

## The Only Option (For Stock Options, That Is)

Pretending they're free didn't work. Expensing them may be the silver bullet we're looking for.

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(PFD File)

Should we throw lawbreaking CEOs in jail? Of course we should. Could the SEC use more money to beef up enforcement? Well, duh. Do we need to figure out better ways to regulate and motivate the accountants who audit companies' books? That's a no-brainer.

Do all that, yes. But as Washington self-righteously scrambles to right the wrongs of corporate America, let's not forget that the illicit book-cooking revealed so far at Enron, WorldCom, and others was trifling compared with the entirely legal book-cooking that most of corporate America engages in: lavishing stock options on top executives and not deducting them as expenses. It is, without a doubt, the mother of all accounting abuses.

Don't believe us? Listen to an acknowledged expert on profit-enhancing tricks: "The most egregious [method], or the one that is used by every corporation in the world, is executive stock options. Essentially what you do is, you issue stock options to reduce compensation expense and therefore increase your profitability."

The expert: Jeff Skilling, the disgraced former CEO of Enron, in testimony before a Senate committee in February. Skilling also used that occasion to get in a well-deserved dig at his inquisitor, California Democrat Barbara Boxer. "I think FASB tried to change that, and you introduced legislation in 1994 to keep that exemption," he said.

For the uninitiated, FASB is the Financial Accounting Standards Board, the body based in Norwalk, Conn., that decides what constitutes the Generally Accepted Accounting Principles (GAAP), to which all U.S. public corporations must adhere. In 1994, FASB was on the verge of requiring that companies charge the estimated value of the stock options they give employees against their earnings. But Congress, in its infinite wisdom, put a halt to that.

The business community, in particular Silicon Valley, lobbied fiercely to make sure it would. Treasury Secretary Lloyd Bentsen, the Big Six accounting firms, and investor groups applauded as a bipartisan Senate posse, with Democrat Joe Lieberman at its lead (and Boxer not far behind), bullied FASB into allowing companies to shunt their options costs into a footnote in their annual reports instead of subtracting them from earnings.

Why'd they do it? For the economy's sake, everyone said. Employee options helped spark Silicon Valley's economic miracle and were a way for the rest of corporate America to share in that tech magic, the thinking went. Expensing them would kill the magic.

That argument has some gaping holes in it, which we'll get to in a bit. But what it came down to in 1994 was that the powers that be in American economic life decided that dishonesty in the service of prosperity was no vice. In doing so, they may have paved the path for the outrages that followed. "Once CEOs demonstrated their political power to, in effect, roll the FASB and the SEC, they may have felt empowered to do a lot of other things too," says Warren Buffett, a lonely voice in opposition to the options steamroller back then.

So, enough already. If corporate America wants to regain the confidence of a wary nation, start by expensing stock options. Failure to do so not only is dishonest but also begets the very rule-bending, risk-ignoring behavior that has gotten so many companies into trouble. Because options are "free," they came to constitute the bulk of CEO pay in the 1990s, which in

turn helped spur the over-the-top greed and sick obsession with stock prices that afflicted far too many top executives.

**And let's not kid ourselves: Options are not free. An option to buy a share of stock at a set price has value--even if that exercise price is above or equal to the current price of the stock. We know that because people pay money for such options every day on exchanges around the world, in hopes that the price of the underlying stock will rise before the option expires. We also know it because there are widely accepted mathematical models that can be used to estimate the value of even those options that aren't traded on exchanges.**

So when a company gives an employee an option to buy its shares in the future, it is giving away something of value. There are those who argue that because employee options are counted toward shares outstanding, the cost of options is already fully reflected in earnings per share. But if you follow that reasoning, then outright grants of stock shouldn't count as an expense either. And when a company pays employees with cash that it raised by issuing new shares, that should be considered free too. Which is, of course, nonsense--especially since some companies spend billions of dollars a year buying back shares to keep options dilution from affecting earnings per share, and those billions are not deducted from earnings.

It is true, as opponents of options expensing never tire of pointing out, that valuing options is an imprecise science. But flawed cost estimates are still infinitely preferable to pretending that options have no cost at all. It's also true that many investors prefer other options-cost measures to FASB's method of valuing the options on the day they are granted. But the professional standard-setters at FASB discussed the subject for years before concluding that their way was best. We're willing to take their word for it.

Others obviously are not so willing. The lobbying forces that stopped options expensing in 1994 have been hard at work this year as well. Options legislation has so far gotten nowhere in Congress, and President Bush has stated that he thinks options accounting is fine the way it is.

That may not matter. In July several prominent companies announced that they were voluntarily switching to expensing options. When FORTUNE went to press, the list included Coca-Cola, Wachovia, Bank One, and the Washington Post Co. With money managers and Wall Street analysts finally paying close attention to options costs, it's possible that trickle will become a torrent, and peer pressure will accomplish what FASB could not.

Failing that, the London-based International Accounting Standards Board, whose accounting rules are followed by most big European companies, is on track to approve a standard next year that will require options expensing. Once the IASB standard is finalized, FASB--which is under orders from the SEC to synchronize its rules with the IASB's--will begin the whole process of proposals and public hearings on options all over again. This time Congress is less likely to stand in its way.

So what happens if all corporate America starts subtracting options costs from earnings? Last year, according to those annual report footnotes, expensing would have reduced the earnings of the S&P 500 by 21%. That's partly because earnings were such a horror show last year; Merrill Lynch guesses that this year the S&P options bite would be more like 10%. At a lot of tech companies, of course, the bite would be much worse: Dell's 2001 earnings would have been reduced 59% if options were counted; Intel's 79%; Cisco's 171%.

That doesn't mean that expensing options would suddenly lead to a commensurate fall in stock prices. Investors are smarter than that. Maybe they weren't in 1999 and 2000--but current stock prices almost certainly already reflect the market's evaluation of stock option costs.

No, it's not financial markets that are fooled by accounting fictions. It's the people who run corporations. The U.S. steel industry is such a basket case now partly because for decades it could make generous pension commitments to employees without counting them against earnings. The 1980s savings-and-loan implosion cost so much because screwy accounting allowed insolvent S&Ls to pretend they were making money when in fact they were digging themselves into ever deeper holes. And because they could pretend options were free, CEOs and boards in the 1990s probably gave out far too many of the things--and ignored other, possibly better ways of linking pay to performance (restricted stock grants, for example).

There is one caveat here. At fledgling companies with lots of growth potential, big options grants may be the best way to pay people. Options don't consume precious cash. They make it possible to hire top talent. And if they bias executives toward taking swing-for-the-fences risks, investors in already risky young companies shouldn't have a problem with that.

If those kinds of companies have to expense options--and at many companies that went public in the late 1990s, estimated options costs dwarfed not just earnings but revenues--will anyone still be willing to invest in them? That is a concern expressed by many in Silicon Valley, but we think it's misplaced. Investors will look past those scary stock options charges if they think the company can generate more value than the options will cost. That certainly has been the case over the years at places like Intel, Microsoft, and Dell--and if investors have become less willing to believe claims that some startup is the "next Intel," you can't blame options expensing for that.

The better question may be, Will the people who run fledgling companies still be willing to give employees enough stock options to motivate the kind of go-get-'em behavior that made America's startup culture the envy of the world? We don't have a clue. But we've given dishonest options accounting a fair try. Let's see where honesty gets us.