The Washington Post

A19

Tuesday, April 9, 2002

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Stock Options and Common Sense

In 1994 seven slim accounting experts, all intelligent and experienced, unanimously decided that stock options granted to a company's employees were a corporate expense. Six fat CPAs, with similar credentials, unanimously declared these grants were no such thing.

Can it really be that girth, rather than intellect, determines one's accounting principles? Yes indeed, in this case. Obesity—of a monetary sort—almost certainly explained the split vote.

The seven proponents of expense recognition were the members of the Financial Accounting Standards Board, who earned $313,000 annually. Their six adversaries were the managing partners of the (then) Big Six accounting firms, who were raking in multiples of the pay received by their public-interest brethren.

In this duel the Big Six were prodded by corporate CEOs, who fought ferociously to bury the huge and growing cost of options, in order to keep their reported earnings artificially high. And in the pre-Enron world of client-influenced accounting, their auditors were only too happy to lend their support.

The members of Congress decided to adjudicate the fight—who, after all, could be better equipped to evaluate accounting standards?—and then watched as corporate CEOs and their auditors stormed the Capitol. These forces simply blew away the opposition. By an 88-9 vote, U.S. senators made a number of their largest campaign contributors ecstatic by declaring option grants to be expense-free. Darwin could have foreseen this result: It was survival of the fattest.

The argument, it should be emphasized, was not about the use of options. Companies could then, as now, compensate employees in any manner they wished. They could use cash, cars, trips to Hawaii or options as rewards—whatever they felt would be most effective in motivating employees.

But those other forms of compensation had to be recorded as an expense, whereas options—which were, and still are, awarded in wildly disproportionate amounts to the top dogs—simply weren't counted.

The CEOs wanting to keep it that way put forth several arguments. One was that options are hard to value. That is nonsense. I've bought and sold options for 40 years and know their pricing to be highly sophisticated. It's far more problematic to calculate the useful life of machinery, a difficulty that makes the annual depreciation charge merely a guess. No one, however, argues that this imprecision does away with a company's need to record depreciation expense. Likewise, pension expense in corporate America is calculated under wildly varying assumptions, and CPAs regularly allow whatever assumption management picks.

Believe me, CEOs know what their option grants are worth. That's why they fight for them.

It's also argued that options should not lead to a corporate expense being recorded because they do not involve a cash outlay by the company. But neither do grants of restricted stock cause cash to be disbursed—and yet the value of such grants is routinely expensed.

Furthermore, there is a hidden, but very real, cash cost to a company when it issues options. If my company, Berkshire, were to give me a 10-year option on 1,000 shares of A stock at today's market price, it would be compensating me with an asset that has a cash value of at least $20 million—an amount the company could receive today if it sold a similar option in the marketplace. Giving an employee something that alternatively could be sold for hard cash has the same consequences for a company as giving him cash. Incidentally, the day an employee receives an option, he can engage in various market maneuvers that will deliver him immediate cash, even if the market price of his company's stock is below the option's exercise price.

Finally, those against expensing of options advance what I would call the "useful fairy-tale" argument. They say that because the country needs young, innovative companies, many of which are large issuers of options, it would harm the national interest to call option compensation an expense and thereby penalize the "earnings" of these budding enterprises.

Why, then, require cash compensation to be recorded as an expense given that it, too, penalizes earnings of young, promising companies? Indeed, why not have these companies issue options in place of cash for utility and rent payments—and then pretend that these expenses, as well, don't exist? Berkshire will be happy to receive options in lieu of cash for many of the goods and services that we sell corporate America.

At Berkshire we frequently buy companies that awarded options to their employees—and then we do away with the option program. When such a company is negotiating a sale to us, its management rightly expects us to proffer a new performance-based cash program to substitute for the option compensation being lost. These managers—and we—have no trouble calculating the cost to the company of the vanishing program. And in making the substitution, of course, we take on a substantial expense, even though the company that was acquired had never recorded a cost for its option program.

Companies tell their shareholders that options do more to attract, retain and motivate employees than does cash. I believe that's often true. These companies should keep issuing options. But they also should account for this expense just like any other.

A number of senators, led by Carl Levin and John McCain, are now revisiting the subject of properly accounting for options. They believe that American businesses, large or small, can stand honest reporting, and that after Enron-Andersen, no less will do.

I think it is normally unwise for Congress to meddle with accounting standards. In this case, though, Congress fathered an improper standard—and I cheer its return to the crime scene.

This time Congress should listen to the slim accountants. The logic behind their thinking is simple:

1) If options aren't a form of compensation, what are they?

2) If compensation isn't an expense, what is it?

3) And if expenses shouldn't go into the calculation of earnings, where in the world should they go?

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