

## Accounting Group Releases Option-Expensing Proposal

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NEW YORK -- U.S. accounting-standard setters, as expected, proposed Wednesday to change an almost decade-old rule to mandate that companies deduct the value of employee stock options from profits, beginning in 2005.

The move by the Financial Accounting Standards Board comes amid growing shareholder demand for stock-option expensing. But the plan has met strenuous opposition from the technology industry, where option grants have been far more generous than in the rest of corporate America.

The end of the free ride for options in income statements, experts say, could affect both the compensation landscape and investors' views on companies issuing options to employees and executives. Meantime, the change, if finalized, will bring the U.S. standard on share-based payments in line with the one set recently by the International Accounting Standards Board, the European counterpart to the FASB.

"Companies will make significant changes to their option plans, including the number of options, the types of options, and the methodology used to value them," Howard Silverblatt, equity market analyst for Standard & Poor's Investment Services, said of the likely impact of the rule change. Investors, he added, will start to take a close look at the cash-flow implications of stock-option plans.

Companies using stock options -- which give workers the right to buy their companies' shares at a fixed price within a specified period -- often repurchase their own common stock to obtain shares required for option plans and to limit dilution to current shareholders.

Under the existing standard issued in 1995 -- the result of a compromise FASB forged under congressional pressure -- companies can choose to simply disclose the value of options in their financial footnotes or to charge it directly against net income. Most do the former.

According to Standard & Poor's, earnings for companies within the S&P 500 index would have been 10.6% lower in 2003, 19.2% lower in 2002, and 21.5% lower in 2001, if all of the member companies had treated options as an expense. About a fifth of the companies in the index now expense options.

Although the footnote disclosures have enabled investors to assess the potential earnings hit from option grants, the disclosure-only practice has also allowed companies to minimize the related cash-flow consequences. The new FASB expensing plan, notably, calls for disclosures that will help investors understand how option grants affect cash flows.

### Valuation, Transition In Focus

As the expensing proposal winds its way through a three-month comment period, the issue that is likely to draw the most controversy is how to determine an employee options' value -- the amount that will go to the bottom line.

While FASB isn't imposing any particular technique to use for valuing stock-option pay, it is encouraging companies to adopt the so-called binomial approach. A key advantage binomial has over other methodologies, such as the much-criticized Black-Scholes model, is that it takes into account the possibility that changes in the stock price may influence the timing of when employees exercise options.

Such an eventuality is something the board says companies should consider when calculating options' fair value. Critics of the board's recommendation, however, point to companies' lack of familiarity with the binomial approach. Right now, only a handful of companies, including American International Group Inc. and Washington Mutual Inc. use it.

"Since what you are suggesting doesn't even exist, there should be a three-year transition period to the new model before you require options to be a charge to earnings," Frederic W. Cook, chairman of the compensation-consulting firm Frederic W. Cook & Co., said of the comment letter he is going to send to FASB.

Another part of the plan that could be contentious is the approach companies will be required to use in making the transition to the expensing of options. Under it, a company will have to include previously granted but unvested options in its calculations as well as the ones granted in the year of the accounting switch.

"Companies are likely to complain about the change, especially those that will bear the brunt of the rule -- technology companies," accounting analyst David Zion at Credit Suisse First Boston noted in a recent report. "They will argue that including prior grants, many of which are still out of money, would represent a distorted view of earnings."

On the other hand, Mr. Zion added, companies that have been scaling back their option grants may prefer this transition approach because "it could generate future earnings growth when the large option grants from prior year begin to drop out of the equation, reducing option compensation cost and increasing earnings."

FASB will hold public roundtable discussions on the proposal in June, before it puts into place a final rule in the second half of the year.