

Stock Options Come Under Fire In the Wake of Enron's Collapse

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WASHINGTON -- One day last month, lobbyists from 30 of the nation's biggest companies met in a conference room here at the offices of software giant **Oracle** Corp. Another 30 joined in via speaker phone.

They represented businesses as diverse as **Citigroup** Inc. and Oracle's archrival, **Microsoft** Corp. In the wake of the Enron Corp. scandal, they were united in a common cause: saving stock options -- a goodie widely blamed for fueling many of the corporate excesses of the 1990s, including Enron's. Their common foe: a broad new coalition of lawmakers from both parties, Federal Reserve Chairman Alan Greenspan, big institutional investors and global accountants.

Supporters of stock options say they give employees a financial stake in their companies' success, which ultimately benefits all shareholders. The options give employees the right to buy a company's stock, in the future, at today's price. Their opponents say stock options have bred a culture of irresponsible greed, showering executives with outlandish paydays that sometimes reach into the tens and hundreds of millions of dollars.

A Vicious Cycle

Last month, when he introduced a bill to rein in the benefits of options, Sen. Carl Levin, a Michigan Democrat, described the cycle this way: Most executive pay packages rely on heavily on options, he said, encouraging corporate managers to push accounting rules "to the limit," in order to make their financial statement look better, so their stock prices will go up, "so that executives can cash in their options."

Options also help companies pump up the earnings figures they report. While companies give employees a lot of money in the form of options, accounting rules don't require those companies to treat options as they do other forms of pay -- as a cost. Now, critics want to force companies to treat options just like wages and salaries, as an expense that reduces profits. Mr. Levin's bill would deny companies lucrative tax deductions if they don't do that.

The last serious clash over stock options was in 1994, and the business lobby won it handily. Odds are that it also will prevail this time around, with a pitch that options make the American economy perform better, by making employees "more likely to pick up the gum wrapper in the aisle and be welcoming to customers," as Lisa Wolksi, a lobbyist for the International Mass Retail Association, puts it. But last year's collapse of Enron has brought the options controversy "back from the dead," says software lobbyist Mark Nebergall, who helped organize the Feb. 19 gathering at Oracle's Washington offices.

For years, detractors have complained that options provided corporate executives with obscene returns, but that didn't seem to bother the American public so much, as long as other investors prospered too. Then, as the Enron scandal unfolded, the nation learned that top Enron executives had continued to make many millions of dollars by cashing in their stock options even as they were leading their company toward ruin. Enron Chairman Kenneth Lay realized \$123.4 million from exercising stock options in 2000. By contrast, most ordinary shareholders ended up losing the bulk of their Enron investments and thousands of Enron workers lost their jobs and much of their retirement savings.

Profit Strategy

Testifying before Congress last month, former Enron Chief Executive Jeffrey Skilling conceded that stock options offer an "egregious" way to inflate a company's reported earnings. "Essentially what you do is you issue stock options to reduce compensation expense, and therefore increase your profitability," explained Mr. Skilling, who realized \$62.5 million in 2000 by cashing in Enron stock options.

In 2000, Enron issued stock options worth \$155 million, according to a common method of valuing options. Had accounting rules forced the company to deduct the cost of those options from its 2000 profit, according to New York brokerage firm Bear Stearns Cos., Enron's operating profit for the year would have been 8% lower, even before Enron made its drastic restatement of earnings several months ago. But current rules require companies to report the cost of issuing options only as a footnote in their annual reports.

Many of Enron's accounting practices were extremely aggressive. But when it came to issuing stock options as a way to bolster earnings, it had plenty of company. Treating stock options as an expense would lower the earnings of nearly every major corporation in the U.S. Out of the stocks in the Standard & Poor's 500, only two companies -- Boeing Co. and Winn-Dixie Stores Inc. -- have chosen to count stock options as an expense in their financial reports.

