Accountants Predicting the Future

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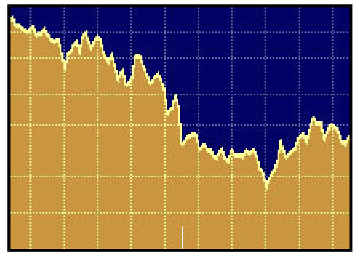

The one prediction you can make about financial projections is that they will never be exactly right. That's one of the reasons it's so difficult to determine company value and why investment bankers and research analysts get paid a fortune to try. As investors, we know that their estimates are really best guesses. We take their calculations and modify them with our own assumptions before determining what price we're willing to pay to invest.

Although we expect these I-bankers and analysts to make their educated opinions, we fully recognize the difference between their conjectures about a company's future performance and the accuracy of financial statements reflecting a company's past results. In fact, we rely on accountants to attest to the correctness of financial reports to a degree that those who fail in their fiduciary responsibility we've put out of business (for a firsthand account, please see Arthur Anderson).

Good accountants are great at sifting through numbers to determine a company's actual earnings. And I-bankers, analysts and investors bank on those audited historical numbers to make their own determinations about a company's true value. Would it be wise to blur those lines by having the people who track the accuracy of historical financials predict future stock value and pass it off as actual values?

Some seem to be asking accountants to do just that. In advocating that stock options be treated as a corporate expense, SEC Chairman William Donaldson is not only disputing the directive of his boss -- Donaldson's boss's name is "Dubya" -- but he's putting both accountants and investors in awkward positions.

His argument is a common one: that stock options should be treated as expenses because they represent employee compensation. In other words, employees are forgoing some cash compensation in exchange for the stock options they receive. The theory behind regarding options as an expense item seems sound enough, but the impossibility of accurately executing the theory invalidates it.

Accountants already provide stock option information in the footnotes to a company's financial statements. And from that information, investors can calculate the value of those options by using the Black-Scholes formula and a few of their own assumptions. But it's a dangerous precedent to be requiring accountants to do our stock valuations for us and incorporate the results into historical financials as expense items. It will only further lull investors into the false sense of security that earnings figures can be relied upon without first carefully understanding the company's business and without then scrutinizing its financial footnotes. It's bad corporate governance if financial statements become less transparent by providing accountants' predictions on stock option value rather than providing investors with the raw data and forcing them to do the calculations themselves.

Furthermore, stock options can eventually become stock, so they actually affect shareholder's equity rather than income. Consider what happens when options are exercised: the company ends up with a greater number of stock shares outstanding and its profits are divided among the new aggregate number of shares. However, the company's *overall* earnings remain unchanged. Treating stock options as an expense presents a false picture that aggregate earnings have declined, when in reality, stock options simply indicate the *possibility* that future earnings may be distributed between more shares of stock.

That's the trick with stock options. Though they may at some point be converted to stock, at the time they're issued, the actual value of options remains unrealized. This makes stock options incredibly difficult to calculate precisely. That computation is so complex, in fact, that the Nobel Prize in Economics was awarded to Myron Scholes and Robert Merton for their work with the late Fischer Black in developing the Black-Scholes option pricing model. (Dr. Black would no doubt have shared in the prize if he were alive in 1997 when the prize was awarded.) It's unreasonable to expect accountants to build assumptions, apply the Black-Scholes formula, develop stock option value and authoritatively stand by that number as a company's expense item. It's downright absurd to expect that expense number -- and corresponding earnings result -- to be accurate in predicting future value.

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These are among the most substantial of the reasons the Bush administration defends the SEC's traditional stance on stock option accounting treatment. Thanks to Chairman Donaldson, however, the message from Washington is becoming a bit blurry. Are companies, accountants and investors to believe that the Bush administration appropriately endorses the prevailing accounting methods for options? Or are we to understand that Washington will ultimately require us to treat stock options as an expense?

It's tough to predict what's eventually going to happen in Washington. But here's a prediction you can make with confidence: publicly contradicting your boss won't be good for the health of your career.

Ms. Kramer currently serves as President of A&G Capital, an investment management and consulting company, and is a contributing editor to TechCentralStation.com.