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HEARD ON THE STREET

Dell Joins Wave of Companies Seeking to Soften Options Hit

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Companies don't yet have to record their employee stock options as expenses, but a number of large companies quietly are taking steps to lessen the impact on their bottom lines.

For fast-growing companies that issue lots of options, such as **Dell Computer** Corp., **Genentech** Inc. and **Oracle** Corp., a requirement forcing them to treat options as expenses would have turned their profits into losses for recent years.

Now, before such requirements go into effect as soon as early next year, these three companies and many others are changing the way they calculate the value of options, resulting in lower expenses. In doing so, they are taking advantage of flexibility in the mathematical model that many companies use to calculate options expenses, known as the Black-Scholes method. It allows them to make assumptions about the future volatility of their stocks, how long the options will be outstanding and even how many might never be exercised.

Companies are "trying to find ways to keep the expense down. One of the ways to do that is to choose the most favorable assumptions you can," says Mark M. Reilly, a partner at compensation consultants 3C LLC in Chicago. "They're working within the system. Part of the problem is the system probably allows them too much flexibility."

For example, the measure of a stock's price swings can sharply affect options expense and thus pretax earnings, Mr. Reilly says. Take an option granted at $10 a share that must be exercised within five years. The value of that option will fall by a third, he says, if a company assumes the stock price might swing by 30% -- that is, between $7 and $13 during the five years -- rather than volatility of 50%, or a swing between $5 and $15.

In calculating its potential options expense for fiscal 2003, Dell earlier this year changed its volatility assumption to 43%, compared with 60% if the company continued to use its historical approach. It used to use a volatility number based on its stock performance for the most recent five years. But now it is making its own estimate of its stock's "expected volatility," according to its annual report. Using the lower number, in part because of the stock-market downturn, Dell shaved its options expense by nearly 20%, says Brian

Foley, a White Plains, N.Y., executive-compensation consultant.

Dell last year issued 84 million options at an average grant price of $11.41 with an estimated life of five years. If treated as an expense, those options would have lowered net income by $712 million, according to Dell's new formula.

Dell says it stopped using a historical approach because "our stock has been much less volatile in the last year than in the five years prior," spokesman Michael Maher says. "Given that fact, calculating volatility from a historical perspective is not as accurate as doing it on a forward-looking basis."

Some market specialists agree market volatility is coming down as big segments of the stock market flatten. "Lower assumptions are consistent with what we're seeing" in indexes that measure volatility, says Robert Bliss, a senior economist at the Federal Reserve Bank of Chicago. VIX, an index published by the Chicago Board Options Exchange, measures volatility in the stocks in the Standard & Poor's 100-stock index and is down 26% this year.

Companies would like to make adjustments to calculations this year so they are ready when the Financial Accounting Standards Board, the private-sector group that oversees accounting treatments, enacts a rule for expensing options. That decision could come as soon as March 2004. Because options are expensed over their expected life, typically three to six years, cutting the expense this year will reduce the bite when it counts.

Genentech, whose financial filings say the assumptions are "highly subjective," also has cut its stock-volatility estimate, to 43% from 63%. Oracle chopped its assumption to 57% from 76% for fiscal 2001, its filings show. EBay Inc. cut its assumption to 68% from 81% a year earlier and says it should decline again this year, further reducing the bite of its options.

"It's not that we're doing things to the methodology, it's that stock-market conditions have changed," says Louis J. Lavigne Jr., Genentech's chief financial officer. Sharp declines in volatility show "how erratic these calculations are going to be. It proves the point these are better placed in the footnotes than on the face of the financial report," he says.

Companies beyond high technology also are rethinking key assumptions. Apache Corp., Hilton Hotels Corp. and Stanley Works have cut the volatility estimates and expected lives of their options, says Jack T. Ciesielski, editor of the Analyst's Accounting Observer in Baltimore. As with a reduction in expected volatility, a reduction in expected life cuts options expense.

In all, 23 of the companies in the S&P 500-stock index used a double-barrel approach to paring options expense -- shortening expected life and volatility estimates this year, he says. Noting the latitude the Black-Scholes method allows in deciding such factors as volatility and expected life, Mr. Foley, the executive-compensation specialist, says: "In those two numbers, there is to some extent more art than science."

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