

## STOCK-OPTION ACCOUNTING HIDES IN THE SHADOWS OF THE FINANCIALS

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Since financial transparency is all the rage these days, it's no surprise that stock option reporting -- or lack thereof -- is back on the front pages.

And, along with the headlines, the issue of stock options reporting is back on the Hill. About a month ago, Senator Carl Levin (D., Mich.), with co-sponsorship by John McCain (R., Ariz.), introduced a bill requiring transparent reporting in this post-Enron world. Part of their plea is to force companies to include employee stock option expenses in their earnings.

At this point, companies don't have to include employee stock option expenses in earnings, and -- shocker -- they don't. That's important, because stock option expenses can be huge for some companies (read: technology firms). So these companies are just getting a free ride on their stock-options expense reporting.

Or are they?

Before we wade into this issue, I need to warn you: This stuff is hairy and requires you to think -- a lot. So pour yourself a drink to help ease the pain and we'll get started.

### The Current Options

The only place you currently can find any real meat about employee stock options is in the footnotes to financial statements.

Here's why: Up until the early 1990s, companies were chugging along just fine without including employee stock-option expenses in their earnings. But in 1993 the Financial Accounting Standards Board decided things needed to change. It wanted to require that companies report option expenses on their income statements. Not surprisingly, companies barked -- mainly those in option-rich Silicon Valley -- and the politicians got involved. So FASB backed down. In October 1995, FASB instead released Statement 123, which basically says "while we want you to include the expense in your income statement, you can just leave the info in the footnotes if that makes you happy."

Way to take a stand.

"Well we'd like you home at 10:00 p.m., but if you want to stay out until 2:00 a.m., that's fine too, just let us know." Gee, I don't know, Mom.

As a result, most companies only include the information relating to employee stock options in their footnotes. The logic here is that the option has no value on the day it's given to an employee, assuming the grant price is equal to the stock's current price, so there's no need to record an expense. (Check out Accounting Principles Board Opinion No. 25 for more light reading on that.)

FASB, however, does require some disclosure in the footnotes. Companies must show what the actual expense of the options would be as well as what that effect on net income and earnings per share would be if that expense was included in the income statement, says Dan Noll, director of accounting standards at the American Institute of Certified Public Accountants.

There is another way to report options expenses, but as far as we can tell, only two companies in the S&P 500 -- Boeing and Winn-Dixie -- use this alternative method. In this case, the actual expense is plopped on the income statement. A piece of that expense is then amortized -- or gradually

eliminated -- each year over the option's life. Remember, the amortization process drags down earnings.

Calculating stock-option expenses can be very subjective but there is a method out there that most pros agree to be a fair measure of a stock option's value: The Black-Scholes model. Black-Scholes uses a bunch of variables -- the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and a risk-free interest rate over the expected life of the option -- to try to determine the option's fair value. No need to try to crunch that calculation; leave that to the finance guys and the M.B.A.s.

The result of this option-pricing model is the amount the company would/should expense. In very simple terms, if the fair value of the option is \$100 and it has a five-year life, then the option expense would be \$20 a year for five years.

All the rest of the companies that report only their stock-option expense in the footnotes use this Black-Scholes model as well to derive their pro forma numbers.

#### To Expense or Not to Expense

What's the right answer? While many professionals feel that the current means of reporting is acceptable since an option has no value at issuance, others -- including big wigs like Warren Buffet and Alan Greenspan -- argue that option expenses should be reported in the income statement in the interest of full financial transparency.

According to a survey done in 2001 by the Association for Investment Management and Research, a nonprofit organization representing about 150,000 securities analysts, portfolio managers, strategists, consultants, educators, and other investment specialists, 83% of its members believe the expense should be reported in the income statement as an expense.

They believe that while it may be true that at the grant date, the option may be worthless, over time, it's not. "That option has a period of time to run and the probability of positive return over ten years is good," says Rebecca McEnally, a financial analyst and vice president of AIMR's advocacy program. So it has value. And by issuing options to employees, the company should incur an expense.

And while it's just dandy for the employee to receive a slew of options, the issuance of stock options actually burns existing shareholders, according to the AIMR.

The most obvious char is dilution. Putting more shares out there dilutes your stake in the company. Remember, when an employee exercises his options, the company issues new shares. The more shares outstanding, the smaller your piece of the pie. Let's say a company only has two shares outstanding and you own one of them. Great. You own half of the business.

It decides to issue two more shares. Your stake drops to 25%. If one more share is issued, you're down to 20%. You get the idea.

