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Sunshine Act: Accounting for Equity Options

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ABSTRACT

The "Sunshine Act" of the Patient Protection and Affordable Care Act was designed to speak to public concerns over physician and industry relationships. There are no rigorous accounting standards set in place for determining dollar values of payments, and errors are most exaggerated in the case of stock options due to the leveraged nature of these instruments. A historical perspective on stock options accounting provides useful insight into potential societal impact of errors contained in the Sunshine Act. We outline accounting and structural flaws within the current databases and propose solutions to close these loopholes.

1. INTRODUCTION

On March 23, 2010, Congress signed into law Section 6002 as part of HR3590, better known as the "Sunshine Act" of the Patient Protection and Affordable Care Act. Its purported intent was to speak to public concerns over physician and industry relationships, clarify financial relationships, consolidate a location for reporting and monitoring, and stop dishonest research, education and clinical decision-making (Services, 2015). After extensive dialogue over the details on execution, the Center for Medicare and Medicaid Services (CMS) released its final ruling on February 8, 2013 ("Code of Federal Registrations 42 CFR Parts 402 and 403," n.d.).

The history of conflicts of interest is extensive, and its current form in medicine dates back to the 1972 Anti-Kickback statute applied to hospitals and nursing homes ("42 U.S. Code § 1320a–7b - Criminal penalties for acts involving Federal health care programs," n.d.). The statute attempted to limit gifts or monetary incentives from influencing practice patterns, and in 1977 the penalty for violation was escalated from misdemeanor to felony("H.R.8980.," n.d.) . The Omnibus Budget Reconciliation Act of 1989 (Kelly, 1989), better known as the "Stark Law," applied restrictions to self-referring clinical laboratory services and eventually in-office services. The goal of both laws is to limit criminal behavior without impeding benefits such as promoting drug discovery and medical devices (Lo, Bernard; Field, Marilyn J, 2009). Nevertheless, within the last decade, there have been reports of sham consulting contracts, kickbacks for publications, and prescription fraud (Fontenot, 2013). Even legal practices such as federally-approved exemptions from the Stark Law have been called into question (Mitchell, n.d.). The Sunshine Act attempts to circumvent the ambiguities associated with prior laws; that is, it attempts to maintain the balance between deterring criminal behavior and encouraging medical innovation through enhanced disclosure rather than setting strict legal standards.

2. CMS ACCOUNTING STANDARDS

Setting standards for disclosures has proven difficult, and the final rulings set by the CMS have resulted in new ambiguities. For example, there were numerous requests for clarification of how to determine the amount of a payment or transfer of value. The framework was set to be intentionally vague and left up to the purview of the manufacturer: "applicable manufacturers should be allowed flexibility to determine value, so we do not plan to create numerous rules for calculating value." Loose guidance is provided under certain circumstances, for example a duplicate item may not be valuable to the recipient but does possess economic value, and therefore would be disclosed. Per CMS, "all applicable manufacturers must make a reasonable, good faith effort to determine the value of a payment." The methodology and underlying assumptions may be included in the manufacturer's assumptions document, which is not disclosed to the public and are only voluntarily reported. It is therefore possible that systematic differences in reported values from one manufacturer to another could deviate significantly from economic reality. Loopholes to disclosures undoubtedly exist and have been described in the past (Lichter, 2015). The economic impact of a loophole can vary from case to case. Equity options are special cases that particularly lend themselves to abuse, due to the complexity of their accounting, inherent leverage, and magnitude of payments.

An option is a contract whose value is derived from an equity position in a company. The issuer writes a contract to allow the recipient to purchase a set number of shares at a certain price in the

future, and the contract price is valued at a fraction of the underlying shares it represents. The ratio between the underlying shares and the value of the contract represents its leverage. Since the value of the contract is calculated, rather than measured, it is critically important to disclose the underlying assumptions for calculation. Despite the fact that CMS requires additional disclosures for equity stakes and options in the form of a separate Ownership database, the quantitative criteria for determining the dollar-value of these payments remains systematically subjective. Notably, current standards do not adhere to Generally Accepted Accounting Principles (GAAP) set by official accounting standards boards within the United States.

3. THE HISTORY OF OPTIONS ACCOUNTING

GAAP accounting for equity options has a rich history within the United States (Figure 1). In 1972, the Accounting Principles Board (APB) released APB 25 (Opinion 25), suggesting the value of a contract be measured by the difference between the issue price and stock market price. Thus, if an option is issued at the same price as the stock price, the value is zero (and leverage is infinite). Since such a situation does not represent economic reality, the rule was extensively criticized. Within a year the Black-Scholes options pricing model was published and would assuage the criticisms of APB 25 (Black & Scholes, 1973). Specifically, it would address the fact that option pricing possesses characteristics beyond price, such as the duration of the contract, interest rates, and volatility. The developers of this model would go on to win the Nobel Prize in 1997 for their work.

