

8/6/02 C1

The Options-Value Brain Teaser

By JONATHAN WEIL
And THEO FRANCIS

WITH EVERY PASSING week, more major companies are announcing plans to begin expensing the stock options they give their employees and executives as compensation. Now comes the hard part: Deciding just how much those options are worth.

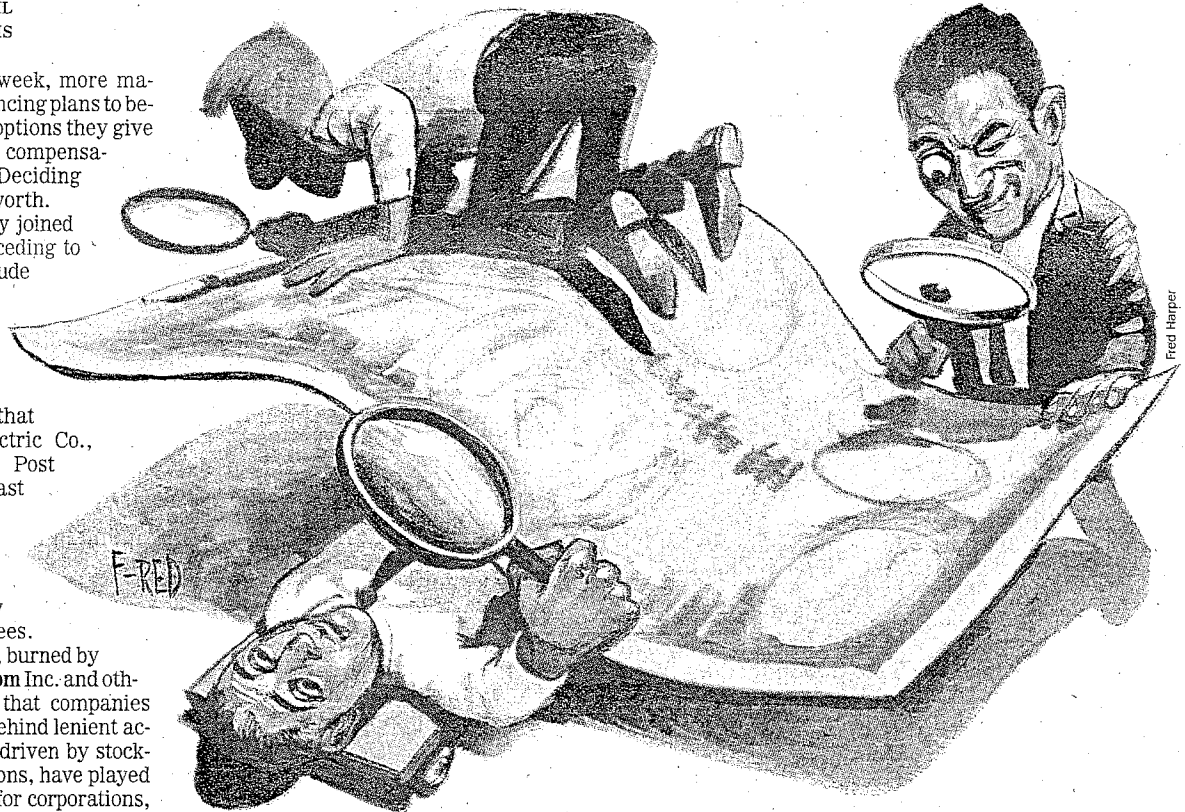
Procter & Gamble Co. yesterday joined the growing list of corporations acceding to shareholder demands that they include stock-option expenses in their By-Company Statements, rather than just disclosing the figures in a footnote to their annual reports as accounting rules still allow. And with each new company that follows the lead of General Electric Co., Coca-Cola Co., and Washington Post Co., which disclosed their plans last month, the pressure grows on others to follow suit, including those in the once-thriving high-technology sector that historically have depended most heavily on options to compensate employees.

The adoptions come as investors, burned by the collapse of Enron Corp., WorldCom Inc. and others, grow increasingly concerned that companies have hidden ugly economic truths behind lenient accounting rules and that executives driven by stock-based compensation, including options, have played fast and loose with those rules. But for corporations, expensing stock options means they must grapple with the potentially thornier issue of how to calculate those additional compensation costs, an issue that has largely been dormant until recently.

And for investors, at least in the short term, the greater push for transparency actually may make comparing financial results of companies more difficult than it already is.

