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Financial Accounting Standards Board  
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The following is an alternative approach to expensing stock options. When I started with what was then Ernst & Ernst in 1949, one of the first principles I learned was the conservative approach that gains were not to be recorded until realized but that losses or expenses were to be recorded, if only on an estimated basis, as soon as known, and that some unusual items were to go directly to retained earnings and not be in operations. I believe that these principles are still appropriate, and that as we move away from them by use of arbitrary formulas like the Black-Scholes options valuation method, we are making financial statements too complex and too mixed with non-operating items to be understandable by ordinary readers.

In my opinion, the true cost of a stock option is only known when the option is exercised and is the difference between what the person pays for the stock and what the company could have sold it for in the open market. Anything else is artificial and false. The option may never be exercised due to termination before vesting or the option not being in the money. On the other side, would we believe that the recipient should record and pay or provide tax on accounting cost the company is recording? While in some ways I would prefer to recognize no cost until exercise, on the principle that a loss is to be recognized when known, I propose that a cost be recognized at the end of each reporting period by providing an accrual measured by the difference between the exercise price and the market price at that date, whether or not vested. No accumulated gain would ever be recognized. However, if the market had declined since the last valuation date resulting in a lower accumulated cost to the company, the provision for the loss would be reduced, resulting in a gain in that period. On a termination without exercise, any previous provision for loss would be reversed. Upon exercising the accrual would be closed and the company would record proceeds of stock sale as if sold at the then market price. This method has the great advantage of recording the true rather than an arbitrary cost and I believe would defuse the argument by those opposed to any recognition of the cost that the cost is arbitrary.

There is still the problem of financial statements being made more obscure by inclusion of non-operating items. This is a growing problem as we move more to marking things to supposed fair value and burying these adjustments in other numbers. Recently, I had

occasion to read the 2003 annual report of Elan PLC, an Irish company, which prepared its financial statements in accordance with Irish GAAP. Under this approach, the Statement of Operations is prepared in three columns: Before Exceptional Items, Exceptional Items, and Total. Exceptional items are defined as those items that in management's judgment are material items which derive from events or transactions that fall within the ordinary activities of the Group and which individually or, if of a similar type, in aggregate, need to be disclosed by virtue of their size or incidence.

Since probably the most important use of financial statements is to form a basis of projecting future results, it is absolutely essential that nonrecurring and non-operating items be disclosed. The fact that GAAP is burying some of these items is a major problem today. It is resulting in pro forma statements on a non GAAP basis being provided by many responsible managements. There need to be standards as to what is exceptional, and I realize that this is a problem, but unless we move to this approach, GAAP statements will be seen as increasingly irrelevant. A major problem today is earnings in the Wall Street Journal sometimes showing exceptional amounts, often none shown although present, and often unclear if the amounts shown are before or after tax, and seldom showing how much they are per share.

I like the concept of "exceptional" items better than unusual, non-operating, extraordinary, non-recurring, or other description. The idea in exceptional is really that the item is one anyone attempting to evaluate the reported result would need to know to make a fair judgment. In the case of a cost related to stock options, were these costs to be recognized as I propose above, they would not be exceptional. However, if recorded all at the time of exercise or by some arbitrary formula would need to be considered as exceptional as the cost would be unrelated to operations of the period. In any event, whatever basis is used for recording the costs, the costs should be disclosed for a time, as inclusion makes the statements not comparable with prior periods by an amount that a reader needs to know.

I strongly urge you to take a look at the Elan statements and seriously consider proposing that approach and avoiding complex arbitrary approaches like Black Scholes formula. If FASB does not do that, I fear that GAAP financial statements will lose most of their value. In fact, they already have done so, in my opinion. I serve on committees responsible for investing endowments of non profit organizations. When I try to get other members to look at annual reports of companies owned, they mostly say, "You do it and tell us what we need to know. We cannot make sense out of the financial statements anymore." This situation cannot be allowed to continue. We cannot have 200 page annual reports with the same thing said in the Chair and CEO letter, the MD and A, and the notes. Nobody will read and attempt to understand all this. If nobody but a CPA or a professional financial analyst will read or can understand our financial statements we will have failed in our responsibility as a profession. The stock option issue provides an excellent time to address these issues.

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