

Loren D. Mellendorf

*7369 Catboat Court
Fishers, Indiana 46038
June 22, 2005*

Letter of Comment No: 6
File Reference: 1102-SCU

Financial Accounting Standards Board
401 Merritt 7
P.O. box 5116
Norwalk, Connecticut 06856-5116

Subject: Accounting for Stock Options

Dear Sirs:

Enclosed (copies of material I forwarded to you on November 18, 2002) still seem to represent a better solution to recording the cost for stock options than the reporting deemed appropriate by the Board. To date I have had no acknowledgment, response or indication as to why the procedures proposed were not superior to the considerations then being given to this subject by the Board nor why they do not represent a superior solution to the stock option expense reporting that was deemed appropriate by the Board. Isn't it time to eliminate the bickering in accounting, business and financial circles and reach an understanding that is hard and fast.

Problem one is that if the price of a share of stock can not be predicted accurately for tomorrow, it certainly can not be predicted years in advance. On the date an option is granted, it has no value. Additionally, the option value changes daily over its life. The person holding an option gets up every morning to check the paper to see what value the option has as measured by the changing market price. The difference in the option price and the market price on the date exercised is the full cost to the corporation and the total value to the option holder.

Problem two is how to report the change in value in financial statements. If an option for 10,000 shares at a price of \$10 per share is exercised when the stock is selling for \$30, the capital accounts of the corporation should increase \$300,000, just as they would increase \$300,000 if 10,000 new shares of stock were sold in the market on that day. In both instances, the par or stated value (assume \$1 per share) would increase by the same amount: \$10,000. For the open market transaction, paid-in capital would increase by the additional \$290,000 in cash collected. For the exercise of the option, the par or stated value would increase by \$10,000 and paid-in capital would increase by the additional \$90,000 cash payment to exercise the option. In addition, the Deferred Compensation Payable of \$200,000 would be closed to the paid-in capital account, making the total increase in paid-in capital \$290,000 the same as for the market transaction. The

capital accounts increases are exactly the same. The only difference is Retained Earnings is \$200,000 less because of the option expense recorded over the life of the option - 10,000 shares at \$20 (\$30 - \$10).

When directors award stock options, they are attempting to reward those persons who are expected to be major contributors to the increase in stockholder value over the option period. The daily movement in the stock price is the market assessment of the value being and expected to be generated. Isn't the change in market price for an accounting period times the shares under option the cost for the options to be exercised? That amount is easily determined for any accounting period by applying the change in market price for that period to the shares represented by options granted. The accumulated deferred compensation during the option period becomes paid-in capital when the options are exercised. Whether the option is currently exercisable, or not exercisable until a future date, would not make any difference in the option expense calculation.

Very truly yours,



Loren D. Mellendorf

Summer Residence (317) 915-8415

cc: Mr. Louis Lavelle, Dept. Editor- B-Schools, Business Week Magazine

Loren D. Mellendorf

7369 Catboat Court

Fishers, Indiana 46038

June 22, 2005

Mr. Louis Lavelle
Editor B-Schools
Business Week Magazine

Dear Mr. Lavelle:

Over recent years, I have read your articles in Business Week about the recording of expense for stock options. I believe it is proper to record stock option expense: but, to date I have not seen any logic in the directions issued by FASB. There should be no doubt that stock options represent deferred compensation for those granted the options. Directors' action in granting options should be combined with their requirement that appropriate recognition of option expense be recorded over the term of the options.

Option expense is the difference in the option price and the market price for that number of shares on the date exercised. Wouldn't it seem logical to record that difference incrementally in each financial reporting period until the option is exercised?

When an option is granted, it is expected that stockholder value will be increased over a time frame going forward. What better way to measure the expense of an option than the market performance of the stock over that time frame?

When an option is exercised, the total of capital stock and paid-in capital should be the same as if the same number of shares were newly issued in the market at the then-market price. The excess of market value over the option payment equals the accumulation of deferred compensation. Since that compensation will not be paid, it represents a gain from trading in its own capital stock and should be closed into paid-in capital.

The shareholder benefits when the share price increases, which is the result intended by the granting of options. The cost to the shareholders for that benefit is the option expense. The expense each year for the options reduces earnings and results in a smaller accumulation of retained earnings. Isn't that the intended result when you conclude the expense for stock options should be recorded?

Enclosed is a copy of a letter sent to FASB on November 18, 2002, wherein I offered a procedure to record stock option expense and maintain a capital structure the same as if the number of option shares were sold in an open market transaction.

Since there is still controversy, I have tried once again to convince FASB that I have offered a better solution by my letter to them dated June 22, 2005. (Copy enclosed).

If you agree, perhaps you could lend support in putting this controversy behind us and bring some practical reasoning to the accounting profession.

Very truly yours,
Loren D. Mellendorf
Loren D. Mellendorf

✓ cc: FASB

COPY

Loren D. Mellendorf
6140 E. Anderson Drive
Scottsdale, Arizona 85254

November 18, 2002

Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Subject: Accounting for Stock Options

Dear Sirs:

I am enclosing a suggested accounting treatment for stock options. This treatment will accurately reflect the fair value of stock options during the option period, properly report monthly net income, and will correctly record capital accounts. It is far less complex than FAS 123 and I believe it to be more accurate.

The Current Problem

Historically, the accounting procedure for stock options had two major problems. The first being the proper recording of the difference between the fixed price for the option and the market value of those shares when they are exercised.

