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A Volatile Brew

Elizabeth MacDonald, 08.15.05

Companies have found how to ease the impact of strict new stock option rules.

The long battle over expensing stock options is over. Starting this past June, by edict of the rule-setting Financial Accounting Standards Board, public companies must deduct from earnings an expense representing the value of this form of employee compensation. (To be sure, options grants do not cost the employer any cash, but that doesn't make options worthless.) Up to then, corporations only needed to report in a footnote the hypothetical expense of an options grant. A few virtuous corporations, such as General Motors and Citigroup, voluntarily started in recent years to take for-real options earnings hits.

So now everyone is virtuous. No more will investors be led astray by earnings that don't reflect the value of options to workers.

Um, not so fast. Turns out the FASB didn't quite mandate the method managements use to figure out option costs, giving them wiggle room. Hence many companies have rewired the black box of accounting, the options pricing model, to ease the earnings hit--chiefly by tinkering with projected volatility assumptions of the underlying stock.

How do we know they rejiggered their models? A study of Russell 1000 companies by Nashville research firm New Constructs found that 210 of them changed their assumptions for 2004 awards to make earnings deductions seem less onerous. While the 2004 options grants are the last with no impact on earnings, it means these outfits have their formulas in place and lab-tested for 2005, when option hits occur in earnest.

A sampling of these wily companies indicates how this game works. Under the old methods, companies would have had to deduct 8 to 41 cents from their earnings per share in 2004. But they adopted a new, more forgiving approach that lessened that bite to just 4 to 28 cents (*see table*), according to New Constructs analysts Kiran Akkineni and David Trainer. For 2005, when option expensing goes live, says Trainer, "Reported numbers won't be what they should be for many companies."

The key component in the options-expense model that New Constructs' 210 companies monkeyed with is volatility. That's the degree to which the price of the company's shares fluctuate in the stock market. Using a little creative accounting, the companies cut their volatility figures by an average of 17 percentage points in fiscal 2004 over 2003, reducing the earnings smackdown from options by a quarter, or $1.4 billion, to $4.4 billion from $5.8 billion. While company disclosures of their new formulas aren't very good (they at least report volatility assumptions and options expense), New Constructs recalculated volatility for 2004 by applying the companies' historical methods, used pre-2004, to their reported EPS results for 2004.

Whether employing the well-known Black-Scholes model or any other, a company typically will arrive at the volatility number by using stock fluctuations from three to five years prior, then estimating volatility for the life of the option. The higher the stock's projected volatility, the better the chance that the option will land in the money--that is, that the recipient can exercise it and take a gain.

Suppose a company's stock is at $50, and an employee gets an option granting him the right to buy a share at $50 anytime in the next ten years. Say the stock's annualized volatility is 20%. Roughly speaking (precision would require a math treatise), this means that a 20% move up or down over the course of 12 months is typical for this stock. On the day of the grant the option has zero intrinsic value. That is, if the employee cashes it in, he gets nothing. But the so-called time value of the option is considerable. This is the amount that a gambler would pay for the paper, in the hope that the stock goes up.

Just how great this time value is depends on some complicated things, including expected interest rates and dividend policies. But as a rough approximation, the value of our hypothetical employee option is $10, explains Craig Cook, a senior manager in Grant Thornton's valuation practice. This would mean a $10 charge to the company's expense line, even though no cash outlay is involved. Of course, by the time the employee gets around to using the option, it may yield a lot more than $10, or a lot less. Or nothing at all.

EchoStar Communications, the satellite TV concern, freely admits in its 2004 annual report that its option costs were going to have "a material negative impact on our results." To cushion the earnings to a smoother 33% as of fiscal 2004 from a stomach-churning 64% under the old method, New Constructs' Akkineni figures.

In so doing, EchoStar's reworked option model spat out a newly minted option cost that would have cut its 2004 earnings of $215 million by just 10%, or $21 million, instead of a hit of 15%, or $32 million. That shaves just 4 cents off its 46 cents earnings per share, instead of 8 cents without the move, says New Constructs.

In a filing, EchoStar explains how a lightning-bolt epiphany in 2004 led it to conclude that "unadjusted historical experience is a relatively poor predictor of our future expectation of volatility." And so it stripped out all the bad stuff, the "extraordinary events" that had rocked its stock in the past, though EchoStar doesn't find them alarming enough to disclose. It terms these events mere blips that didn't matter. The company won't comment.

New Constructs found that Gilead Sciences, a biopharmaceutical firm, also changed assumptions and expected volatility, slashing its stock option costs to $104 million in fiscal 2004 from what New Constructs says would've been $150 million under its old way. That's a cut of 24 cents a share, down from 35. Gilead won't comment. Biotecher Genentech saved a nickel a share with its maneuvering, utility parent Edison International 10 cents and XTO Energy 9, New Constructs finds.

The exact math these companies use for their new models is murky. Genentech says it measures "marketable instruments and comparative companies." Its assumptions, Genentech says, are "proprietary." Why the need for changing models? The argument won't wash that the market has seen so many anomalies in recent years that volatility numbers must be adjusted. After all, the overall market's volatility hasn't changed much. The S&P 500's at year-end 2004: 16%, down a tad from 17% in 2003, and 18% in 2002.

Easing the Earnings Hit

Using creative accounting, these companies rejiggered their calculations for 2004 to shrink deductions of options grants from net income.

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Company	**Earnings per share 2004**	**new method**	**old method**
EchoStar Communications	$0.46	$0.04	$0.08
Edison International	2.81	0.07	0.17
Genentech	0.74	0.20	0.25
Gilead Sciences	1.04	0.24	0.35
Lexmark International	4.38	0.25	0.41
Xilinx	0.89	0.28	0.33
XTO Energy	2.03	0.20	0.29

Note: Prior methodology is the companies' practice of estimating volatility as of 2003.

Source: New Constructs.