Two’s a Crowd and Three’s Confusion When Accounting for Options Expenses

By ROBIN SIDEL

With so many companies agreeing to record their stock options as an expense, investors might think it soon will be a snap to compare, across companies, the cost of the popular employee benefit. They will just glance at the earnings statements. Don’t bet on it.

Under a proposal being considered by the Financial Accounting Standards Board, companies would be able to choose one of three methods for expensing options. But because the three are vastly different, determining the cost of the options will still likely require some intense scrutiny of the dense footnotes that accompany an earnings report.

That is drawing the ire of some investors and accounting professionals who say the proposal goes against the goal of expensing options in the first place: creating a clear picture to determine how much effect they have on the bottom line. They want the board, which sets the nation’s accounting standards, to craft a uniform standard for the transition. That way, they say, investors can easily compare costs.

“If the investor still has to get out a pencil and a calculator, we haven’t accomplished anything,” says James H. Hance Jr., chief financial officer of Bank of America Corp., which has said it will begin expensing options next year.

HEARD ON THE STREET

The Charlotte, N.C., bank recently sent a letter to FASB, urging the selection of one method. So has the Investment Company Institute, a trade group representing mutual funds.

“The adoption of a standard approach by FASB would facilitate the ability of all investors to evaluate the effects of options upon earnings for all companies on a uniform basis,” Matthew P. Fink, the group’s president, wrote in an Aug. 21 letter to FASB.

FASB concedes it is unusual to provide companies with several options for their accounting, but says the proposals are meant to encourage companies to treat them as an expense.

“We want to make it as palatable as possible. The board believes this is the best way to go,” FASB spokeswoman Sheryl Thompson says.

The issue is growing in importance as more companies, feeling heat from investors about the cost of often-large options programs, change their accounting methods to treat options as an expense. So far, they still aren’t required to do so, but scores of companies in recent weeks have announced plans to make the change, many motivated by shareholder demands for more financial information following a spate of accounting scandals. For years, companies have been reluctant to expense options because they can take a bite out of earnings.

Under current guidelines, a company that takes the plunge to expense options can take what is called a “prospective” approach. In this method, options granted in the current year are expensed, and all old ones—including those vesting only now—are ignored. Current and future earnings may take a hit, but the damage would likely be less than if previous options also were included.

Last month, FASB proposed two new methods for companies to consider in addition to the “prospective” one. The board will open the proposals to public comment later this month, with the aim of finalizing them by the end of the year.

Under the proposed “modified prospective approach,” a company would include previously granted unvested options in its calculations as well as the ones granted in the current year. This approach would make a bigger dent in earnings than the “prospective” one, because it wraps in far more of the options held by employees.

The other alternative goes a step further. It is called the modified retrospective or modified prospective method. Under it, a company not only includes those old unvested options in its current earnings report, but restates prior results as well to show the effect. So under this method, earnings are hit for multiple years.

Despite FASB’s belief that the multiple-choice approach is a positive, not everyone agrees.

“We believe FASB’s proposal to permit different transition methods would undermine the comparability and usefulness of financial statements in the near future,” according to a recent report issued by UBS Warburg.

David Bianco, who heads UBS’s valuation and accounting research group in the U.S., puts it even more plainly, saying “in order to keep all the constituents happy, they’re putting out alternative methods that may create more anxiety and confusion among investors.”

FASB counters the criticism by saying new rules will require more expanded disclosure about stock options in a company’s footnotes.

Bank of America favors the method that calls for the inclusion of old options but stops short of restating prior earnings, saying it provides the necessary clarity. Many other companies aren’t stepping up yet to say which proposal they favor, but accounting professionals already are favoring different methods.

In its report, UBS dissected the effect of each proposal. In a hypothetical example of a company expensing options in 2003, the approach that calls for a restatement would lower earnings by a cumulative 14% over a three-year period. Under the prospective method, earnings would be down just 4% over the period, while the modified prospective method dents them by a total of 6%.

In the report, UBS says the “modified prospective method is a good compromise.” The report notes that while a current period’s performance wouldn’t be comparable with historical numbers—because past years aren’t restated—the earnings figures would include a full year’s cost of stock options, providing “a better indication of future options cost. Adjustments to historical numbers can be made based on footnote disclosures.”

UBS concludes that the prospective method “provides the least useful information for investors,” saying it lacks appropriate historical and future numbers.

Beer, Sterns & Co., on the other hand, in a recent report describes the method that calls for restatement as “analytically superior” than the others because it demonstrates the historical picture. But it also notes that the method “may be misleading” because the historical results may not be representative of the future options trends.

For some, the debate over the method is a minor detail in a larger, more important issue.

“The reality is that my preference is to get options expensed,” says G. Peter Wilson, an accounting professor at Boston College’s Carroll Graduate School of Management. “I believe FASB is making a reasonable trade-off.”