stock option costs been treated as an expense include ATI Technologies, Celestica, Imax, MDC Communications and Newbridge Networks. And the problem is not limited to high tech companies. The earnings of some large, well-regarded companies such as the

Royal Bank of Canada and Power Financial would also have been reduced had all compensation costs been recorded.

The Wealth Effect

Here at Manitou, we recalculate the earnings of companies with traditional stock option plans to reflect the full compensation cost. Most investors, however, do not follow this practice. Consequently, the overstatement of earnings causes the market to overvalue stocks, particularly stocks of the largest U.S. technology companies which drive the S&P 500 index. This in turn leads investors to believe that their wealth is increasing. They spend accordingly. Recently, consumers have not only neglected to save, they have effectively dug into their savings. For the past twelve months the savings rate in the United States has been negative. This buying binge temporarily increases the revenue and profits of companies which, in turn, raises share prices further. This smoke and mirrors market cannot last. And, when the tide turns, the wealth effect will reverse itself.

All Compensation Costs Should Be Recorded As an Expense

The solution is clear. All compensation costs, including the cost of stock options, should be recorded as an expense.

Who can make this happen?

Not the accountants. Sadly, history has proven that their corporate clients call the tune.

Not the company's directors – despite the fact that they are supposed to look after the shareholders' interests. While changes in corporate governance practices have resulted in more truly independent directors, they remain in a minority. Most directors are still invited to join the board by the CEO, and consequently feel a strong sense of loyalty to management. In some cases corporate directors have even issued stock options to themselves. This is akin to a group of security guards joining in the looting of a store they have been hired to protect.

It is the regulators whose point of view is closest to that of the shareholders. To date, however, the regulators have only issued warnings. The SEC has expressed concern, as has David Brown, chairman of the OSC. And, at the end

of August, Alan Greenspan specifically identified options as creating a stock price bubble. But more than warnings are required.

The major pension plans, insurance companies and mutual fund companies are in the best position to both influence the regulators and to vote against the creation of traditional stock option plans. Warren Buffett, the Chairman of Berkshire Hathaway, one of the world's largest insurance businesses, has been a highly articulate critic of the accounting treatment of stock options. In Canada, Claude Lamoureux of the Ontario Teachers' Pension Plan Board has spoken out, as has the smaller but always-vigilant Fairvest Securities Corporation. More of this is needed.

Critics Suggest Class Action Law Suit

The more extreme critics of stock options have suggested launching a class action law suit against the management and directors of companies who use stock options to materially overstate their profits. These critics point out that, in Canada, paying cash bonuses based on stock price appreciation is more tax-effective, and therefore the only possible reason for a profitable company to institute a traditional stock option plan is to overstate profits. By hiding the option cost, option recipients receive compensation *far* greater than they could expect if the costs were fully reported. Over the past three years in North America stock options have resulted in a truly massive transfer of wealth from shareholders to management. Regardless of the outcome, a class action would have the effect of concentrating wonderfully the minds of a number of CEOs and directors on this fundamental issue.

The Bubble Must Be Pricked

It is hard to imagine how the current bubble can be deflated without a sizeable explosion. And that explosion will reverberate throughout the entire North American economy. Nevertheless, the longer that management are allowed to hide the real cost of doing business, the greater the damage when the problem is finally corrected.