AP

Gimmickry of Accelerated Option Vesting

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By Rachel Beck, AP Business Writer

ALL BUSINESS: Accounting Gimmickry of Accelerated Stock Option Vesting

NEW YORK (AP) -- Why not just call the rampant acceleration of stock option vesting "legalized accounting gimmickry" -- because that's what it is.

The way companies like JetBlue Airways Corp. and Xerox Corp. are speeding up how quickly employees can claim their options is being done before the start of new rules that will force the deduction of option costs from earnings. Vest the options now, and such costs never will hit the bottom line.

No laws are being broken. But the accounting sleight of hand sure reduces the accuracy of financial statements. Who does that hurt the most? Shareholders.

Stock options are perks given to employees that allow them to buy shares of their company's stock in the future at a set price. Corporate executives like to tout options as an important compensation and retention tool, and a way to align employees' and shareholders' interests.

When an option is granted, it is valued and a compensation cost is then fixed over the option's vesting period, which generally runs between three and five years. Previously, companies could just include option costs in a footnote to their financial statements.

But under new rules from the Financial Accounting Standards Board, option expenses must be subtracted from earnings just like salaries and benefits are. The change could be costly: Earnings for companies in the Standard & Poor's 500 index would have dropped 6 percent in 2004 and 8 percent in 2003 had options been expensed, according to Credit Suisse First Boston.

That's why companies are scrambling to do all that they can to minimize their option costs, and the easiest way to get that done comes through accelerated vesting.

The first wave of that started last spring just before the rule change took effect for companies with fiscal years ending after June 15. A big push is expected in the coming weeks as the glut of companies with December year-ends rush to shuffle those expenses off their books.

According to compensation consulting firm Equilar Inc., nearly 300 companies have already accelerated their vesting this year. Technology companies lead the pack, largely because that industry has relied so heavily on options in compensation packages.

Among those changing their option programs: low-cost airline JetBlue. Last month, the carrier said that it would accelerate vesting of up to about 13 million shares as of Dec. 9. That represents all the unvested stock options, excluding those going to its top officers and board members. The company estimates that if it had not pushed up the vesting date, the options would have shown up on its income statement as $90 million in expenses over the next seven years.

Xerox also expects big savings -- to the tune of $31 million in 2006 -- from its accelerated vesting of options for both employees and officers.

Some companies are accelerating different batches of options at different times, while others are just speeding up the vesting of officers and directors' options. There are those that are allowing just-granted options to vest immediately or in an unusually short period of time, which Jack Ciesielski, author of the popular industry newsletter The Analyst's Accounting Observer, calls this "insta-vesting."

"It is a lot like promising yourself one really rich meal, with shareholders picking up the tab, before going on a diet tomorrow," he said.

Among those that he cites for "blank check" vesting is pet-care products maker Heska Corp., which promised instant vesting on any options granted through the end of this year.

By not having to recognize the option expenses, Ciesielski estimates that public companies will save some $2.7 billion in compensation costs. Should corporate performance in 2006 be comparable to that seen in 2004, he believes managers preserved about 12 percent of next year's earnings by accelerating option vesting in recent years.

What's ironic is that all this maneuvering wipes out the premise for options. So much for retaining employees and aligning their interests with shareholders. As CSFB's accounting analyst David Zion points out, that doesn't exist when vesting is accelerated.

By speeding up vesting, companies are showing that options are largely a thing of the past. They're expensive, and soon those costs will be hard to ignore.

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