

# THE WALL STREET JOURNAL.

## 'Kind of Right' Isn't Good Enough

By Craig Barrett

23 April 2003

[The Wall Street Journal](#)

Over the past 18 months we've seen many companies restate earnings, enter bankruptcy or worse -- among them corporate behemoths like Enron and WorldCom. In response to the crisis of public confidence, Congress and the SEC have attacked the issue with the Sarbanes-Oxley Act and SEC certification procedures. I agree that it's our job as CEOs to enforce proper controls within our corporations, and I support these reform despite the substantial time commitment required for new compliance activities.

Unfortunately, Sarbanes-Oxley is running head-on into the laws of unintended consequences.

Recently, the Financial Accounting Standards Board voted unanimously to proceed with plans for determining how to expense employee stock options. Treating options as an expense will present a significant conflict for companies like Intel that offer broad-based employee stock-option plans, and we are opposing the effort. Employee stock options do not create a cash cost like salaries or rent, and they do not have a market price since they cannot be sold. To record an "expense," companies would have to create an estimate for the value of the options.

The usual method for expensing employee stock options is to derive an estimate using the Black-Scholes model. But this model was not designed for valuing employee options, instruments that are not tradable. Despite results that are inherently inaccurate and unreliable for this purpose, Black-Scholes is the only model available.

To see how unworkable the model is, consider Intel's experience from 1995 through 2002. The information in question is published in the footnotes of our annual report and is widely available. If we had been required to expense options using Black-Scholes during this period, we would have expensed over \$3 billion just for the portion of those options where the price is currently underwater (where the exercise price is higher than the current market price). These options may never be exercised unless the stock price increases in the future -- yet we would have to carry their "value" as an expense.

In addition, regardless of price, we also would have had to record an expense for vested options that will never be exercised because they were granted to employees who have since left the company. Black-Scholes does not give an accurate representation of the financial picture at Intel. In fact, a \$3 billion error is so large that it makes a mockery of all the controls, certifications and accounting demands that Sarbanes-Oxley invokes.

Recent comments from Paul Volcker, current chair of the group with oversight responsibility for the International Accounting Standards Board, Robert Herz, chairman of FASB and others, concede the fallibility of Black-Scholes. The Economist magazine

recently cited Mr. Volcker as saying, "It would be better to expense inaccurately than not at all." That's not exactly a ringing endorsement.

If the standard-setters who support stock option expensing were required to certify their work, I wonder whether their tolerance for inaccuracy would be the same? I know of no situation where it would be acceptable for a CEO to certify that a company's results were "kind of right" -- the term used by FASB's Mr. Herz to describe the results produced by the Black-Scholes model.

Suppose FASB requires companies to expense options. Per Sarbanes-Oxley, as CEO I have to certify that Intel's quarterly and annual financial statements "fairly present in all material respects the financial condition, results of operations, and cash flows." Failure to sign these certifications could result in SEC sanctions and criminal penalties. Since I don't believe Black-Scholes provides an accurate picture of the financial condition of our company, how can I certify our financial results using it to guesstimate the cost of options?

What value is it to the investing public to have to rely on numbers that include this guesstimate? Is it any wonder that the financial analysts tell us that if we start expensing options they will simply factor out the expense using a pro forma profit and loss statement to get at the real financial condition of the company?

If stock-option expensing becomes reality, it leaves CEOs with two options: Comply with Sarbanes-Oxley and certify as accurate numbers that are inherently flawed. Or, support the spirit of the new law and refuse to sign off on the numbers because we don't believe they present an accurate financial picture.

I support corporate reform, but with all due respect to Mr. Volcker, Mr. Herz, Warren Buffett and others, results that are "kind of right" aren't good enough.

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Mr. Barrett is the CEO of Intel.

### **UPDATE 3-Intel's Barrett raises stakes in options battle.**

By Daniel Sorid and Deepa Babington  
23 April 2003  
[Reuters News](#)

NEW YORK, April 23 (Reuters) - Intel Corp. Chief Executive Craig Barrett on Wednesday suggested CEOs may refuse to certify financial results if stock option expensing was forced upon them, opening a new front in the bitter battle between accounting rulemakers and the tech industry on the issue.

In an interview with Reuters, Barrett criticized the Financial Accounting Standards Board, which sets U.S. accounting rules, and suggested the fight against stock option expensing was far from over.

"FASB is being a bit disingenuous in terms of their inviting opinion, inviting discussion, on whether options should be expensed or not," Barrett told Reuters. "They went directly from Enron and WorldCom to 'Let's figure out how to expense options because there's this public outcry against CEO compensation.'"