The business lobby is fighting hard to defend options because the stakes are so high. Consider Oracle, which hosted the mid-February strategy session. Oracle Chief Executive Larry Ellison gained \$706 million last year from exercising stock options. And, according to Bear Stearns, Oracle's operating income was \$933 million higher for 2001 than if it had given employees cash instead of options.

Another company represented at last month's meeting was Citigroup, whose chairman, Sanford I. Weill, realized \$15.9 million from exercising options last year. Not counting options as an expense boosted Citigroup's operating income for the year by \$919 million.

Simple Argument

Legendary investor Warren E. Buffett, one of the few business executives who rail against options, makes a simple argument for counting them as a cost: "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 calculations of earnings, where in the world should they go?" Mr. Buffett said in the early 1990s as the last options battle was beginning to heat up.

Many companies counter that options don't cost them any cash, since the company is just doling out shares. Moreover, options can't be expensed accurately because it's too hard to calculate their value. If a company grants an executive a 10-year right to purchase 10,000 shares at \$20, the current market price, it can't know if he will actually do so because it can't know whether its stock will rise or fall over that period.

Accounting-rule writers grappled with the issue at least as far back as 1972. Not only weren't stock options widely used back then, but the challenge of calculating their cost was daunting. So officials decided that options needn't be treated as an expense.

During the 1980s, however, stock options became increasingly popular, particularly in Silicon Valley, where high-tech start-ups often offered them not just to executives, but to employees of all ranks. In the early 1980s, the nation's major accounting firms told the Financial Accounting

Standards Board that they thought stock options were clearly a form of compensation, and thus should be accounted for as an expense.

By the early 1990s, there were sophisticated new methods available for projecting the long-term value of stock-option grants. Companies were beginning to use a mathematical model developed by economists Fischer Black and Myron Scholes to tell employees how much their stock options were worth. Mr. Scholes later won a Nobel Prize in economics for the model. The FASB reasoned that if companies could estimate the long-term value of the options to their employees, they could also give shareholders an accounting of the long-term costs of those options.

And so, the FASB voted in April 1993 to require companies to treat options as an expense, based on the estimated future value of those options. The vote produced a political tsunami that started in Silicon Valley, gathered force in Washington, and slammed into Norwalk, Conn., where the accounting board is based.

In 1994, thousands of high-tech workers gathered in Northern California for a raucous pro-options demonstration called the "Rally in the Valley," sporting T-shirts and placards with such slogans as "Stop FASB!" and "Federal Accounting Stops Business." The new accounting rule would "destroy the high-tech industry," warned the head of the American Electronics Association. The high-tech sector circulated studies predicting that corporate profits would fall by 50% and that capital would dry up as a result of the new rule. More than 100 high-tech executives flew to Washington to work Capitol Hill.

The Clinton administration weighed in against the FASB. So did institutional-investor groups, who said the rule change would muddy financial statements. A nonbinding resolution opposing the FASB rule change passed the Senate by a vote of 88-9. Its sponsor, Sen. Joseph Lieberman, a Connecticut Democrat, later proposed legislation that would have, in effect, put the FASB out of business. The Business Roundtable, a group made up of major corporate leaders, threatened to refuse to adhere to FASB decisions.

By the end of 1994, the FASB withdrew the rule, deciding instead that companies would have to disclose the value of their options only in a footnote in their annual reports. At the time, Silicon Valley was starting to power the strongest U.S. economy in a generation and a bull market in stocks, and nobody was in the mood to tinker with success.

By the end of the 1990s, however, some policy makers began to worry about the unchecked explosion of stock options. Mr. Greenspan said that the failure to expense options was artificially inflating profits and stock prices. "This distortion ... has overstated growth of reported profits," he said in 1999.

Since then, Mr. Greenspan's criticism of options accounting has grown increasingly blunt. Between 1995 and 2000, S&P 500 companies averaged a heady annual earnings growth rate of 12%. Internal Fed research concluded that, if those companies had expensed their stock options, as Mr. Greenspan now advocates, their average earnings growth would have been reduced to 9.4%. In 2000 alone, Fed researchers concluded, operating income would have been 13.8% below that which the companies actually reported.

