

# Option Absurdity: Hoping for Lower Prices

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As investors worry about what the Securities and Exchange Commission will find in its investigations of accounting at Qwest Communications and WorldCom, perhaps the strangest part of the whole affair is that many employees at both companies have reason to hope that their share prices fall further.

It may sound crazy that companies align the interests of their employees with those of the short sellers. But such are the lengths that companies are going to these days to preserve the accounting fiction that options can be handed out at no cost to the company.

Employees of both companies were offered the opportunity to cancel their old, hopelessly out-of-the-money stock options. In their place, they were offered an equal number of options — to be issued with an exercise price equal to the market price months from now.

The delay is six months and one day from the time the old options are canceled, but because it takes time to organize these deals, there are usually about eight months during which employees know that they are in line to get new options — and know that a lower price will mean better option terms. For Qwest employees, the period ends June 3. For WorldCom workers, the date is Aug. 15.

In explaining these deals, companies say that new options will "better align the interests of our employees with those of our shareholders," as Joseph P. Nacchio, Qwest's chief executive, said last October. In fact, their interests are the exact opposite of those of the shareholders, at least until the options are priced. Top executives usually stay out of the swap, knowing how bad it would look.

Why the delay? If companies simply repriced options immediately, then the accounting rules would force the companies to reduce their profits if the value of the options rose over time. But the delay keeps such reality out of earnings statements. "So many people are scared to death" of that accounting, said Patrick McGurn of Institutional Shareholder Services. So, he said, "they will not do what makes sense." More than 100 companies have used the strategy since it was pioneered by Sprint in 2000.

Stocks tend to go down when these deals are announced, and not just because more options signal more dilution for shareholders. A company that uses this strategy is implicitly forecasting that its shares will not bounce back for at least eight months. (Think how angry employees would be if the share price had soared by the time new options were priced and issued.) Most of the time, that forecast turns out to be true.

All of which brings us back to the S.E.C. investigations that began during the repricing periods. A conspiracy theorist might wonder whether some workers who knew that funny things were going on wanted to make sure the news was known before the new options were priced. Perhaps it is coincidence, but WorldCom and Qwest shares are down more than 40 percent since their announcements.

When accounting rules lead companies to do dumb things, that is an argument for changing the accounting. If all options were accounted as employee compensation expenses, there would be no reason to delay an option repricing's effective date. That is what the accounting would be if politicians, led by Senator Joseph I. Lieberman, the Connecticut Democrat, had not intimidated the Financial Accounting Standards Board into backing down on that in 1994.

**Now there is a chance for change. The International Accounting Standards Board is poised to propose, probably this fall, a standard that would require many foreign companies to treat options as an expense. American companies fear such an outbreak of rationality and are mounting a campaign to block it. The result of that fight will be one indication of whether all the post-Enron talk of accounting reform will amount to anything.**