Barrett's comments mark the first time a major U.S. company, let alone the world's largest microchip maker, has argued that civil disobedience could be a suitable response to such a rule. The remarks, penned in an opinion piece in the Wall Street Journal, come as FASB pushes ahead quickly to formulate new rules requiring companies to treat stock options as a regular expense.

Like many of his peers in the tech sector, Barrett argues that the most widely used model for valuing stock options - the Black-Scholes model - comes up with a wildly misleading figure for stock option costs and in turn, would lead to misleading financial statements.

But in a twist to that argument, Barrett adds that by swearing by those options calculations, executives might end up violating the Sarbanes-Oxley Act, passed in the aftermath of the accounting scandal that brought down Enron Corp. (ENRNQ.PK), which requires executives to swear that their financial statements are accurate.

FASB added a project on stock options to its agenda earlier this year and on Tuesday agreed it would focus on treating options as an expense. The group has said it will try to find a better way to value options, if possible.

A stock option gives the recipient the right to buy shares at a fixed price before the option expires. "If stock-option expensing becomes reality, it leaves CEOs with two options: Comply with Sarbanes-Oxley and certify as accurate numbers that are inherently flawed," Barrett wrote in his op-ed piece. "Or, support the spirit of the new law and refuse to sign off on the numbers because we don't believe they present an accurate financial picture."

Barrett dismissed as "speculative" the question of whether he would ultimately refuse to sign off on Intel's financial statements if stock-option expensing became mandatory. But he said he had discussed the idea with other technology companies and promised to continue lobbying aggressively against stock-option expensing.

"You're looking at the equivalent of a FASB tsunami or avalanche or steamroller coming down," Barrett said in the Reuters interview. "So we talk a lot in terms of, 'Well, what can we do to get our message out?'"

The technology industry, which relies on stock options to attract and motivate employees, has long fought against efforts to treat stock-option costs as a regular business expense, since doing so would pummel earnings at several tech companies. In the mid-1990s, the tech sector used its political muscle and fierce lobbying to beat back such a proposal from FASB.

"The people opposed to expensing options are looking for any way they can possibly find to support their position and raise concerns about expensing," Dennis Beresford, who headed FASB when it took up the stock options issue in the mid-1990s, said about Barrett's latest comments.

Initially, the tech industry argued that expensing stock options would force companies to rein in options grants and would hurt rank-and-file employees toiling in Silicon Valley. Lately, technology companies have pointed to the difficulties in valuing stock options as the main reason why they should not be expensed.

In the past, analysts have said it would be tough to kill the FASB proposal given the investor support for stock option expensing after a spate of accounting scandals.

"If I was superconfident would I have written an op-ed piece?" Barrett said when asked if he was confident of beating back FASB's efforts. "We're trying to get our message out, we're trying to work with the legislators, we're trying to resolve this issue, so it's an open question right now."

(Additional Reporting by Elinor Abreu in San Francisco).

## Valuating options

Robert S. McGee  
Financial Post  
28 April 2003  
[National Post](#)

Re: Option Rules: Certified Inaccuracy, April 25.

Intel's CEO **Craig Barrett** quite correctly points out that the Black-Scholes model is totally unsuitable for use when estimating the expense of employee stock options. There is, however, a much simpler alternative that ought to be considered by the Financial Accounting Standards Board:

1. The ultimate cost of an employee stock option is any positive difference between the strike price and the value of the underlying stock at date of exercise. That difference represents the amount that the treasury could have obtained had it sold stock by means other than options. Since the actual cost is not known until exercise date, there remains the question of how to estimate it and how to allocate the estimated cost to the intervening fiscal periods between vesting time and exercise time.
2. It would seem appropriate to estimate the cost to be allocated to an intervening period as the positive difference between the strike price and fair value of the underlying stock in that period. This may present a valuation problem for smaller companies whose stock is not publicly traded, but where valuation is not available or practical, book value could be substituted -- after all, we are only dealing with an inter-period cost allocation problem -- similar to depreciation.
3. When an option expires or is exercised and the actual cost (if any) is known, adjustments can be made within the year and/or to earned surplus of earlier years to reconcile the actual and previously allocated costs.
4. Until an option has vested, it cannot be exercised and has no commercial value. Thus the corporate treasury has foregone nothing, and there is nothing to expense. However, if the strike price of an option is less than the value of the underlying stock at date of vesting, the option has an immediate intrinsic value. That is the amount that the corporate treasury immediately foregoes, and that amount should be expensed at vesting time.
5. If the strike price is equal to or more than the value of the underlying stock at date of vesting, the option may serve as an employee incentive, but it has no intrinsic value. Thus the treasury has foregone nothing, and there is nothing to expense at vesting time.
6. Where the price of a stock deflates so that its value is less than the strike price and likely to remain so (underwater options), the option is unlikely to be exercised. In such

cases it would be appropriate to make expense and surplus adjustments to reverse the cost estimates already allocated

This approach simplifies an otherwise overly complex computation, is consistent with practical accounting estimating procedures ... and it is something that the general public would understand. Moreover, unlike the Black-Scholes approach, it is suitable for all companies whether public or private.

