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TRACKING THE NUMBERS

Outside Audit

Wall Street Turns Blind Eye to Results Of Option Expensing

 By **DIYA GULLAPALLI**

Staff Reporter of THE WALL STREET JOURNAL


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Most followers of finance know companies must now treat stock options as an expense. Much of Wall Street must have skipped class the day that lesson was taught.

Last month, accounting rules kicked in requiring public companies to treat stock options like any other compensation cost, similarly nicking net income. The first batch of companies subject to the new rules will put out full-year results shortly, while others have until next year to reflect the change.

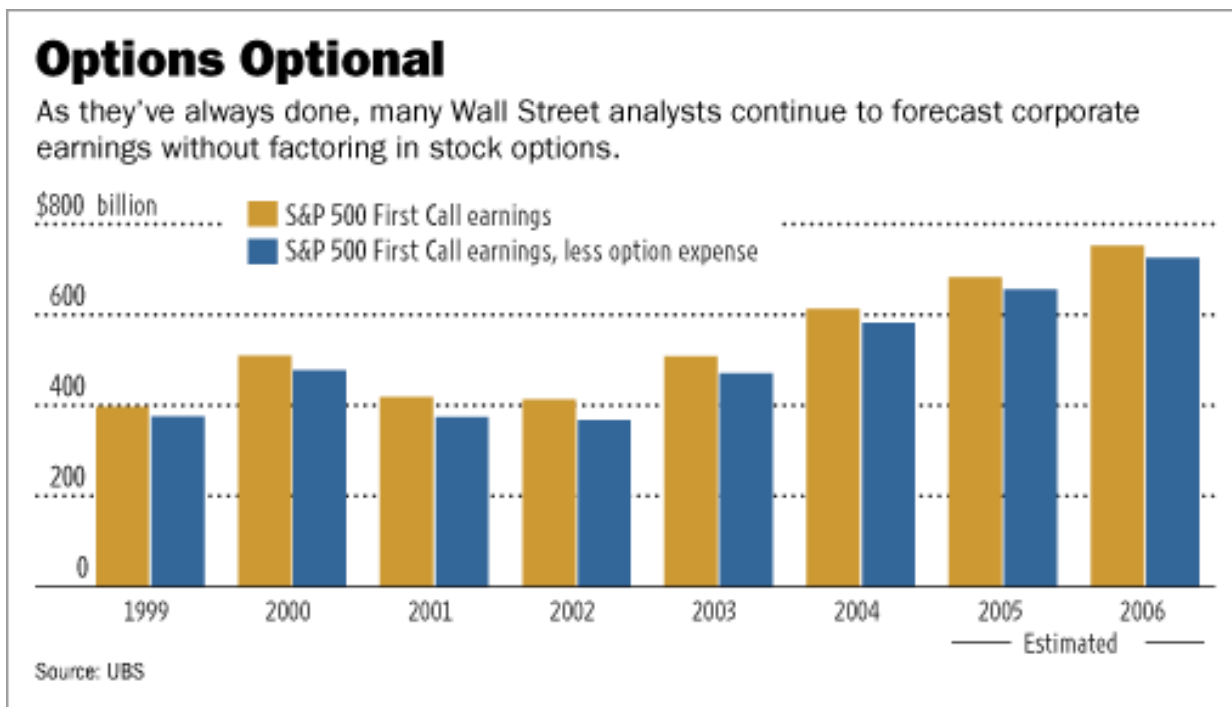
But an early read shows that many Wall Street stock analysts are continuing to ignore this sometimes steep cost by excluding it from the earnings-per-share figures in reports to investors. It isn't just corporate chieftains whom they are seeking to appease: Many mutual-fund managers and other Wall Street trading clients prefer the higher per-share figures, too, analysts say, fearing the lower earnings forecast that would result from factoring in options would ding the stocks they already hold.

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"We're sort of confused about what to do," says Elmer Huh, an accounting analyst at **Morgan Stanley**. "It's definitely a client issue."

The disagreement has reared its head across industries. In April, **Microsoft Corp.** issued an earnings outlook that included the effect of stock-option expensing, yet only 15 of 29 analysts who cover the software company have factored this effect into their earnings estimates. Recent consensus estimates for Microsoft's 2006 earnings per share were \$1.42. With expensing, the consensus would have been about 10% less at \$1.30.

Last month, defense contractor **CACI International Inc.** also opined on stock options, projecting that options expense would reduce its per-share earnings by 15% to 17%, to about 60 cents, for the first fiscal quarter ending Sept. 30. However, 13 of 15 stock analysts following CACI didn't work that cost into their estimates. Ditto for **American Greetings Corp.** and **International Business Machines Corp.** They, too, have issued guidance on options expensing that some analysts are omitting from estimates.

"We're in the client-service business, and the majority of our clients tell us they prefer a pro forma number without the options impact in there," says Michael Masdea, a semiconductor stock analyst for **Credit Suisse First Boston**, part of **Credit Suisse Group**. He plans to submit earnings-per-share figures that exclude the expense to consensus compilers like Thomson Financial, even though some companies he covers, like **Maxim Integrated Products Inc.** and **Linear Technology Corp.**, are big issuers of the perks.

To remove the burden of decision from stock analysts' shoulders, some Wall Street firms are putting policies in place to require analysts to take the cost of options into account. A few weeks ago, **Bear Stearns Cos.** issued such a policy; analysts there must revise their estimates by the end of September. In mid-June, UBS Securities, a unit of **UBS AG**, issued a 145-page report. "Goodbye Bad Option Accounting." The firm is requiring its analysts to include option expenses in estimates by the end of the year, or even earlier "provided it does not result in exclusion from consensus measures."

Therein lies another wrinkle: Those who are pro-option expensing in the investment community blame Thomson Corp.'s Thomson Financial, Reuters Group PLC's Reuters Estimates, and Zacks Investment Research, which collect and report earnings estimates, for adding to the confusion. The firms issue consensus earnings estimates based on how a majority of analysts calculate corporate earnings. So if most analysts exclude the cost of options when crystal-balling a company's numbers, then those estimates including it would be thrown out of the consensus calculation.

"The majority system is horrible," says Ken Broad, a portfolio manager at Delaware Investments. The data-collection firms have become "a repository of data," he says, abdicating "quality-control measures."

Representatives of Thomson, Reuters and Zacks say they are in the business of compiling data, not enforcing accounting rules. They argue that the problem lies with managers of mutual funds, pension plans and other institutional investors who don't support options expensing because lower earnings-per-share figures could dent valuations for stocks they own. "We've seen a lot of resistance from the buy side," says Mike Thompson, director of research at Thomson Financial.

Some Wall Street firms now use multiple earnings metrics to cover all bases. At Bear Stearns, for instance, analysts currently provide earnings estimates both with and without options expense. Goldman Sachs Group Inc. is considering multiple measures, although it acknowledged in a January report that such a move would provide investors "with at least five metrics for valuation and some degree of confusion."

Spokespeople at Morgan Stanley, CSFB and Merrill Lynch & Co. say their firms are examining possible policies.

The matter is likely to get murkier in the next few months, when dozens of companies with fiscal years ending in June, July or August -- including Sun Microsystems Inc., Cisco Systems Inc. and Intuit Inc. -- are slated to post earnings results showing the effect of options expensing.

Write to Diya Gullapalli at diya.gullapalli@wsj.com¹

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(1) <mailto:diya.gullapalli@wsj.com>

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