Contrary Intel Won't Expense Options

But It Will Offer Investors Data About Employee Grants And Executive Compensation

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By Don Clark B1

BOSS TALK

ANDY GROVE helped build a philosophy at Intel Corp. known as "creative confrontation." The phrase, in essence, means that it's better for employees to get in shouting matches and solve problems quickly than let issues fester for fear of offending someone.

Now, Intel's chairman is extending that principle into the debate over employee stock options, taking a decidedly contrarian stance to the corporate trend.

Starting with a quarterly Securities and Exchange Commission filing expected to become public today, Intel plans to provide a new level of detail about its stock-option programs to enable shareholders to make more informed decisions about approving them. The Santa Clara, Calif., semiconductor firm's Form 10Q report will include a table that highlights option grants over five years, the dilution caused by issuing the options, and the percentage of the options that went to the company's five highest-paid employees.

What Intel won't do is jump on the new bandwagon of accounting for options each quarter as regular business expense. Mr. Grove insists that expensing options doesn't confront the real issues—the potential for shareholder dilution and excessive compensation of top executives.

"The AFL-CIO is going to demonstrate on Wall Street because they are upset over high executive compensation, and they want to get obstacles in the way of granting stock options," Mr. Grove said in an interview. "What they should be after is executive compensation itself."

Mr. Grove argues that the "deafening rhetoric" is doubly misplaced in the case of a company like Intel, whose broad distribution of stock options has had the effect of spreading wealth generated by the company to secretaries and factory workers as well as top managers. While options represented a hefty 11.4% of total shares outstanding at the end of last year, Intel's top five executives accounted for just 2% of options granted through Dec. 31, compared with 18% to nearly 30% at some companies, he says.

Moreover, Mr. Grove and Andy Bryant, Intel's chief financial officer, assert that the current expensing fad could actually wind up making things worse. Among other things, Mr. Bryant predicts that companies will simply urge investors to look at earnings before option expenses—a move back toward nonstandard "pro forma" measures at a time when many companies are trying to shift to generally accepted accounting principles.

Options are a right to buy a stock at a locked-in price. They are issued to give employees an incentive to help push their company's stock up, so they can buy shares and resell them at a profit. When Intel was founded in 1968, options were granted to professional staff, representing about a third of the work force. In the mid-1990s, Intel opted to

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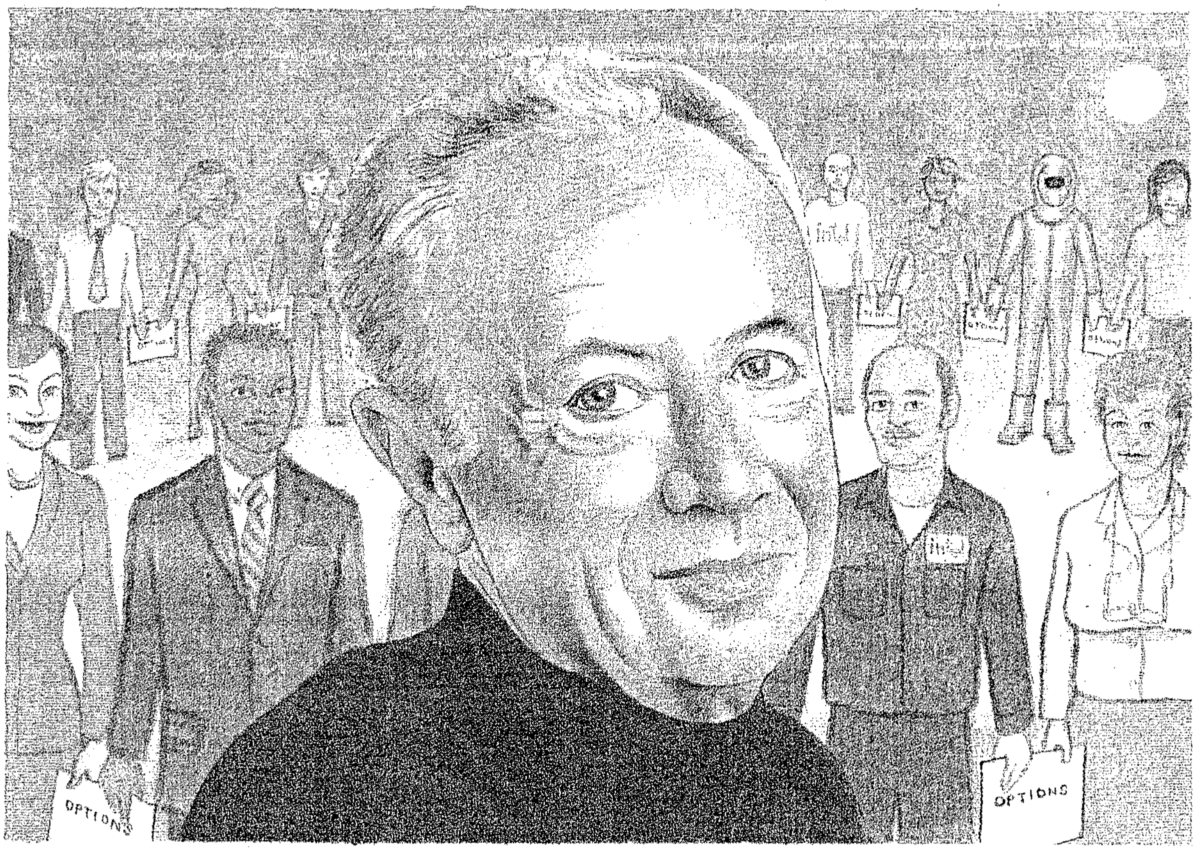
Question of the Day: *Would the expensing of options boost your confidence in a company? Visit* **WSJ.com/Question** *to vote. And see a graphic listing the companies that have decided to expense options in the Online Journal at* **WSJ.com/JournalLinks**.