Robert S. McGee, CGA, Ottawa

### **Letters to the Editor: Running Out of Options**

29 April 2003

[The Wall Street Journal Europe](#)

Holman W. Jenkins Jr. argues ("Much Ado About Stock Options -- The Epilogue," April 24) that stock options should not be expensed because 1) no one cares anymore whether they are expensed, i.e. it's now a non-issue 2) options issuance is already perfectly understood by investors thus necessitating no change in the definition of earnings and 3) the tools to measure the value of stock options are bunk. All of these arguments are flawed.

If stock-options accounting is not an important issue then what is Intel CEO Craig Barrett doing penning an article ("Not Good Enough," April 24) on this very issue on the same page as Mr. Jenkins' article?

As to Mr. Jenkins' second point -- that investors already perfectly understand the stock option issue so nothing further needs to be done -- I found from my experience presenting to hundreds of professional investment managers that stock-options accounting is not well understood. Individual investors, lacking the in-depth training in accounting and valuation methodologies that many professionals have, are even more in the dark. Professional investors often use discounted cash flow and other cash-flow return models to value companies, sidestepping some of the flaws inherent in the current definition of earnings. The urgent need for options accounting reform stems from individual investors' frequent reliance on earnings, and through earnings, the P/E ratio, as a valuation tool.

So what are investors missing when they use earnings under its current definition? Let's take a look at another of Jenkins' assertions. He states that the proposed options expense "deduction would occur without any of the company's cash having disappeared or become any less available for other purposes."

From the current shareholders' point of view this is incorrect. Options issuance diverts the firm's future cash flows away from current shareholders. It does this because it creates expected future dilution. The same future returns flow to a greater number of shareholders, so less to each current shareholder.

Mr. Jenkins then picks up on one of the favorite recent arguments of the anti-expensing camp, that measurement of the value of stock options is flawed because it relies on "esoteric mathematical operations." In fact, the model most commonly used to value employee stock options, the Black-Scholes options pricing model, is used by options traders and many investment professionals, and while not perfect, does a good job of approximating the market value of options. Crucially, the model also approximates that portion of a firm's future returns that are diverted away from current shareholders as a result of the dilution effect -- precisely what shareholders need to know to adjust downward the future returns they should expect in the presence of stock options.

Mr. Jenkins is right about one thing though: investors should not be overly reliant on earnings, what he terms the "earnings fetish." Earnings are only one of many financial indicators. But that is no reason to turn our back on improvements to make the earnings number more meaningful.

Barry Ehrlich, London

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In his April 24th op-ed, Craig Barrett discusses the Financial Accounting Standard Board's imprudent efforts to mandate the expensing of employee stock options without a clear-cut and accurate vision of just how stock options can be valued reliably. The result, as Barrett notes, is the likelihood of a new accounting standard that will complicate the income statement with new, confusing, and unreliable numbers.

The FASB has been driven to their untenable position by the International Accounting Standards Board, which has its long-term mission the harmonization of accounting standards on a global basis. It seems odd that the IASB would target stock options accounting as an early candidate for global standardization since employees stock options are one management tool used pretty much exclusively by American companies.

Why is the IASB focusing on options accounting? As the IASB itself noted in a background paper published last year, "when national standard setters have attempted to introduce new standards on accounting for share-based payments, a common concern of their constituents has been that entities in their countries would be at a competitive disadvantage if standard setting bodies and their constituents have emphasized the need to deal with this topic at an international level."

Who are these anxious "constituents"? They are mostly European corporations and economic bureaucrats who find it difficult to compete with America's entrepreneurial culture, which has long relied on stock options to encourage key employees to think like owners. The United States is the Seabiscuit of the world's economy, and what the IASB is trying to do, at the behest of its "constituents," is to place a little regulatory lead in our saddlebags. It's disheartening to see the FASB, in the name of misplaced accounting purity, assist in this endeavor. Perhaps the time has come for American business leaders, investors, and employees -- as perhaps Congress as well -- to reconsider the putative benefits of accounting multilateralism.

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