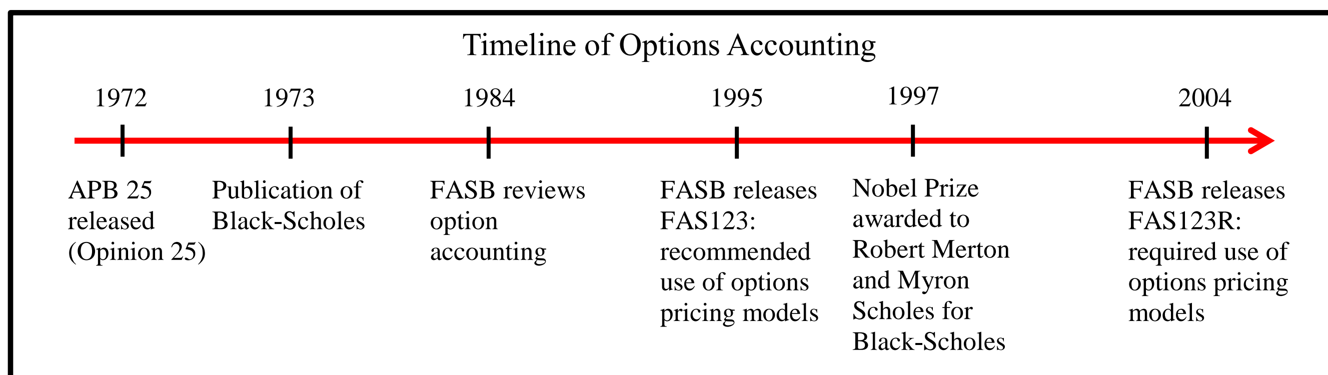


Figure 1: Abbreviated Timeline of Options Accounting from 1972 to 2004 **Source**: Accounting Principles Board, Federal Accounting Standards Board, Royal Swedish Academy of Sciences Nobel Memorial Prize in Economic Sciences. (Abbreviations: APB, Accounting Principles Board; FASB, Federal Accounting Standards Board; FAS, Financial Accounting Standards.)

Despite its existence for decades, there was continued debate and slow adoption of options pricing models and their recognition as a compensation expense. In 1993, Senators Carl Levin and John McCain introduced the "Corporate Executives' Stock Option Accountability Act," and again in 1997 as the, "Ending Double Standards for Stock Options Act." Neither bill passed, and later the Chairman of the Securities and Exchange Commission (SEC) Arthur Levitt testified that his single biggest mistake during his tenure was his inability establish accounting standards for stock options (Smith, 2002). Eventually, accounting scandals involving stock options from the Enron collapse prompted the FASB to require the use of options pricing models by 2004.

The Enron debacle raised awareness of how loose accounting standards could affect the general public (Akhigbe, Madura, & Martin, 2005). Indeed, regulators were alarmed by its collateral damage: excessive compensation through options accounting had set up an incentive system that resulted in over $60 billion of fraudulent losses. Moreover, questions of compensation-related ethics would spread to every industry, including healthcare (Horton, 2004; Soule, 2007; Taylor, 2002). The history of options accounting serves as a cautionary tale, and highlights its societal significance, extraordinary complexity, and large-scale potential for abuse rooted in historical precedent. While the CMS' efforts for disclosures are well-intentioned, one must ensure they are sufficient for critical analysis.

4. CURRENT DISCLOSURES AND PROPOSED IMPROVEMENTS

In its current form, the magnitude of stock option compensation is immeasurable in the CMS OpenPayments database. An example is provided below ("The Facts About Open Payments Data - Open Payments Data - CMS," n.d.):

> Physician Name: (removed)
>
> Address: (removed)
>
> Submitting Manufacturer: C.R. Bard & Subsidiaries
>
> Total Payment: $472,945.81
>
> Form of Payment: Stock, stock option, or any other ownership interest
>
> Nature of Payment: Current or prospective ownership or investment interest

The disclosure does not differentiate between stock, stock option, or another form of ownership interest. In the event the payment represents a stock option, there is no way to discern whether an options pricing model was utilized, and if one was used the assumptions used to calculate the contract value are not provided. These factors make it impossible to calculate a leverage ratio, and thus impossible to measure the economic value of the payment to the recipient. As previously mentioned, the leverage inherent within an option can cause the economic value to deviate from reported value by orders of magnitude.