The problem: As in so many areas of accounting that require estimates and forecasts of long-term future trends, there is no universally agreed-upon way to value the cost of options. Even the most commonly accepted mathematical models require companies to incorporate their own assumptions about such things as their stocks' future volatility, in order to arrive at

Please Turn to Page C14, Column 4



Looking for a Standard

Some companies that expense or plan to expense the cost of stock options

COMPANY	WHEN	COST
Amazon	Early 2003	Would have widened 2001 net loss by \$396 million
Bank One	Now in practice	\$8 million in latest quarter
Coca-Cola	Fourth-quarter 2002	A penny per share in 2002
Computer Associates	Fiscal year ending March 2004	2 cents a share in 2002
Freddie Mac	Now in practice	Less than \$4 million in latest quarter
General Electric	Beginning in current quarter	Less than \$30 million
Procter & Gamble	Fiscal year ending June 2004	N.A.

WSJ

Deciding Value of Stock Options May Be Trick

8/6/02

Continued From Page C1

answers that are plugged into financial statements as if they are precise figures.

"It's not as clear-cut as the question of whether to expense or not," says David Blitzer, chief investment strategist for Standard & Poor's, a unit of McGraw-Hill Cos. "There will be some pretty technical arguments about how to calculate option prices."

It isn't that the prevailing practice—acting as if stock-option compensation carries no cost—is any more appealing to investors. But it's an issue that companies already are being forced to grapple with in their push to offer investors greater financial transparency in the wake of so many corporate collapses.

To be sure, by Standard & Poor's count, only about 35 companies have signaled their intentions to begin treating options as an ordinary expense. But like the trickle of companies that were the first to abandon Arthur Andersen LLP early this year as its Enron woes were unfolding, many market observers believe the converts could be the first of a flood to come.

The prospect of a sea change already is prompting accounting-standard setters to dust off their prior pronouncement on accounting for stock-option compensation. At a board meeting tomorrow in Norwalk, Conn., the private-sector Financial Accounting Standards Board plans to begin discussing whether companies that elect to begin recognizing option expenses should restate previous financial statements or start expensing options only for future periods. Whatever solution accounting experts arrive at is unlikely to satisfy everyone, and is likely to leave room for dishonest executives to manipulate results, and will leave considerable discretion in the hand of execu-

tives preparing the financial statements.

"Financial reporting in many cases is not based on economic reality, but on a uniform set of principles" that investors can use to compare one company's results against another's, says Rebecca Miller, an accountant and partner with McGladrey & Pullen LLP. "It's not actual performance, it's just comparable performance."

Or, at least, as comparable as possible. Currently, publicly owned companies in the U.S. that choose to treat stock-option compensation as an expense are required to measure their costs using mathematical option-pricing models. Most such formulas stretch back to the model published in the 1970s by Fischer Black and Myron Scholes. Often called the Black-Scholes formula, the model was the first to gain widespread acceptance.

But like most of its progeny, Black-Scholes hinges on assumptions. Perhaps more important, options-pricing models typically require a projection of the underlying security's future volatility. That isn't an easy thing to project accurately in instances where a stock has 50 years of historical trading upon which to draw, much less with start-up companies that just went public.

Even small changes in the assumptions used in the estimates of that volatility can make crucial differences in a model's results—and a company's reported expenses and earnings. So even similarly situated companies using the Black-Scholes model can arrive at widely disparate results. "If you find me three statisticians, I can give you at least six estimates for the volatility of stocks," says Mr. Blitzer, the S&P chief investment strategist. "There will be people who will try to be clever with these kinds of numbers."

Still another fundamental problem with option-pricing models is that they tend to be

designed for pricing tradable options, not the nontradable kind granted to employees, which also tend to have much longer lives.

For its part, Coke is floating a free-market solution to this and other problems—and indeed, the first preference of accounting-standard setters is that companies determine the fair value of their option packages based on quoted market prices. Coke says it plans to secure offers from two investment banks to purchase or sell options under the same terms and conditions of the options that the soda maker is granting to its employees and executives. For valuation purposes, it will average the two banks' bids. And the risk for the banks is that, if their bids are out of whack with the market, then Coke will be able to execute the trades at the prices quoted.

Some investors say that will go a long way toward crafting an objective method to determine how much a stock option is worth at the time the option is granted.

And as more companies join the options-expensing bandwagon, that in turn will heighten the pressure on U.S. accounting-standard setters to make the practice mandatory for all companies in the U.S. to further ensure comparability. Already, the Financial Accounting Standards Board is feeling some pressure from its overseas counterpart.

Members of the newly formed U.K.-based International Accounting Standards Board are now preparing a new standard under which all companies using international standards would be required to treat options as expenses. Once finalized, that standard likely will prompt the U.S. accounting-standard setters to revisit their 1995 options standard, which allows companies a choice between expensing options or merely disclosing their calculations of option expenses in footnotes to the financial statements.