Discussion at Intel: the Two Theories of Stock Options

By Don Clark

IN ANDY GROVE'S world, the controversy over stock options comes down to Theory N (for narrow) companies and Theory B (for broad) companies. The first camp heavily distributes options to a narrow group of top employees. Theory B companies, like Intel, believe in broad distribution throughout the company to motivate and retain employees at all levels. Here are excerpts of a discussion with Mr. Grove and Chief Financial Officer Andy Bryant about the models and how they fit into the options debate.

On the difference between the two approaches:

Mr. Grove: Consider what happens when a stock does well. The consequence in Theory B companies is that a whole bunch of people end up sending kids to college, buying houses, buying second cars and the like. Everybody gets moved further in the economic spectrum.

In Theory N companies, a handful of people are rewarded in a very extreme, leveraged fashion because of the large percentage of uplift that comes to them. What happened in the latter part of the 1990s is the combination of the Theory N companies and positive stock-market conditions led to very high executive compensation ... I find a deafening rhetoric that almost equates executive compensation with the use of options, without digging one level deeper to get at the distribution issue.

On the Bandwagon

Some companies that have recently announced plans to expense employees' stock options

COMPANY	DATE EFFECTIVE
Coca-Cola	Fourth quarter 2002
Computer Associates	April 2003
Cooper Industries	January 2003
General Electric	Current quarter
General Motors	January 2003
Marathon Oil	January 2003
Procter & Gamble	Fiscal year ending June 2004

On why Intel opposes expensing stock options:

Mr. Bryant: I would never deny there is value in options. But I would argue that it is already accounted for in earnings per share. If you take any other path, you are going to have a less accurate answer than if you do it the way we do it.

Mr. Grove: My concern is that this debate over how the valuable options should be reflected, in the profit-and-loss statement or in the capital accounts of the company, should be done without a concern over excessive compensation casting a shadow over it. They are two different issues and you will not come up with the right answer to the first one if you mix the two together.

On alternatives to expensing:

Mr. Grove: An option is a grant of ownership given by existing shareholders to employees. I as a pre-existing owner decide how much dilution of my ownership I want to give up for this motivational purpose, and in conjunction with management, I control how that gets distributed.

Shareholders have not exercised this right. Shareholders don't know about it. This issue of distribution is completely buried. It's not that it's not available, but it's kind of like hiding a pebble in the beach. It's buried in the footnotes and the proxy statements. It needs to be highlighted.

Mr. Bryant: Putting information on the profit-and-loss statement is not going to make this information available. What's more likely to happen is companies are just going to take a pro forma approach [highlight earnings before options expense] ... What Andy is suggesting is, let's make sure

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ke them available to all full-time em-ployees. Like many other technology companies, the chip maker has used options heavily as a recruiting and retention tool. Grants can range up to 200,000 options.

