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Director of Major Projects
File Reference No. 1102-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Dear Major Projects Director:

RE: Share-Based Payment Exposure Draft

Introduction

I have supported the recognition of compensation expense for stock options long before the FASB put the stock-based compensation project on its agenda. I applaud the FASB for reconsidering its prior statement and for concluding that expense recognition is mandatory. However, I have also been a constant critic of the use of the grant date as the ultimate measurement date. Alas, the concerns that I have voiced to the FASB and the IASB in earlier comment letters, and in my appearance at an early public hearing of the FASB, have not been sufficiently persuasive. Undaunted (and at my age accustomed to periodic rejection), I will try once again to persuade the FASB of the errors of its ways. As my concern deals with a very fundamental issue, I will focus only on it and peripherally touch upon some of the other issues identified in the latest exposure draft.

Simply stated, my view is that pure vanilla stock option plans are contingent compensation plans for which the grant date represents the inception of the plan and the exercise date (or a later date if either the granting entity or the employee to whom the option was granted continues with some obligation related to the option or its exercise—for the sake of simplicity, this will be denoted “exercise” or “exercise date” in the remainder of this letter) represents the completion of the transaction and the point in time when the ultimate measurement of compensation expense should be made. The FASB’s grant date approach misses the entire contingent aspect of this compensation methodology, by treating the compensation as fixed as of the grant date.

Analysis of major arguments in favor of FASB approach

I see few pro arguments for the FASB’s grant date approach and those arguments are flawed:

Pro argument	The flaw
Compensation is recognized under the FASB approach.	The sounds nice, but it also means that compensation is recognized in situations

Pro argument	The flaw
	<p>when in the end (no exercise of the option because the option price has never been such to make exercise an economically viable decision). I acknowledge that there is an overhang during the holding period, but that can be recognized by use of an interim period recognition methodology that bases interim compensation expense on changes in the current market value of the underlying stock.</p>
<p>Compensation measured under the FASB methodology is a fixed amount at the grant date.</p>	<p>While those who abhor fluctuations in financial results cheer this argument, the methodology ignores the fact that such plans are contingent and are subject to value changes (often significant) between the grant date and the exercise date. Failure to recognize this as a substantive element of the compensation is sticking one's head in the sand.</p>
<p>The FASB methodology is consistent with that of the International Accounting Standards Board.</p>	<p>I think we all remember our mothers saying something to the effect, "If everyone else was jumping off a bridge, would you do it to?" We should not go for harmonization in cases when the other body is out of tune.</p>

Additional contrary views to FASB approach

The arcane measurement methodology employed by the FASB is too subjective, does not contain a reality check upon exercise, and is not reflective of how the grantee and the world view the cost of options.

Granted, many subjective approaches are used to determine measurements in financial statements. However, those methods include a reality check in that the accruals are adjusted to actual at the conclusion or settlement of a transaction—the amount initially recorded is not set in stone. Focusing solely on compensation related measurements—expenses related to all employee postretirement plans are initially determined on an estimated basis, but in the end the amount recorded in financial statements reflects what is actually paid (admittedly, spread out over quite an extended period of time, but still the actual cost is nonetheless recognized). I see no move to freeze these amounts based on the initial calculations. Similarly, wouldn't it be nuts to book an accrual for bonuses that are to be based on a percentage of sales at the inception of the bonus plan using an estimate of what the sales were expected to be and ignore the actual sales when they occur?

As a recipient of stock options, I can assure you that the holder of those options views the compensation element as the difference between the exercise price and the market value of the shares received on the exercise date. Accounting on this basis is more realistic, more understandable, and would better meet the needs of financial statement users.

The FASB approach treats the grant as an element of permanent capital of the grantor. In fact, if the option is cancelled or lapses without exercise, there is no permanent effect on the capital of the enterprise. I heard an FASB member indicate that to use an exercise date approach would be akin to having an enterprise constantly adjust its shareholders' equity for changes in the market value of its outstanding stock. Such a view places an option holder on the same footing with a shareowner, and this is clearly not the case. There are continuing obligations between the grantor and the grantee regarding the outstanding options, there are no similar obligations between an enterprise and its permanent shareowners. The accounting proposed by the FASB fails to recognize this.

The FASB has been moving steadily to mark-to-market accounting in many areas that involve unsettled transactions. Yet, while option accounting seems well suited for a mark-to-market approach, the FASB has opted for a market estimate only at inception of the transaction rather than at its settlement.

Possible government intervention in FASB rule making

I'd be remiss if I didn't comment on the moves in Congress to legislate the accounting for stock based compensation. I've had the opportunity to work in Eastern Europe in recent years and I've seen first hand the damage that is done when a government enacts laws to regulate the accounting that obfuscate the technically correct answer. The financial statements become meaningless and, even more troublesome, many users accept the legislated accounting as a fact and make erroneous decisions based on these financial statements. While I do not agree with the FASB approach, it is clearly more conceptually correct than the legislation that I have heard bandied about. I am opposed to any legislative interference in the objective accounting rule making process that we have in place in America.

Conclusion

Okay, I've said my piece. And, as Dick Cheney has recently said, "I feel better having done so" (or something to that effect).

I'll be happy to respond to any questions. My contact information is in the heading to this letter.

Very truly yours,

Michael P. Bohan