The second problem (actually the other side of the first problem) was that accountants did not report the expense the company had incurred in providing the option over the life of the option. More recently, this problem was recognized and discussed in FAS 123, but not resolved. FAS 123 recommended an estimation of fair value for the option at the date of grant with amortization over the life of the option. FAS 123 stated a complex method to determine the fair value of a stock option (in fact on the date of the grant it has no value). In attempting to establish a current value for some future development, it became entangled in concern for a vesting period, ignored future price fluctuations, and lost touch with the realworld.

Assuming the optionee is a factor in the price of a stock (a fact assumed by the Board of Directors), the amount of deferred compensation earned by the optionee for the results produced is only determinable by reflecting the changes in the price of the stock. For different time frames, this may be either a plus or a negative, but will never be a net negative for the expired time from the granting of the option. The value of the option viewed by the grantee will increase or decrease over the option period as a result of the success or failure of the optionee. The change in market price is the measure of that value and needs to be the factor used to record the deferred compensation expense for the option. At issuance of the option there is no value to either the company or the optionee. Unfortunately, FAS 123 is estimating what can be accurately calculated as it is earned, and thus loses sight of the total consequences of the granting.

The IRS deferral of income from stock options until the optionee sells the stock has clouded both these problems. This deferral has caused concentration on the purchase side of the stock and not the operations of the company. Since the cost to the company for the option is not tax-deductible, its cost has been slow to be recognized. There is never a current or deferred tax consequence as the result of a stock option under present IRS rules.

I am reminded of a personal experience about 40 years ago. The CEO asked me to come up with a plan to solve a complex financial problem. There were a lot of nuances to deal with and I offered a solution to the CEO. He called in the news media to announce a breakthrough. His unfamiliarity with all the details led to a minor disaster and killed the plan. I learned the KISS principle that day and have tried to follow it ever since - KEEP IT SIMPLE STUPID.

Reasons for Granting Options

Boards of Directors see a direct relationship between the efforts of key personnel and the growth in value of the investment held by shareholders. They see a stock option (making available a set number of shares at a pre-established price per share for some period of time) as a way of sharing with that person the increase in the value of shareholder investments brought about by the optionee's efforts. By having a locked-in price, the optionee is able to share in any value increase when the market price of a share of stock increases. If the value of stock does not increase, the option has no value. The change in the value of the option can be determined and recorded for any financial reporting period as a

result of the change in market price. This is exactly what an optionee does every day---look up the price of the stock and multiply his option shares times the increase or decrease in price!

Proposed Solution

NOTE - Stock-based compensation should be dealt with in two parts. The first I will call a pure stock option: the option price being equal to or above the market price on the date of the grant. The second would be all other. This discussion deals with only pure stock options. The value of the option at any point after granting is the current market value for the same number of shares covered by the option less the fixed price to make the purchase under the option..

First, for any financial reporting period, make a calculation of the change in value of the option by using the current market price for the option shares compared to the prior period's value for that number of shares.

Second, record that increase by charging Deferred Compensation - Stock Options (an expense account) and crediting Deferred Compensation Payable (a liability account). For a decrease make a reverse entry.

Third, record a transfer from the Deferred Compensation Payable to the Capital Surplus (Paid-in Capital) account when the option is exercised.

These actions will eliminate the two problems previously outlined.

The first problem was how to deal with the difference between the exercise price and the market price for the option shares. Under this proposal, on the date the option is exercised, the capital structure of the company will increase by the market value of the shares sold. There will be a recording of the stated (par) value of the shares sold and an increase in capital surplus (paid-in capital) for the payment in excess of par value. The closing of the Deferred Compensation Payable to the capital surplus (paid-in capital) account as previously referenced will then bring the total capital to the same balance as if the stock was sold at the then market price. Retained Earnings will have been reduced by the cost for the options over the optioned period and correct reporting will have resulted.

The shortfall of cash from the optionee to cover the market price for the stock being purchased is in effect the deferred compensation now being paid to the optionee and returned to the company in the way of paid-in capital - all of this a non-taxable transaction in the eyes of the IRS. This deferred

compensation was earned by the optionee from the date of grant to the date of exercise.

Under this plan, both the capital structure and the cash received from the exercise of stock options are accurately recorded. This procedure accurately records the deferred compensation as measured by market price and it does it as it is earned. It avoids a too-common trap for accountants of recording a complex entry net of all its elements. This procedure also complies with the KISS principle.

The second problem as outlined above was that accountants have not recorded an accurate cost for the option over the life of the option. Under this proposal, the accurate cost is recorded each financial reporting period, whether it is an increase or decrease. It should be noted that the Deferred Compensation Payable can never be reduced below zero---at that point the option has no value.

The company expenses are thus accurately measured each financial reporting period and are properly reported in the monthly net income of the company. Per share data is already being reported on an actual and fully diluted basis; therefore, the shares under option would be included as outstanding for purpose of reporting fully diluted numbers.

My Background

- Retired as Executive Vice- President and Chief Financial Officer for American Water Works Company in 1991 after twenty-five years.
- Treasurer and Asst. Controller with Indianapolis Water Co., leaving after almost nine years.
- Public accountant with PMM & Co in Indianapolis for nearly ten years.
- Obtained my CPA certificate from Indiana in 1954.
- Member of the Indiana CPA association for 48 years

I look forward to hearing from you. If there are any questions I have left unanswered, I may be contacted at my winter residence here in Scottsdale or by telephone at (480) 443-3969.

Very truly yours,


Loren D. Mellendorf