Policing accounting standards is not within the purview of physicians or the CMS, but at the same time the authors see no reason why our own field would be immune to the adverse consequences of loose standards experienced by others. Fortunately, an attractive alternative exists. Rather than invoking the good faith of manufacturers, adherence to GAAP accounting under FASB standards for stock options should be mandatory. The landscape of options accounting is ever-changing, and the FASB has been appointed oversight over standards since 1973. Many companies already comply with these standards for purposes of other disclosures (i.e., Securities Exchange Commission and Internal Revenue Service), and would incur minimal additional compliance cost. More importantly, the costs of potential abuses, while impossible to eliminate, would be minimized when compared to the current standard.

5. CLOSING DISCLOSURE LOOPHOLES

Beyond weaknesses in payment quantification, there are large loopholes in how option exercising is disclosed (Figure 2A). When an option is exercised, the contract is converted into the number of shares it represents. If, instead, the contract is sold, the rights to the shares are transferred to the purchaser. Lastly, a contract may be forfeited or expire. The CMS addresses only one of these possibilities: when an option is exercised, the recipient of the equity stake originally listed in the General Payments database becomes listed under the Ownership database. The delay between disclosures is contingent on the contract duration, which can span decades. If the contract is instead sold, there is no publicly disclosed evidence of the transaction.

Further limiting the ability to track options is a discrimination between publicly traded stocks and privately held stakes. Under disclosure rules, a publicly traded stock does not qualify as an ownership interest("42 U.S. Code § 1395c - Description of program," n.d.):

> "Ownership of the following shall not be considered to be an ownership or investment interest…:
>
> …Ownership of investment securities (including shares or bonds, debentures, notes, or other debt instruments) which may be purchased on terms generally available to the public and which are…securities listed on the New York Stock Exchange, the American Stock Exchange, or any regional exchange in which quotations are published on a daily basis, or foreign securities listed on a recognized foreign, national, or regional exchange in which quotations are published on a daily basis…"

Thus, when a recipient exercises an option in a publicly traded company, there is no CMS record of the ownership stake. There is no apparent reason why a publicly traded company should gain exemption from such disclosure, as it would seem likely that a recipient would be equally susceptible to conflicts of interest whether the payer is public or private. Of the $49M in stock, stock options, and other ownership interest payments in 2014, we estimate approximately 59% of these are by publicly traded companies.

These loopholes have been identified in the past and were addressed in the CMS' final rulings ("Code of Federal Registrations 42 CFR Parts 402 and 403," n.d.):

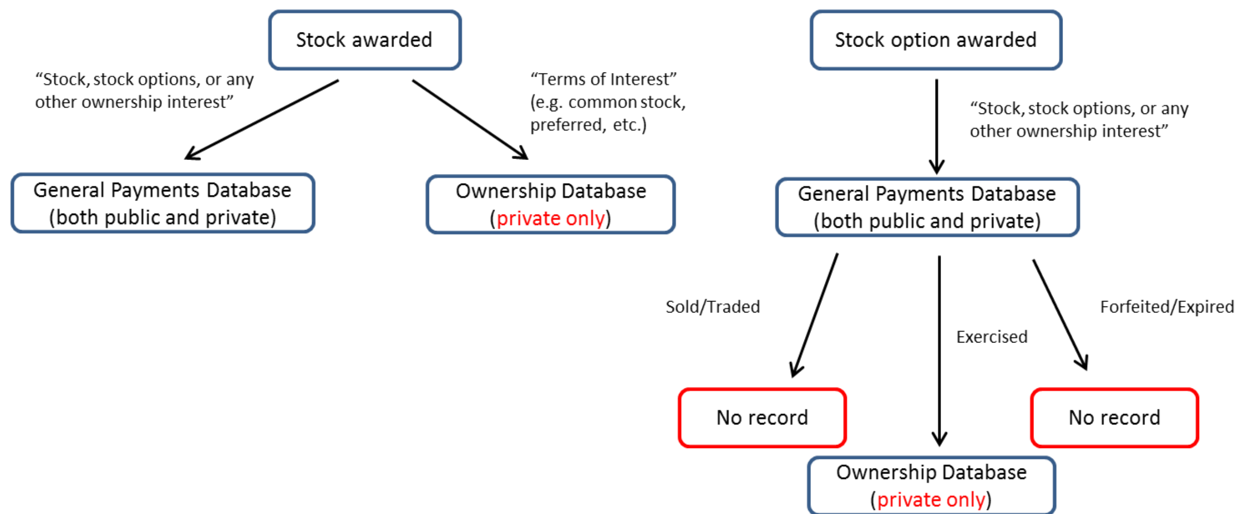
> "…a few commenters also recommended that CMS require reporting of stock options as ownership or investment interests when they are granted…
>
> …we understand the concerns regarding stock options received as compensation and requiring reporting of options when granted, rather than when exercised. However, we believe that stock options before they are exercised are traditionally considered compensation, rather than an ownership or investment interest, so we do not believe that we should require them to be reported as held ownership or investment interests…"
>
> "…As required by statute, we proposed that an ownership or investment interest shall not include an ownership or investment interest in a publicly traded security or mutual fund."

