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COMMENTARY

Bubble Act Redux

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The Financial Accounting Standards Board is about to change the way employee stock options are treated for accounting purposes. Faced with the collapse of the stock market bubble and the accounting scandals of the anything-goes 1990s, FASB is responding to the new political environment in which a premium is placed on any changes that appear to be "tough" on corporate America. With politicians and the media looking for targets, change is good because moving targets are harder to hit.

This is a cycle as old as financial markets. After the collapse of the South Sea Bubble of the 1720s, Parliament passed the Bubble Act, which banned the creation of any new joint-stock companies without Parliament's express approval. The ban stayed on the books for 105 years. The prosecution of wrongdoing is essential to the clean-up process, but history suggests that when political institutions run out of wrong doers, they often turn to ill-conceived systemic changes. These changes, like the Bubble Act, undermine sound economic activity with little impact on wrongdoers.

FASB's proposed change is no exception. To begin with, it undermines a key principle of accounting: the link between the balance sheet and the income statement. FASB proposes requiring that firms treat stock options as a current expense. A true expense reduces the net asset value of the firm. But no such reduction in net asset value occurs when a stock option is granted. Granting an option does dilute the value of shares of existing shareholders by effectively increasing the number of potential shares outstanding. But the total value of the firm and its profits remains unchanged; they are merely spread among more shares.

FASB has been searching for a way to credit owners' equity to hold the balance sheet harmless from mandating fictitiously reduced income. But no elegant solution exists for fixing a fundamental violation of accounting principles. FASB's jury-rigged proposal would distort the earnings per share calculations by changing both the numerator and the denominator, causing a double counting of the impact of options on earnings per share. Moreover, if the stock options expired and were never exercised, the stock option expense would stay on the books, and the profits of the firm would be permanently reduced, even though no economic transaction occurred.

FASB's proposal is not only conceptually wrong, it is also technically wrong. The primary methods used to calculate the value of stock options, like Black-Scholes, are valid only for tradable options that are readily converted into cash. Employee stock options are long term and non-transferable. The fact that they cannot be sold means they cannot be measured by market-based option calculators. FASB is violating its own

Statement of Financial Accounting Concepts No. 5, which states that "revenues and gains are realizable when related assets received or held are readily convertible into known amounts of cash or claims to cash."

There is no question that shareholders need better information on the effect of stock options on the value of their shares than they got during the bubble years of the 1990s. Under current accounting rules, the dilution effect of stock options is appropriately shown in the diluted earnings per share calculation. This dilution effect is both important and variable, and so is shown on a quarterly basis so that shareholders are aware of its evolving impact. This should be upgraded to include the disclosure of vested and unvested options for both in-the-money and out-of-the-money options and should also include more disclosure on employee purchase plans and other claims on equity. The FASB plan does none of this.

But the adverse effect of FASB's plan is not just on accounting principles; its effect on the high-growth sector of the American economy is even greater. Options give an employee a stake in the firm and a concern for its future. This is particularly vital in high-technology industries where a good portion of the firm's capital is human capital that can walk out the door at any time. It is also a way of conserving scarce cash for high return investments.

If the FASB plan is implemented, credible estimates suggest the average technology rich Nasdaq 100 firm would suffer a 44% drop in reported profits. Some high growth firms that use their cash for investment will appear to be underwater. These firms are hit hardest because they have both the highest price/earnings ratios and the highest volatility. In the complex formulae used to calculate the value of options, higher projected volatility leads to a higher assigned value to the option.

The adverse effect on high-tech firms can be 20 times as great as a percent of net income compared with traditional companies. Hence, more mature firms like Coca Cola are more inclined to accept expensing of stock options. By double-counting the effect of options on earnings per share, the net effect of FASB's proposal would be to reallocate capital from cutting-edge firms to more mature and slower-growing companies. It would be particularly devastating on start-up firms with emerging technologies.

This protection of the well entrenched is one of the more ironic aspects of the history of political responses to the collapse of bubbles. Back in the 1720s, the South Sea Company was one of the behind-the-scenes supporters of the Bubble Act, even though it was at the center of the controversy. It reasoned that if new joint-stock companies could not be formed, its own access to capital would be enhanced. It is hard to see how having fewer investment opportunities helped the shareholders of the day. It is similarly hard to see how today's shareholders or workers will benefit from a one-size-fits-all formula that restricts innovation and will reduce the public offering of shares in the high technology firms that will form the base of America's economic future.

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