This dilution affects the earnings per share calculation -- earnings divided by shares outstanding. With shares outstanding as the denominator, earnings have to keep up or EPS will drop.

Because companies were throwing stock options at their employees in the late 1990s, the number of shares out there is way up.

No surprise, the telecom sector has seen a 16.5% growth in shares from 1998 to 2001, according to Morgan Stanley. But can earnings keep up?

It's not going to be easy. Of its shares outstanding, reported in its 10K filed March 19, **Broadcom** has over 50% covered by options, according to Albert Meyer, an analyst with David W. Tice & Assoc.

That means the company will have to issue at least 50% more shares to cover all the option exercises. So earnings, in turn, must rise more than 50% or there will be no increase in EPS thanks to all that dilution. Whoa.

Another concern for shareholders, say some experts, is the cash the company forgoes by issuing an option instead of just selling the share to the market. When the company issues an option to an employee rather than selling that share to the market, it forgoes the capital it would receive from issuing the share to the market. Currently, that cost is being ignored, says Ms. McEnally.

The M.B.A.s call this a "missed opportunity" cost. If your company just sold those shares to the open market, it would take in cash. That's more money for the company to use toward its business.

And here's a bigger question: Are those stock options part of an employee's compensation package?

"Is there really a difference between giving employees cash bonuses or giving them securities that convert into cash?" asks Ms. McEnally. Either way, the company is trying to compensate its employees for a job well done. If it just handed out cash bonuses, you would see that expense on the income statement as part of the overall compensation expense. If, instead, they opt to shower their employees with stock options, all you get is a lousy footnote. Seems inconsistent, no?

#### Free Tax Deductions

Unfortunately, we have to delve into the tax world here for a minute, so bear with me.

Currently companies get a tax deduction for the difference between the exercise price and the market price of the stock on the day the employee exercises his options. Now let's think about this. Companies are not required to report an expense for these things, yet they get a huge tax deduction for them. You know from your own tax return that deductions are marvelous -- they help lower your tax bill.

So the larger the spread between the exercise price and the market price, the fatter the company's tax deduction. It's no wonder Cisco and Microsoft rarely pay corporate taxes.

In 2000, Lucent had a \$1 billion "tax benefit from employee stock options."

Without that huge freebie, its cash flow from operations would've been a negative \$760 million, as opposed to the positive \$304 million the company boasted.

You have to wonder, without this gratis tax benefit, would stock options have taken off at all?

#### Exercise Your Options

Now you know the logistics of these things. Regardless of where you think options should be reported, until someone takes a stand on this issue, you have to commandeer the controls and look out for numero uno.

Pull up your company's 10-K -- the annual report filed to the Securities Exchange Commission -- and read the stock-option footnote.

Look at the pro forma numbers, the "what-if" numbers that will show you what earnings would look like if your company had to expense all its option grants. Don't throw up.

Compare the number of options outstanding to the total number of shares outstanding. Is that a fair number of shares to be giving out to the employees? Think about the dilution factor. For a typical tech company, dilution of more than 10% per year may be hard to swallow.

But be realistic. "If that's what it's going to take to get John Chambers to get up in the morning and do his job then maybe it's okay," says Don Luskin, chief investment officer of TrendMacrolytics, a service that provides real-time market analysis to the institutional investment community.

Still, if the number of outstanding options bothers you, get off your duff and go to the next shareholders meeting. Or at least read the proxy. Any plans to offer more shares are in the proxy statement and subject to shareholder approval.

Be sure to look at the company's growth forecast. Is it growing fast enough to keep up with all those shares it's issuing?

Pay attention to share buybacks. They're a great way to reverse dilution. **IBM** does this often with its extra cash on hand. **Broadcom** does not have loads of cash, so don't expect to see that there.

Also, look at how many shares are currently exercisable. If the price of those options is above the current stock price, management may have to do something to keep its people happy. Should they reprice the options? Give cash bonuses? **Tyco** claims that its cash flow was negative because it had to pay so-called retention bonuses. Could it be that its employees' options were way underwater? Either way, it's a cost to the investor's pocket.

Finally, try to find the tax benefit from employee stock options in the cash flow statement. While it's not required, some companies do present it. In most cases it's a separate line item, although you can understand a company's incentive to bury it. Lucent and Cisco seemed to be very proud of the fact that fluff was bumping up their numbers. IBM, on the other hand, buries that number with all its other tax benefits.

Whew. Nothing like a little light reading before the weekend. Now how about another drink?