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To the members of the Board:

I write this letter to congratulate the Board for finally taking the step of requiring that stock options be expensed. Although there are some aspects of the proposal with which I disagree, on the whole it is a positive development in this unnecessarily long and contentious affair.

The voices in opposition to expensing have no basis whatsoever for their position on this proposal other than their own self interests. Their arguments can be easily disputed. I provide the following brief analyses.

The argument that disclosure is adequate. If disclosure is adequate, then investors already incorporate information on these costs into their assessments of the value of the stock. In that case, charging these costs as expenses would have no harmful impact on shareholders. Studies have already shown that companies that voluntarily expense suffered no negative effects. (For references, see my paper cited below that provides a survey of the literature on expensing.)

The argument that options are critical to economic development, particularly in certain key industries. This argument depends on the assumption that companies would no longer use options or would not substitute other forms of compensation and incentives. Moreover, the argument ignores the fact that not expensing options generates costs of misinformation, whereby analysts and investors are unable to accurately assess the true cost of these instruments and could penalize companies accordingly. Expensing options would remove some, if not most, of these costs.

The argument that options are a needless distraction from more serious problems of executive compensation and corporate governance. Options are so widely used that it is hardly surprising that executives who engaged in fraudulent activity benefited from holding them. But the executives would have benefited had there been no options. Options are not the smoking gun and discouraging their use will not reduce the incidence of fraud. Moreover, if options are expensed, there will be greater transparency, which is a strong deterrent to fraud.

The argument that if options are expensed, lower level employees will be hurt the most. There may be some truth here, but to use this argument is to suggest that companies would not find other ways to compensate and incentivize employees and that it is nonetheless acceptable to pay employees with company resources that are not accounted for, just because they are employees and not executives.

The argument that options are not even an expense. Indeed some options will never vest or others will vest but expire with no value. This problem can be handled by requiring marking-to-market, a recommendation you have not made, but one that I strongly support (see my arguments below). The other aspect to this argument is that expensing options results in double counting because the number of shares is already included in computing diluted earnings per share. This argument is totally false and exhibits either complete ignorance of accounting principles or incredible self-service. If a company issued equity and used the proceeds to pay expenses or buy depreciable assets, income would be reduced due to the expense and the number of shares would be increased. Recognition of the expense is one thing; how the expense is paid is another. No accountant or financial expert would argue that accounting for how the expense is paid, without accounting for the expense itself is proper. Also note that restricted stock, which must be expensed under current rules, is also dilutive but no one is arguing that it should not be expensed.

The argument that expensing will tempt many firms to abuse the flexibility offered by option valuation models and manipulate earnings. Companies already manipulate earnings within generally accepted accounting principles. By expensing options, companies will at least be forced to state publicly their assumptions and investors and economists can more easily validate these numbers. It is unbelievable that someone could argue that transparency will encourage manipulation. The current method, under which options are expensed at zero value, is the ultimate manipulation.

The argument that option pricing models are not sufficiently accurate to support expensing. This is the closest anyone can come to a valid argument. The process of option valuation is complex, particularly in light of the special characteristics of these options. But it is far better to value these options in the best way we can and record an estimate of the cost than to continue the current system of valuing them at zero and pretending this is the true cost. But even if option valuation models are highly inaccurate, it is disingenuous for companies to use these instruments if they really believe they have no idea of the values of the options. Would a company enter into an acquisition or develop a new product if it could not obtain estimates, however uncertain, of value? Accounting statements are full of estimates. We should not impose greater demands on option values than we do on the values of depreciable assets, pension funds, or loan loss allowances.

These arguments voiced by the opposition are self-serving and simply do not hold water.

I have analyzed the proposal in great detail. I find that it comes up short on a significant matter. These options should be marked to market, that is, revalued each quarter and adjusting entries should be made. In FAS 133 you affirmed the importance of providing market valuations for other derivatives. These executive and employee

options are derivatives and should be handled accordingly. Moreover, with marking to market, the ultimate expense will be the final true values of the options.

One other matter that concerns me is the attempt to incorporate vesting and forfeiture into valuation models. Let me clarify these points. Forfeiture must be viewed as having two types: pre-vesting forfeiture and post-vesting forfeiture. The effect of failure to vest because the employee leaves or is fired can be easily accommodated within a binomial model by restricting early exercise (this does depend somewhat on *how* the binomial model is being used). Post-vesting forfeiture, the effect of an option either being abandoned or exercised early due to the employee leaving the company or being fired, should not be handled within the valuation model. The current state of knowledge is such that this factor cannot be properly accounted for within the models, because the risk imposed by it is not one to which option holders or issuers are indifferent, as is assumed by the model. As such, economists and accountants are spending needless amounts of energy trying to incorporate these effects into models that are not capable of handling them. This does not mean that adjustments should not be made to reflect these effects in the accounting entries, but these adjustments should be external to the valuation models. There is an analogous procedure in accounting principles, the recording of depreciation expense. Determining this expense is done by taking the asset cost, subtracting an estimated salvage value, and allocating the difference over a period of time (the expected life) according to a specific schedule. The estimated salvage value, however obtained, is a highly uncertain estimate of the future selling price of the asset. In many ways it is analogous to an option value, although it is likely to be much less accurate than a value from an option pricing model, which at least has an analytical foundation. But in any case, the salvage value is internalized within a modeling process. The remaining factors (estimated life and rate of depreciation) are external to the process of determining the salvage value. Executive stock options should be done in a similar manner: the option value should be estimated separately from the risk associated with vesting and forfeiture. That latter should represent adjustments made to the estimated option value to obtain the accounting entry.

Please see my paper, "Expensing Executive Stock Options: Sorting Out the Issues," which can be downloaded at

<http://www.bus.lsu.edu/academics/finance/faculty/dchance/Research/ExpensingExecutiveStockOptions.pdf>

for more details of my recommendations. In addition, the paper contains an extensive survey of the issues and the literature associated with the expensing of these instruments. There has been a large body of research on valuation models for these options, and I am confident that, even though we know a lot more now than we did five years ago, we'll know a lot more in five more years.

I strongly urge you to not buckle under to self-serving political pressures. While I do not believe your proposal should be the final word on the matter, I do believe the proposal should become policy for the time being. From that point forward, I hope the Board will be receptive to new knowledge on the best ways to value and account for these options.

Sincerely,

