GSI Market View

3rd Quarter 2002

To expense or not to expense, is that the question? Given the market's seemingly overblown fixation with stock options and whether or not they should be expensed, we thought it a worthy topic for examination.

To begin, we must define a stock option. *Simply put, a stock option gives the owner of the option a right to buy a certain number of shares of the stock in question at a given (strike) price*. At the time of issuance, the strike price of the stock option is normally above the current market price. The idea is to incent employees and management alike to enhance the growth and profitability of their respective firm, resulting in an increase in the price of the company stock. With the right to purchase their shares already locked in, anything over the strike price represents profit to the employee. In short, stock options were designed to be an effective "pay for performance" tool for both employees and management. Also important to remember is that stock options have expiration dates. If they are close to expiring valueless or "out of the money," they are often re-priced with the expiration dates extended.

Although stock options have been around for many years, their recent popularity was borne out of a 1992 congressional initiative by Senator Tom Daschle and others to limit the tax deductibility of CEO pay at $1 million. Although this legislative effort did not amount to law, many US corporations passed resolutions making all CEO pay above $1million "performance based," and payable in either bonuses or stock options.[1] Although bonuses are also popular compensation vehicles, they are subject to strict FICA withholding requirements and have not proven to be nearly as popular as stock options (especially with senior management). To date, roughly *60% of all CEO compensation now comes from stock options*. In fact, *16% of all S&P 500 stock shares currently outstanding are ear marked for stock options*. This is nearly double the amount found ten years ago. [2]

Why the fuss, you may ask? While many high profile CEOS like Dennis Koslowski (Tyco), Gary Winnick (Global Crossing), Ken Lay (Enron), and Bernie Ebbers (Worldcom), to name a few, *made millions exercising and cashing in on their stock options, many "individual investors" and employees of these companies were "fleeced."* Hence the close scrutiny as it relates to stock options.

Some high profile investors like Warren Buffet have launched strident campaigns to reform the use of stock options. Mr. Buffet and his supporters have argued that stock options should be "expensed" going forward, forcing companies to recognize the cost (at issuance) of any stock options as compensation expense. This charge would appear on the income statement, giving money managers and investors alike, a clearer picture of the financial impact of stock options on the operations of the company in question. As indicated earlier, *stock options are currently not required to be recognized as a compensation expense although companies may deduct them for tax purposes*.

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[1] A Decade of Executive Excess: The 1990s, Sixth Annual Executive Compensation Survey.
[2] Options: Too Much of a Good Incentive?, Business Week Online, February 22, 2002.

Mr. Buffet's idea sounds feasible on the surface but may have its flaws. The primary argument regarding the expensing of stock options is that the company in question is not taking any charge (expense) against earnings while getting a full deduction for the options issued. This is not really the case. When options are issued, the outstanding shares (stock) of the company in question will increase by the same amount, thereby "diluting" the current shareholders and decreasing the value of their holdings. *In an effort to counter this dilution, the issuing company will buy back the same number of shares in the open market*. This can amount to a tremendous cash outlay and seemingly qualifies as an indirect "expense" relating to the use of stock options. *So, is there already an expense associated with the issuance and use of stock options? The answer is yes*. Just yesterday (August 8) in the Wall Street Journal, Andy Bryant from Intel cited this very reason for deciding not to expense stock options at Intel.[3]

For those who have accepted the notion that stock options should be recognized as a compensation expense, the question is when to recognize the expense. Should these options be expensed at the time of issuance, as Mr. Buffet has purported or should they be expensed at the time that they are exercised (if they are exercised) as supported by Senator John McCain? Will those companies taking a charge against earnings for option expense be allowed to credit earnings in the future given the options in question expire valueless? As a side note, we at GS Investments don't take charges against earnings unless legitimate expenses have occurred.

Why then do Mr. Buffet and others push to recognize stock options as a direct charge against earnings? Could it be that Mr. Buffet's "value" approach to investing (currently in vogue) supports the expensing of stock options where the "growth" approach to investing may not? This could be the case. Either way, Mr. Buffet has indicated that the financial impact regarding the use of stock options would be easier to quantify if they were expensed. This move, say his critics, would only serve to distort earnings.

What about the issues of re-pricing stock options, the extension of expiration dates for stock options and the deductibility of stock options?

Specifically, should senior management be allowed to re-price (often lower) and/or extend the expiration dates of their stock options? Normally the reason for doing this is that the performance targets of the company have not been met within a given period of time. Because of this, some argue against extending or re-pricing stock options for senior management.

On the other hand, some have suggested a longer holding period for the options in the first place. According to these people, this would discourage senior management from "front loading" or manipulating earnings in an effort to exercise their stock options and cash out before being discovered. Again, the divergence of opinion is great and a resolution has yet to be put in place.

Finally, the market looks to be in the process of forming a base from which we may rally. Time (and events) will tell. Again, we will remain patient and focused on the long-term goals of each of our clients.

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[3] Contrary Intel Won't Expense Options, The Wall Street Journal, August 8, 2002.