Mr. Greenspan doesn't have direct oversight of accounting standards, but he does sit on a committee that advises President Bush on post-Enron reforms. And his views on almost any issue shape debates in Washington.

The Fed Chairman used that clout in telling Congress earlier this month that stock-option expensing was his top post-Enron reform priority. "I do not deny that earnings would be lower if you expensed them," he said. "I do not deny that there may be greater difficulty in attracting capital ... ," he added. But he suggested that the extra capital many companies attracted with earnings reports that failed to reflect the cost of stock options was probably money they didn't deserve anyway.

Meanwhile, a campaign for common global accounting standards has been gathering steam. Last September, the newly formed International Accounting Standards Board unveiled one of its first initiatives: It would consider requiring companies around the world -- including in the U.S. -- to treat stock options as an expense. "The use of options has gotten to the point where it is abused as much as used correctly," former Fed Chairman Paul Volcker, a leader of the London-based board, told Congress recently. Mr. Volcker is currently leading an effort to overhaul Arthur Andersen, the big accounting firm that audited Enron's books and is fighting an indictment on charges that it destroyed documents in connection with the Enron matter.

Cold Front

Investors also appear to be cooling toward options. Many shareholders had bought the old argument that they, too, would benefit from management's options-related vested interest in raising stock prices. But even before Enron's collapse, shareholders had witnessed a wave of options "repricings," in which various companies had lowered the stock price at which employees could make a profit on their options. Options thus no longer served the goal of aligning executives' interests with shareholders -- executives could still gain from their repriced options, even if average shareholders lost money when share prices fell.

In 2000, when the FASB finally succeeded in imposing curbs on repricings, many companies simply found ways around them. Institutional investors also grew frustrated as companies kept trying to shield their options plans from shareholder votes.

The change in investor sentiment was on full display Monday, when the Council of Institutional Investors, an influential coalition of pension funds, endowments and investment houses, voted overwhelmingly to reverse its mid-1990s position and endorsed the expensing of options. "We recognize the downside of options more," said Sarah Teslik, the group's executive director. "They turn companies into Ponzi schemes," she added.

The political climate, too, seems a little chillier. Some legislators once considered likely to fight Sen. Levin's bill to crack down on options now seem to be keeping their distance from pro-options lobbyists. Mr. Nebergall, a former Justice Department litigator who has been lobbying for software companies since 1993, and a few of his fellow lobbyists met last month with Wyoming Republican Sen. Mike Enzi, the Senate's only certified public accountant, hoping that he would lead the opposition to the Levin-McCain bill. But Mr. Enzi, who is up for re-election this year, has so far refused to jump into the fight. "He wants to make sure he looks at all sides of the issue" before committing himself, a spokesman says.

Still, the pro-options camp retains some powerful backers -- and is working furiously to attract more. While the White House hasn't taken a stance yet, longtime options ally Sen. Lieberman sent a letter earlier this month to members of the Bush cabinet urging them to join him in defending options. Shortly after Mr. Volcker's global accounting-standards group took up the issue, the chairman of the House Financial Services Committee, Rep. Michael Oxley, an Ohio Republican, released a letter decrying the move as "unnecessary and unwise," and one that risked "harming American workers in a profound way." Securities and Exchange Commission Chairman Harvey Pitt told Congress recently, "I'd be exceedingly reluctant to re-open the issue."

A trade group of financial officers, meanwhile, has ponied up \$500,000 to hire two top Washington lobbying firms to press the pro-options case on Capitol Hill. Earlier this month, 40 high-tech CEOs flew into Washington to do the same. And last week, executives from Verizon Communications Inc., one of the most vocal options advocates, raised thousands of campaign dollars at a New York City breakfast for Montana Democratic Sen. Max Baucus, the chairman of the Senate Finance Committee and a key figure in the congressional debate.