WSJ.com THE WALL STREET JOURNAL. ONLINE

LONG AND SHORT MAILBOX
By JESSE EISINGER

A Crossroads for the Market

July 25, 2004 5:52 p.m.

My column on Microsoft Corp. (Microsoft Can Count. Intel Can't1, July 21) generated a mountain of e-mail. Most lauded my effort, suggesting to me that most investors understand that stock options are an expense that needs to be recorded on the income statement. But there were some who still argue that it isn't. I am troubled that these people seem so impervious to reason.

I quote extensively from Cliff Asness's recent piece in the July/August issue of Financial Analysts Journal called "Stock Options and the Lying Liars Who Don't Want to Expense Them." Mr. Asness, a University of Chicago Ph. D in finance and a successful hedge-fund manager, is a clear and entertaining writer.

His piece isn't on the Web site (www.aimrpubs.org/faj/home.html2) yet, but I assume it will be eventually. In the meantime, I will send it to those who ask. Some letters have been edited for length and clarity.

Stock-Options Expensing Is a Big Test for the Markets

I am glad somebody at a major publication is pointing out how absurd this House Resolution is. If you do a follow-up article, perhaps you should mention that all these Silicon Valley companies feel very strongly that options are wages -- they expense them -- when it comes time to pay their own taxes. Thus, some of the most profitable companies in the U.S. are lowering what they should pay to the government. Given the expanding budget deficit, maybe these congressmen should explain their standpoint: letting companies expense for tax purposes, but not for earnings-per-share calculations. But, of course, fiscal responsibility is not held very highly in Congress. I did like your point about only selectively expensing, because it demonstrates the bizarre levels that these special interest groups are willing to go to. I personally believe (and have for about six years) that this is one of the most important issues facing the markets and the economy in the U.S.

Brad Brooks

My Reply:

Thanks for your comments. I agree that this is an issue of crucial importance. I agree with Banc of America's Tom McManus, who interpreted Wednesday's drop in the market to the passage of the House bill.

Mr. McManus admitted that his theory was impossible to prove. And I am always wary of single explanations for any one-day movement in the stock market. However, I found his comment plausible: To see our politicians act in such a feckless manner, at the behest of clearly self-interested companies peddling sophistry scares the markets and investors. They realize that their companies aren't interested in doing right by them.

Are Stock Options Really an Expense?

You need to be clearer with your use of the word "expense." The cost of stock options is dilution, as you make clear in your last paragraph. But earlier you state that the writers of the Baker Bill knew "something is wrong with not expensing stock options," implying that disclosing the dilutive effects of the options is not enough. You then go on to state: "If Congress could just go ahead and outlaw all 'expenses' at the nation's companies, the economy would really boom."

The point you sarcastically make is that investors would see right through such a ploy. If a company had $1 million in revenue but had to pay its employees $400,000 in cash and had to pay $100,000 for property, plant and equipment, investors would clearly realize the company is making a half-million dollars no matter what Congress defines as an expense.

But stock options are different. By issuing options, current shareholders have a smaller and smaller claim on the $500,000 in earnings. Again, as you state, investors need to figure out the "pernicious dilutive effects" of these options. Nonetheless the $500,000 still exists. If the company above issued options valued with Black-Scholes at $600,000 would this mean that the they are losing $100,000? Clearly not …

In short, issuing stock options divides equity up into smaller and smaller pieces. It does not decrease it as paying wages, interest expense, or the CEO's salary out of the companies bank account would. You need to clarify this point.

Peter Mork
San Diego

My Reply:

Stock options are an employee expense. It's not just an issue of dilution, though that plays a role in explicating why stock options aren't free.

The company is giving something of value to its employees when it gives them stock options. As Cliff Asness, a hedge-fund manager for AQR Management and University of Chicago Ph.D. in finance has pointed out, it is an expense even if the options aren't exercised -- because the company doesn't know beforehand which options will be in the money. If a company, to borrow from Mr. Asness, went out and gave stock options to random people in a mall, would this be an expense? Yes. So what makes it different to give them to employees?

