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NEWS ANALYSIS

Start Weighing the Options

New FASB rules make stock options an expense, and companies are using a slew of tactics to lighten the cost burden

With the long-awaited decision by the Financial Accounting Standards Board in December requiring U.S. companies to expense their stock options, one of the great accounting debates of all time has ended. Barring congressional intervention, by July most public companies will begin treating stock options as an expense. But that doesn't mean the battle is over. Instead, companies that use options are gearing up for the next round: cutting their expense by any means legally possible.

The difficulty of putting a value on stock options should give them plenty of wiggle room. Unlike other forms of pay, the expense associated with stock options is simply an estimate of future value. By changing the assumptions underlying that estimate -- reducing the assumed volatility of the underlying stock, say, or trimming the duration of an option -- companies can dramatically reduce the expense they must book and minimize the hit to earnings. Changing the length or vesting period of the options themselves can produce a similar impact.

ASSUMING LESS VOLATILITY. In the past, says Jack T. Ciesielski, publisher of *The Analyst's Accounting Observer*, many companies went overboard on options because they had no effect on the bottom line. "Now there's a consequence, and they're taking steps to manage [it]," says Ciesielski.

No industry has objected to the new rules more than high tech, which depends on options for a larger chunk of compensation than do other sectors. So tech companies are taking steps that will result in reduced option costs. One way is to lower the assumptions made about how volatile the company's underlying stock is, since volatility -- a measure of how much a stock price fluctuates -- is a key component of Black-Scholes, the commonly used formula for estimating an option's value.

A new study of 93 Silicon Valley companies by pay researchers Equilar Inc. found that two out of three trimmed their volatility assumptions over the last three years, with a median decrease of 14%. By comparison, less than half the companies in the Standard & Poor's 500-stock index lowered their volatility assumptions over the same period, with a median decrease of 10%.

OPTIONS' SHORTER LIFE. Of course, cutting volatility estimates in many cases makes sense, given that stock performance has often been less jumpy than it was in prior years. But whatever the rationale, the impact on options expenses is clear. Consider the case of Ciena ([CIEN](#)), a Linthicum (Md.) maker of optical networking gear. Ciena has cut its assumed volatility in half, from 131% in 2001 to as low as 63% in 2004.

The change reflected less volatile trading in Ciena shares as their price dropped from 117 in late 2000 to less than 3. The lower volatility assumption, along with the flat-lining stock price, helped reduce its option expenses a staggering 90%, from \$27.92 per share to \$2.82 -- and by itself would have cut the cost of the 37 million options it granted in 2004 by an estimated \$60 million. Company spokeswoman Suzanne DuLong says the volatility assumption reflects reality. "The stock has been a lot less volatile than it was in the bubble years," she says.

Another favorite tactic: reducing the expected life of options by cutting the number of years that employees are

expected to hold them before they are exercised. The lower number might reflect employees who exercise options before they expire or options that expire faster. Either way, it reduces the stock's potential price appreciation, and therefore the value of the option.

TRANSITION STRATEGIES. In all, Equilar says, nearly 28% of S&P 500 companies -- and 33% of tech companies -- have reduced option life assumptions during the past three years. In October, for example, executives at Advanced Micro Devices ([AMD](#)) received options with seven-year terms, down from the 10 years on options the company awarded a few months earlier. AMD declined to comment.

Changing vesting schedules can also trim options costs. Since options are expensed over the vesting period, one way to reduce the annual hit to earnings -- although not the overall cost of the options -- is to lengthen the vesting period. In August, Cisco Systems ([CSCO](#)) did just that, awarding CEO John T. Chambers 1.5 million options that vest in seven years, up from five a year earlier. The company says the purpose was to provide a longer-term incentive, but the end result is the same: a smaller earnings hit each year.

Companies are discovering other strategies as well, some of which take advantage of the rules for the transition to mandatory expensing. Come July, most companies must expense all unvested options from previous years -- a potentially massive hit to earnings. To avoid that, HCA Inc. ([HCA](#)) last month opted to accelerate the vesting on more than 19 million underwater options that had not yet vested -- eliminating what would have been \$83 million in expenses through 2008. In a statement, Chairman and CEO Jack O. Bovender Jr. said the move was "in the best interest of the company and its shareholders."

SWAN SONG? In the post-expensing world, accounting methods used to reduce option expenses will make it more difficult for investors to evaluate earnings quality. Comparing companies or industries will become tougher, as investors will have to plow through footnotes to figure out which companies boosted earnings by tweaking accounting assumptions for options, which didn't -- and which changes were warranted.

But there's a far simpler way to trim option costs that doesn't involve changing option grants or accounting assumptions, and won't have shareholders running for the aspirin: granting fewer options. Pay consultants say most companies are replacing some stock options with restricted stock, with the biggest changes happening at companies that have already begun expensing options. The trend will likely accelerate in 2005 as the biggest users of stock options -- tech companies -- face a future where such generosity comes with a hefty price tag.

By [Louis Lavelle](#) in New York

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