The Options-Accounting Sideshow

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The lodestar of whether corporate America has reformed itself, various sages tell us, is whether stock-option grants are charged against reported earnings. OK, I guess, but some of us remember FIFO and LIFO.

For anyone who missed the inflationary 1970s, those are inventory accounting conventions, first-in-first-out and last-in-first-out. With inflation the price of whatever's in your inventory is going up. So FIFO will let you record a profit on inventories and report higher earnings. But this increases your tax liabilities, and thus reduces cash flow. Now, Mr. CFO, which will boost your share price, a good-looking earnings report under FIFO or more cash in the till under LIFO?

This is a no-brainer, and many businesses switched to LIFO. And I, at least, carried away some lessons: Accounting often needs to be arbitrary, and earnings per share is a false god. Just recently, I heard another old-timer reminisce about his accounting professor's admonition, "Profit is an opinion, cash is a fact." So I'm skeptical, to say the least, about any notion of reforming business by changing accounting conventions.

Beyond any question, as Alan Greenspan, Warren Buffett and others observe, a stock option is *something* of value. The right to buy a stock a year or 10 years from now at today's price is obviously worth something, and a corporation gives options to an employee in lieu of cash compensation. It currently doesn't have to record the options as an expense, though cash compensation is of course counted and deducted as earnings are calculated. This is a prima facie incentive to issue too many options, a market imperfection arguably contributing to the recent boom-and-bust. So, the case runs, deduct options from revenues to get earnings.

This is no trivial case, but it does not follow that anyone with doubts is in the grip of a malign "business lobby." The problems start with the question, how much do you deduct? What is that option grant worth *today*, before the right can even be exercised? Maybe a lot if the stock will rise, but maybe zero if it turns out to fall. The only reliable way to find true present value would be to create a market by letting the employees sell the options. This would defeat the whole purpose of options, which is to make sure executives focus on the share price that rewards owners rather than, say, corporate aircraft and expensive entertaining.

In assigning an option value, the green eyeshade crowd will fall back on the Black-Scholes Option Pricing equation, depicted nearby. This is not a joke; a lot of option-market traders have used BS to make a lot of money. As a technical matter, though, it requires a number of assumptions. Assumption number one is a liquid market, which at least to me means the options can be sold. Also at issue is whether it applies when option-holders can influence the results, which is precisely why options are given to top executives.

And what if you've recorded a big options expense when the stock is high, and then it falls below the exercise price? Do you get a credit to take back the expense you've already booked but won't realize? If so, options charges would reduce earnings in good years and boost them in poor years. Phasing in the options charges, as Coca-Cola is doing, would have some of the same effect. I suspect that such a damper on volatility would degrade rather than improve earnings as an accurate reflection of a company's performance and prospects.

To put it another way: The essential purpose of earnings reports is to help the market price stocks accurately, so incorporating the share price into earnings is circular and confusing. Earnings per share is a calculation with a numerator and a denominator. Options will already show up in the denominator as they're converted into shares; they're already included in "fully diluted" EPS. By what logic should they be factored into the numerator as well?

Now, stock options may indeed have been abused in the recent boom, but there are other ways to curb them. The cleanest thing is, as Felix Rohatyn proposes, to give grants not of options but of stock, which has a downside potential. Or when top executives exercise options make them, as Henry Paulson suggested, hold the stock for the long term. The real abuses arise not from the timing of the exercise of an option but from the timing of the often-related sale.

As a fully disclosed experiment, it's fine for Coca-Cola and the Washington Post to adopt options expensing. Under Mr. Buffett's guidance, the necessary guesswork will be done in a reasonable way, and we can watch to see whether it helps them to attract capital. As a rule imposed on all businesses, however, it seems to me a truly dangerous idea.

Because some CEOs and CFOs have abused options and earnings reports, we're now going to put the Black-Scholes equation in all earnings reports? Take another look, and imagine what a corner-cutting CFO could do with that! Earnings reports should be accurate, but they should also be transparent, that is, easily understood. Certainly options should be prominently included somewhere in financial statements, but using some guess at their present value to calculate earnings is the opposite of transparency.

Would that all the energy now going into this accounting crusade were directed at another message. To wit, there is not and never will be a perfect number to sum up a company's results. Earnings per share is a good starting point, but you have to go deeper for real understanding. Getting this message home to Wall Street and beyond would do more than a peck of laws and bushel of accounting changes to prevent future WorldComs and Enrons.