

Comments of John B. Clinton, CPA and Managing Partner, Conning Capital Partners

I write to comment on the proposed accounting for stock options. I am a CPA and have been responsible for the preparation and analysis of financial statements. As an experienced private equity investor, I regularly sit on boards where we determine the role of equity-based compensation paid to management. I feel that I have applicable experience and insight.

My opinion has been developed over the past 25 years - I feel strongly that stock-based compensation is not a transaction of the company itself, but a transaction occurring between the shareholders of the company and the individuals to be compensated. The accounting should follow the underlying facts, and not reflect options as an expense of the company. I note the following:

1. All equity-related compensation programs are approved by the shareholders, and in every board I have served on, public or private, specific grants under those programs have required board level review and approval. This shows the willing participation of the shareholders and their representatives in these transactions.
2. The options are awarded based on past or promised future performance, generally defined as a measure based on the financial statements. This shows the consideration paid to the shareholders, and points to an auto-reflexive character to any accounting that expenses equity-based compensation.
3. The valuation of companies is based in expected future cash flows arising from share ownership, and the effect of stock options and grants is and should be reflected in the calculation of earnings per share. This accounting is desirable and consistent with historical financial statements. The EPS calculations are also important indicators of the economic reality of merger and acquisition economics, and changing stock option accounting would have the effect of de-emphasizing this important disclosure.
4. The alternative accounting treatments are unworkable. The valuation of the options is so uncertain and will be so inconsistent that there will be reduced comparability of statements across companies. The footnote disclosures related to option valuation are expected to be opaque, and make an unreasonable requirement for the math skills of the average reader of financial statements.
5. A material non-cash item will distort the income statement. I serve on boards of start up and expansion stage companies. These companies operate near breakeven cash flow, and the users of financial statements focus on EBIT as an important measure of the company's progress. A material non-cash item reduces the effectiveness of the EBIT measure.
6. Users of financial statements will not find the new information useful. I am an active director, and represent an investment fund that typically owns 20% to 50% of a given company. I am normally involved in the compensation planning decisions of a company. In that role, I am confident that I can negotiate an equity compensation package that delivers to all shareholders a motivated management and employee group. I am comfortable and confident that the current stock option accounting is appropriate for my use and the use of other stakeholders. The proposed accounting provides information that I have not asked for and will not find useful.

In addition to the accuracy and integrity of financial statements, I have been told that the drafters of the proposed accounting are also concerned about appropriate corporate governance over the award of stock options. I note that if accepted, the proposed accounting for options will cause a material distortion of the financial statements of those companies where shareholders already have the most intimate knowledge of and greatest effect on the management teams. The new accounting will not affect the ways in which options are awarded, and may diminish the role of shareholder and director approval in determining option awards.

Thank you for the opportunity to share my views. I would be pleased to provide expanded supporting testimony.

Sincerely,

John B. Clinton, CPA  
Managing Partner  
Conning Capital Partners