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Letter of Comment No: 44
File Reference: 1102-100

From: Schoenberg Steven [sschoenb@cisco.com]
Sent: Tuesday, April 20, 2004 1:36 PM
To: Director - FASB
Subject: re: File Reference No. 1102-100

An interesting article:

Expensing Stock Options Is a Faddish Fraud

by Alan Reynolds

July 18, 2002

Alan Reynolds is a senior fellow with the Cato Institute.

Coca Cola, Bank One and The Washington Post will soon begin to "expense" the cost of employee stock options (ESOs). In reality, what is being expensed is not an actual cost at all, but a wildly inaccurate estimate of the "fair" value when options were granted. And the ample information stockholders now receive about other companies' ESO plans is about to vanish for these three.

For other companies, there is more than enough information about stock options in the annual reports. Joseph Stiglitz, writing in The Wall Street Journal, claimed stockholders have to "read through dozens of footnotes to find the implications of options." Actually, notes to financial statements are in full-sized type and full of tables. There is only one note about ESOs, not dozens, and it usually requires 2 to 6 pages. Stiglitz also claimed companies conceal "how much their equity claims on the firm could be diluted by options." But that information is highly visible in diluted earnings per share.

The "footnote" shows how many options were granted and exercised at what prices, and how many old options were trashed because the stock fell or employees did not stay long enough to be vested. The footnote also provides a Black-Scholes estimate of the approximate "fair value" of newly granted options if they could be sold and hedged. It is this estimate -- not any actual cost -- that is about to be treated "as if" it were a cost by companies that adopt expensing. Other companies put such pro forma games in the footnote along with their purely hypothetical impact on earnings. The reason for not treating these estimates as real money was explained in Talbots' annual report:

"The (Black-Scholes) option pricing model used was designed to value readily tradable stock options with relatively short lives and no vesting restrictions. In addition, option valuation models require the input of highly subjective assumptions including the expected price volatility. Because the options granted to employees are not tradable and have contractual lives of tens of years and changes in the subjective input assumptions can materially affect the fair value estimate ... the models do not necessarily provide a reliable measure of fair value of the option."

Jeffrey Garten recently wrote in Business Week that employee stock options should "be charged against corporate income when they are cashed in." Unfortunately, the Financial Accounting Standards Board (FASB) won't allow companies to do that. Instead, rules set down in 1995 by five of the seven FASB members only permit expensing of an estimate.

Apologists for treating estimates as actual expenses, such as Warren Buffet, claim these estimates are no more problematic than estimating how quickly a machine will wear out. That formulaic analogy is an evasion. In the case of depreciation, we know the exact amount of expense. The only uncertainty is about how quickly the expense should be written off. The estimated fair value of unvested stock options, by contrast, do not provide the slightest clue whether the actual expense at the time options are exercised will turn out to be zero or some figure hundreds of times larger than "fair value" when granted. There is no reason in theory or fact to expect estimated fair value to be even remotely similar to the actual expenses. Economists can also estimate the fair value of a lottery ticket, after all, but doing so tells us nothing about whether the jackpot will be paid, how large it will be or who will get it.

To promote its lottery-like accounting for ESOs, the FASB invites companies that expense their estimates to do away with all the useful information required in every other annual report. In the name of increased transparency, all information about employee stock options from Coca Cola, Bank One and The Washington Post is about to vanish completely. In its place, a meaningless and unexplained estimate of "fair value" will be mingled with other operating expenses in a way that will make future earnings statements inherently indecipherable and inevitably incorrect. It is about to become very difficult to make an informed long-term investment in any company that adopts this politically

4/20/2004

popular accounting gimmick.

To make estimated fair value the basis for cost accounting seems a foolish deception. But to make such estimates the basis for limiting tax deductions, as the Levin-McCain bill would have done, would be dangerous nonsense. Exercised options are actual taxable income for employees and an actual deductible expense for employers. Estimates, on the other hand, are just estimates.

This article originally appeared on Creators.com on July 18th, 2002.

Date: Tue, 20 Apr 2004 11:43:52 -0400
 To: director@fasb.org
 From: Schoenberg Steven <sschoenb@cisco.com>
 Subject: re: File Reference No. 1102-100

Dear Chairman Robert H. Herz,

My name is Steven Schoenberg. I am 32 years old and have been employed by two companies who were both very proactive in awarding employees hard work with ISOs (Incentive Stock Options). In 1994 I graduated NC State Univ and began work with a company in Morrisville, NC called Tekelec as a

Software Engineer. I was given 1000 stock options after my first year there vesting over 5 years. During that time the stock at Tekelec split 3 times and I made in excess of \$150,000 dollars from exercising those options. The company grew from 80 to near 1000 people from 1994 to 2000. My salary was much lower at Tekelec than other companies and I could have left Tekelec to earn more money, but due to the options I stayed there over 6 years. Stock options provided with me with the following:

- 1) incentive to stay at Tekelec
- 2) incentive to work harder at Tekelec and earn promotions to get more options
- 3) ability to get out of college debt and loans from exercising options
- 4) other financial benefits (purchase home, pay for wedding, new car, etc.)

Without those options the government would not have collected around \$50,000 in taxes and the shareholders would not have benefited from my hard work. If employers are forced to expense options I think it will be a negative impact to shareholders, employers, and employees. I feel the whole purpose of expensing stock options is politically motivated without any real thought to the damage the economy will suffer.

I now work for Cisco Systems who is even more enthusiastic about rewarding employees with options than Tekelec. Cisco employees near 30,000 tax payers who I know without a doubt will suffer in many ways if companies are forced to expense options. Here are my opinions of what will happen:

- 1) employee turnover
- 2) negative impact to employee moral
- 3) less consumer spending
- 4) quality of work will decrease
- 5) hours of work will decrease
- 6) less taxes paid

7) distrust of politicians who imposed this politically motivated bad idea

I urge the FASB to rethink how companies should expense an option that may never be worth anything, may never get exercised, and is really not an expense to the company. The P/E ratio is what is impacted when we exercise options. There has to be another way that is a win-win-win for shareholders, employers, and employees.

Steven Schoenberg
concerned taxpayer, shareholder, and employee of Cisco Systems Inc.