Here I'll use Mr. Asness's example, from a paper he wrote in the Financial Analysts Journal titled "Stock Options and the Lying Liars Who Don't Want to Expense Them" in the July/August 2004 issue, since he puts it so clearly:

"Suppose a company goes to its widget supplier and says, 'Instead of paying you now, let's agree to a deal in which next year, if a coin flipped then comes up heads, we pay you three times the normal amount but if it comes up tails, we pay you nothing.' Did the company simply eliminate all expenses this year? Is there no expense this year and only an expense next year if heads comes up? Nope. The basic principle of accrual accounting is to recognize expenses when they are incurred, not when they are actually paid. A reasonable estimate for expense this year under this scheme is 1.5 times normal levels (and, by the way, that is how the widget supplier would recognize it as a bad deal!) because there is a 50 percent chance of 3 times normal expense and a 50 percent chance of 0. Black-Scholes valuation, or anything like it, is basically carrying out a similar exercise for stock options -- looking at future payoffs and probabilities and estimating today's economic expense. If this 50/50 gamble were not an expense, imagine the incentive companies would have to inflate current earnings by paying for things with noncounted bad deal gambles on the future! Oh, wait a second … Doesn't this sound a bit like not expensing options?"

Tech Companies Behaving Badly

Thank you for an excellent article on "Microsoft Can Count. Intel Can't." I very much enjoyed reading your piece and agree with you completely. The behavior of the management of companies like Intel and Cisco Systems in trying to get politicians to usurp power from the Financial Accounting Standards Board has been absolutely despicable.

First of all, the FASB has many bright, conscientious, independent experts in finance and accounting. In making decisions, it goes through a very rigorous process. The FASB is a vital institution that should be respected and left to do its proper work. Yet, a handful of high tech execs think that politicians inexperienced in finance and accounting can make better standards? This is absurd. Just look at the idiocy the House produced with this bill.

Second, a majority of shareholders at many high tech companies want options to be shown as an expense. Theoretically, these executives should do their best to serve the shareholders and do as asked. At a minimum, they should remain silent on the issue. Yet, many high tech executives are actually actively lobbying against shareholder wishes and using company money to do so? This is truly atrocious.

This bill now before the Senate is a critical test of principles. If this country is going to prosper going forward, our institutions have to be respected.

Chris Waldorf

My Reply:

I'm hopeful that this won't make headway in the Senate. But I have spoken with some accountants who lobbied the House to reject this bill and they are certainly less sanguine about the bill's death in the Senate now than they were a couple of weeks ago.

There is no question that the tech lobby scored a huge victory this week. At the least, I think they are going to manage to delay the implementation of stock-option expensing. FASB needs to move quickly on this and without further delay. I regard it as one of the most important issues for the stock market.

Microsoft Is Still Darth Vader

While I disagree with your position on expensing stock options, I do agree that it has been the path to personal wealth for a great many privileged executives; and that stock buyback programs have been a path to transfer corporate cash to employee assets and incentives. When this privilege is abused (not shared reasonably within the ranks), it becomes an executive privilege, and at that point it is a violation of shareholder trust. Beyond that, you make the "Dark Side" sound like a trusted friend. The FASB position does not register with me.

We cannot predict the future value of stock options. Instead, limiting or exposing the value of options to the privileged elite in the corporate world, does serve to limit the excessive remuneration.

Wise up on Microsoft. They have unfairly eliminated competition by giving away features that others charged for, e.g. Netscape and Real Player. They discounted their "features" below true cost. Their purpose was to drive out competition and own the operating system and peripheral areas where they could target future revenue. Their dominance was not achieved fairly; therefore, your elevation of Microsoft as a suitable corporate example is flawed and repugnant.

Beyond that example, I find your column an interesting read.

Bill Kahrs

My reply:

Bill, Microsoft may have competed unfairly. I think there is value in having a universal operating system for our computers, though I am troubled by unfair competition.

However, I see a significant change in corporate behavior at Microsoft. And the way the company has dealt with stock options and its cash is exhibit number one. I think the company is making a serious effort to become a better corporate citizen. Toward that end, they have eliminated stock options. I don't think stock options are wrong in and of themselves, but they have been abused -- mainly because they haven't been expensed on the profit and loss statements. So it's good that MSFT took a stand against that.

Intel Is Not For Us

Several years ago we sold all of our Intel shares after reading a press release in which Intel bragged about having spent $4 billion in the previous year to buy back stock. Closer inspection revealed that the total outstanding shares had hardly declined. The $4 billion was just disguised compensation. In a similar case, Dell over a three-year period reported, in its cash flow statement but not the income statement, sufficient stock-option-related expense to the IRS to wipe out its reported tax for the three years. It would be an eye opener if companies were required to disclose to owners the stock-option expense they report to the IRS.

While Silicon Valley has been adamant about protecting their greed, the rest of the corporate world is not innocent. After all, didn't the Business Roundtable, the National Association of Manufacturers, and the U.S. Chamber of Commerce all support the House bill, which, as you note, Warren Buffett recently, correctly, described as "mathematical lunacy"? It is really lamentable that few CEOs have joined Buffett in demonstrating real leadership.