The authors believe the CMS' response contains confusing inconsistencies, and is not in the best interest of the public. Both equity stakes and stock options are forms of ownership interest. In the former case, there would be a dual listing under the General Payments and Ownership databases (assuming a private payer). In the latter case there would be a single listing under General Payments without a listing in the Ownership database. There is no reason why a stock option

cannot be both a form of payment and ownership stake, similarly to how equity stakes are currently treated. The treatments of these ownership stakes are internally inconsistent, and adopting one policy or the other, but not both, would greatly aid interpretation of payment data.

Our proposal for improving equity and options disclosure is simple in concept (Figure 2B). First, stock options should be listed separately from other equity interests and included as an ownership interest upon grant date. Next, disclosures on contract duration and assumptions for calculating values should be provided. Lastly, there should be no distinction between publicly traded companies and private in consideration for ownership stakes. These recommendations would require changes to multiple facets of disclosures, but would serve to greatly improve the value of equity disclosures.

A.



B.

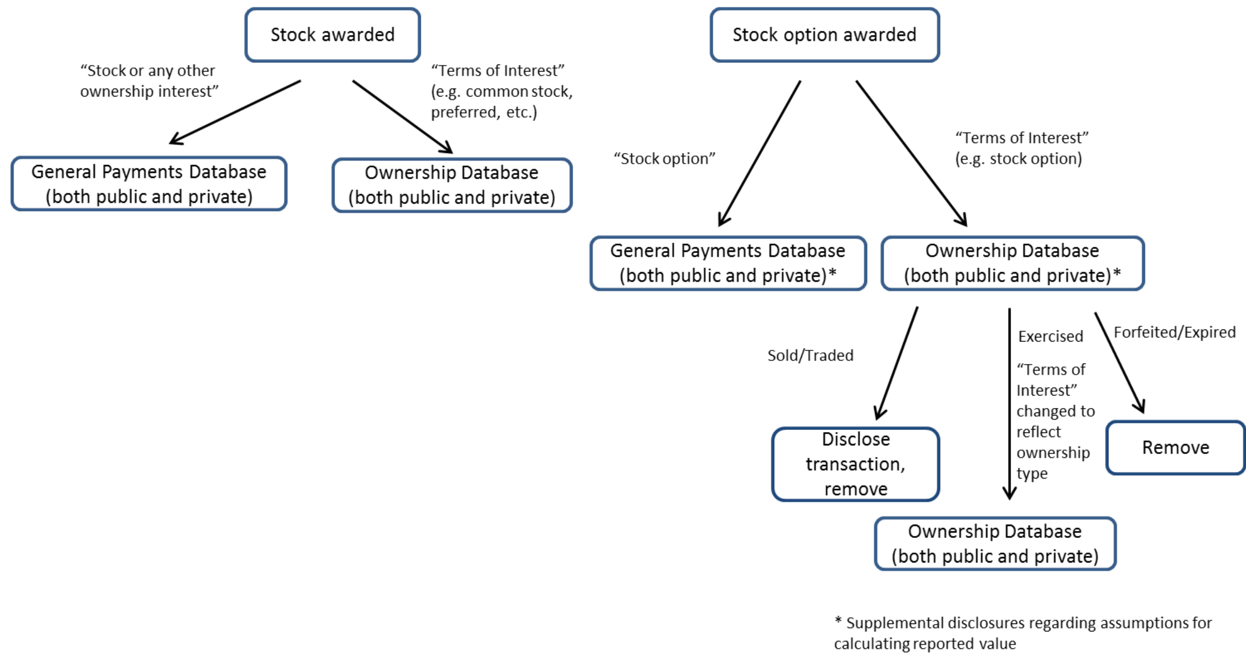


Figure 2: A) Current Sunshine Act disclosures for equities and options. Current standards categorize stock, stock options, and other equity interests in the same category. The Ownership Database tracks equity stakes in private but not public companies. Options are not considered ownership interest until exercise and sales, trades, expiry, and forfeitures are not disclosed. B) The authors' proposed restructuring. Stock options are separated into its own category with supplemental disclosures for calculating the reported value. The Ownership Database covers both private and public companies. Option awards are immediately recognized as an ownership in the Ownership Database, rather than deferring until exercise. Sold or traded option contracts are disclosed prior to removal from database.

6. CONCLUSIONS

Stock options are inherently leveraged equity stakes and require additional disclosures within the Sunshine Act. Relying on good faith for manufacturers to calculate value is inadequate, and adopting FASB standards is an attractive alternative. Furthermore, stock options should be recognized and treated as both a form of compensation and ownership stake within public disclosures.

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