Intel has lobbied hard against mandatory moves to expense options, arguing that its net income could be disproportionately affected. In 2001, the company estimated that expensing options would have shrunk Intel's already-meager earnings that year from $1.3 billion to just $254 million. That argument doesn't wash with critics, who believe earnings are more accurately expressed by expensing.

Options have certainly benefited Mr. Grove, the Hungarian-born engineer who came to Intel shortly after its founding and was chief executive officer from 1987 to 1998. Since 1990, according to public records analyzed by Thomson First Call, Mr. Grove has raised more than $160 million by selling shares that mainly came from option grants. "I made a lot of money on ·ck options," he acknowledges. But ·se options were granted for past service, he notes, so it doesn't follow that he is motivated only by self-interest in discussing future treatment of options. Indeed, he says he has at times leaned toward expensing options, most recently influenced by conversations with investor Warren Buffett at a gathering of big-name CEOs in Sun Valley, Idaho, in July.

"I came back probably under Warren's influence at the Sun Valley meeting, being sufficiently confused that I raised the issue with Mr. Bryant," Mr. Grove recalls. "He screwed my head up right."

Mr. Bryant, an executive vice president who became chief financial officer in 1994 and also holds the title of chief "enterprise services officer," says he has been debating Mr. Grove on the issues of options since at least last March, when the two had a lengthy argument in a car on the night of a dinner.

Proponents of expensing argue that companies have treated options as if they had no value, which defies common sense since they have enriched many people. Mr. Bryant argues that their value is already reflected in companies' earnings per share as dilution increases the number of shares outstanding. Intel's new 10Q filing is designed to illuminate dilution and distribution of options. It states a goal of keeping new options issued each year to 2% of outstanding shares.

The company came in above that goal last year, issuing net grants of 198 million options, or about 3% of outstanding shares. But grants declined to 0.3% in the first half of 2002. Grants to Intel's top five officers rose to 5.6% of total options issued in the first half of the year from 0.7% last year, reflecting new grants to counteract the stock market's downturn, but are expected to be 3.7% of total grants for the full year, the company estimates.

Mr. Grove wants the heads of the board's audit committee and its executive-compensation committee to begin making presentations at Intel's shareholder meeting to help shareholders further decide whether to approve or reject option plans.

These additional disclosures are likely to please corporate watchdogs but may not entirely head off pressure to also change the company's accounting.

"I applaud what Mr. Grove is doing," says Charles Elson, director of the Center For Corporate Governance at the University of Delaware. "But I continue to believe we need to search for an appropriate metric to expense options."

Intel's Grove, Bryant Discuss Options, Other Topics

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that when you file your 10Q form, when you do your paper work, when you do your shareholder meeting, no one can mistake it. I know that I'm agreeing to 2% dilution.

On possible effects of expensing options:

Mr. Grove: If the pro forma charade happens, there would be absolutely no change in our options. If that does not happen, there is financial or perceived financial pressure to eliminate the new option expense that lowers your earnings per share, which is the Holy Grail of all corporate earnings, and people pull back on option grants—I'm going to ask what a Theory N company would pull back on, and how many Theory B companies will retreat to a more narrow distribution?

Whose options are going to get cut, CEO options or technician options? So all of those people who are demonstrating on Wall Street ought to think ... I don't think it's going to cut down on the funny business.

On the reason for speaking out.

Mr. Grove: I think corporate America has acted less forthrightly and aggressively under attack than one might wish. What I'm hoping to achieve is for some of our colleagues to come out of their shell-shocked state and speak up and debate and discuss this as well as other issues.

Mr. Bryant: I' m part of the reason Andy is so fired up. Intel has a history of doing the right thing. Every time I read about another company saying, 'We are going to expense options because it doesn't matter anyway,' it just drives me crazy.

On what conversations with other companies have been like so far.

Mr. Grove: Heated. I've not had an unheated conversation with anyone, except Mr. Bryant here. A close friend of mine—I had dinner with him on Sunday night—it ruined yet another dinner. With Warren [Buffett], another dinner was ruined. People are a little too dogmatic on this subject. This subject deserves thought and analysis rather than jingoistic table- or chest-pounding.