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'Fair Value' Is Fatal Flaw of Option Expensing Plan

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By Charles J Thayer

The Financial Accounting Standards Board should be embarrassed!

There is no question that investors have been badly spooked by accounting irregularities and subsequent financial restatements. The board must address a number of serious issues to help restore investor confidence in financial statements.

Many of today's issues are simply too important to be entrusted entirely to academics and technical accountants. We believe it is essential for bank chief executive officers, chief financial officers, board members, and investors to become actively involved in today's accounting debates. Bankers have little right to complain if they don't express their opinions concerning new FASB proposals to their CPAs, the American Bankers Association (which has excellent accounting staff), and the FASB.

The FASB made an offer on Dec. 31 that may be too good for a CFO to refuse: Corporations that "voluntarily" adopt Financial Accounting Standard 148 prior to the release of March 31 financial statements will be able to minimize the near-term impact of expensing stock options.

FAS 148 provides three alternatives for the "transition" to expensing stock options. (The FASB has not released a final rule - generally accepted accounting principles do not require expensing stock options - so there is actually no assurance that this announcement represents the final word.)

Prospective method. Expense options after the beginning of the fiscal year in which the fair-value method is first applied. (Start in the first quarter of this year; expense new options only with no earnings impact from options issued in prior periods.)

Modified prospective method. Expense options after the beginning of the fiscal year in which the policy is first applied as if the fair-value method had been used for all

options after 1994. (Recognize the expense of new options issued this year and expense options that vested during the period from the prior 10 years.)

Retroactive restatement method. Restate all prior periods to reflect stock option expense under the fair-value accounting method for all options issued after 1994. (Restate the prior 10 years.)

In simple terms, Alternative 1 offers CEOs and CFOs the opportunity to "voluntarily" adopt an accounting policy for 2003 that will minimize the expected cost - in the near term - and avoid restatement. CFOs who do not "volunteer" will be subject to much harsher accounting treatment, including the worst alternative in today's suspicious investment market - restating previously issued financial statements.

We recommend that CFOs consult with their CPA firm today. Alternative 1 must be adopted prior to the release of March 31 financial statements to avoid possible restatement of 2003 quarterly results at yearend.

So if we recommend that CFOs avoid restatement, what's wrong with the FASB's offer?

First, each alternative provides very different results. What happened to the concept of consistent accounting policy consistently applied? Introducing additional inconsistency and confusion into published financial statements will not help restore investor confidence. The FASB should be embarrassed to announce an accounting standard designed to encourage such "voluntary" adoption with such "optionable" accounting treatment.

Without question there have been too many examples of egregious stock option awards. However, the root cause is poor compensation oversight by boards, not bad accounting. The rush to judgment to apply "fair value" accounting to stock options is not the solution to poor governance on behalf of board compensation committees.

We support stock-related incentive plans and believe encouraging employee ownership is an important element of business success. However, we have long believed that new stock-option plans should have been subject to shareholder approval. The stock exchanges should never have provided such a loophole; successful self-regulation requires self-discipline and independent judgment by those charged with regulation.

Much of the Sarbanes-Oxley legislation addresses important governance and board oversight issues. The legislation is well-intended - but we also predict it will produce unintended consequences. In our view the act does little to help restore investor confidence in corporate financial statements.

We believe current accounting policy suffers from two key problems:

First, "fair value" accounting is part of the problem, not the solution.

For example, Enron used "fair value" accounting to overstate both revenue and income - Enron's use of special purpose entities was designed to cover up these "fair value" overstatements. "Fair value" accounting was the root cause of Enron's subsequent financial restatements. The public focus on Enron's (and other) SPE cover-ups has distracted attention from the root cause.

We believe every financial statement should have a warning label, like a cigarette pack: "Fair Value Accounting May Be Hazardous to Financial Statement Accuracy".

The "fair value" method is based on estimates of future cash flows - estimates that are affected by a wide range of assumptions. It's not unlike increasing your own net worth on your personal financial statement by recognizing the present value of your expected future income as today's income.

"Fair value" represents today's best guess about future events, so it is most likely wrong, and is therefore subject to constant correction. Footnotes describing such "fair value" accounts are unintelligible to all but technical accountants. Obviously, such hypothetical valuations are subject to serious risk.

The Black-Scholes model is the benchmark for calculating the "fair value" of stock options. We believe it is important to remember that the "experts" who won the Nobel Prize for the Black-Scholes model are also the "experts" who helped create a worldwide financial crisis in 1998 with the collapse of Long Term Capital Management.

Second, those wonderful folks who gave you Enron's "fair value" accounting standards are still in charge!

We find it disturbing that the FASB continues to promote "fair value" as the solution to restoring investor confidence in financial statements. In our opinion their proposed cure is worse than the disease!

The current practice of calculating fully diluted EPS is intended to reflect the financial impact of stock-option plans and all other obligations to issue new stock.

It's not a perfect method, but in our opinion it's a more accurate measure of the potential impact on shareholder value than any of the three methods using "fair value."

Mr. Thayer is the managing director of Chartwell Capital Ltd., a Fort Lauderdale, Fla., private investment banking firm that specializes in advisory services to banks, corporations, and institutional investment clients.

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