After all of the scandals in recent years, it is shameful that business leaders still don't get it. In 1992, Warren Buffett wrote, "[T]he business elite risks losing its credibility on issues of significance to society -- about which it may have much of value to say -- when it advocates the incredible on issues of significance to itself."

Arthur D. Clarke
Arthur D. Clarke & Co.

My Reply:

Thanks very much for your comments. Tech companies have a choice of a responsible paths set before them and they are choosing not to take it. I have to throw my lot in with Mr. Buffett on this one. I think the compensation has gotten so extreme that executives will fight anything that curbs it to the extreme, rather than face that this was a thing of the past.

Calculate This!

Your article today regarding stock option treatment was obviously one-sided and does not represent the type of objective journalism I would expect from the WSJ.

The reality is the proposed stock option treatment by the FASB is flawed on multiple fronts. Ultimately, it is EPS that matters, and exercised options accordingly reduce EPS by increasing the denominator in the calculation. What is being suggested by the FASB and all others who have no understanding of how financial information is generated, is to reduce both the numerator and the denominator. That is bad accounting and bad public policy.

Furthermore, it is clear to everyone that there is no financial model that can accurately determine the cost of options. For example, what happens when a charge is recorded for an option that is never exercised because it goes under water. You also failed to mention all the job creation in the U.S. economy from the technology companies that you seem to despise and find underhanded.

Finally, you indicated investors will only flock to those companies that take the right path. I'm glad to hear that you are the one person in this country who knows what the right path is on this issue. Perhaps you should ask yourself the last time you did an EPS calculation.

Bill Zerella
VP, Finance and Administration & CFO

Calient Networks

My Reply:

Thanks for your comments. I am concerned that a chief financial officer at a technology company would honestly attempt to argue that stock options are not a compensation expense that belongs in the profit and loss statement. Stock options don't only matter when they are exercised. The company is giving its employees something of value at the time of the offering. That's compensation. And so what if it's hard to calculate? As has been said many times before in this debate, it is better to be approximately right than precisely wrong. We know that stock options are not worth zero at the time of the grant.

What High Multiples?

"And then there is the path of the irresponsible. It has been chosen by Intel Corp. and Cisco Systems Inc. and denizens of Silicon Valley. Nonetheless, these companies are celebrated by investors and accorded huge multiples."

Intel, huge multiples? What planet are you on?

Kevin Cahill

My Reply:

I was speaking in general of tech stocks there. But Intel has frequently been accorded a huge, unwarranted multiple. It was trading at one last year, when the stock almost hit $35 in the fall. Yes, the valuation for Intel has come in, but I contend that the gross margins have peaked for this cycle and that growth in areas like PCs will likely disappoint next year.

Intel is a highly cyclical stock and I argue it should trade at a low double-digits multiple, perhaps even a high single digits multiple times peak earnings. So if one looks at the price-to-earnings multiple of 17.5 times the projection for next year, it might not appear that expensive. But it is, I contend, not only because the company may not hit that number but because it is approaching -- or has already hit -- its peak earnings for this cycle.

I could be wrong, but that's how I view the stock.

A Modest Proposal

I propose that any congressman or congresswoman that votes in favor of the Baker Bill be held liable as a codefendant in future shareholder lawsuits where accounting transgressions resulted in material loss of value. After all the shenanigans that have surfaced over the past few years and congressional hearings, for Congress to even consider meddling with FASB on this is a new 52-week high in political pampering and pork barrel and perhaps a new land-speed record for political reversal and hypocrisy.

Alex Vallecillo
Senior Portfolio Manager
National City IMC

My Reply:

I am sure that there are a lot of people who are annoyed by this House vote. But it's an election year and these guys saw an opportunity to grab dollars from tech companies. I think there isn't much more of an explanation needed.

URL for this article:

http://online.wsj.com/article/0,,SB109059456350672283,00.html

Hyperlinks in this Article:
(1) http://online.wsj.com/article/0,,SB109035182748468780,00.html
(2) http://www.aimrpubs.org/faj/home.html
(3) mailto:longandshort@wsj.com

Long & Short is a new commentary column on Wall Street and markets. I will endeavor to identify underappreciated risks and uncover opportunities. I will attempt to hold companies, investors and Wall Street accountable for decisions. To hold me accountable, e-mail me at longandshort@wsj.com3.

ABOUT JESSE EISINGER

Jesse Eisinger writes the Long & Short column for The Wall Street Journal. Prior to writing Long & Short, Mr. Eisinger wrote Ahead of the Tape and before that the Heard in Europe column for The Wall Street Journal Europe. Mr. Eisinger has also covered pharmaceuticals and biotechnology for TheStreet.com and Dow Jones Newswires. He has a BA in American Studies from Columbia University.