

# The *Ambachtsheer* Letter

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## **RECONNECTING GAAP AND COMMON SENSE: THE CASES OF STOCK OPTIONS AND PENSIONS**

*“Information is data endowed with relevance and purpose.”*

Peter Drucker

### **Closing the Information GAAP**

The failure of simple investment arithmetic to produce a positive prospective equity risk premium during the last 5 years led us to a 3-path characterization of future stock returns in previous writings. The least likely path was a continuation of the outsized excess returns of the 1990s. The more likely outcomes were (a) bond-like equity returns for many years, or (b) the much more rapid re-appearance of a significant equity risk premium through an up to 50% price reduction in the broad equity market indexes. In mid-summer 2002, events appear to be conspiring to produce Outcome (b) rather than (a).

Media coverage notwithstanding, Outcome (b) is not a universally bad thing. Prospective equity returns are now higher. Enterprise-level risk management disciplines will now get the respect and attention they deserve. The effectiveness of both corporate and fund governance structures is now no longer taken for granted, as is the ability of Generally Accepted Accounting Principles (GAAP) to provide investors with information “endowed with relevance and purpose”. In short, Schumpeter’s characterization of democratic capitalism as a process of “creative destruction” is with us still.

Two particularly vexing accounting issues receiving a lot of attention today are the GAAP rules

regarding employee stock options and DB pension plans. Both can be (a) highly material elements of employee compensation, and (b) highly material items in financial statements. Thus they are of special interest to readers of this *Letter*. We show below that current GAAP rules fail Drucker’s “endowed with relevance and purpose” test in both cases, and thus should be destroyed. Fortunately, the creative application of common sense can fix both failures. Schumpeter would be pleased.