

Quality Financial Reporting®

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June 30, 2004

Dear Members of the Board and Staff:

We thank you for the opportunity to comment on the March Exposure Draft, "Share-Based Payment—an amendment of FASB Statements No. 123 and 95."

To begin, we congratulate the board on persevering to the point of proposing mandatory expensing of stock options. The preceding ten years have been awkward, even embarrassing, without a requirement for recognizing this expense on issuers' income statements. This draft culminates a major effort and we acknowledge your work in getting the project to this stage and we encourage you to withstand the continuing political pressure. The integrity of public financial reporting hinges on getting this requirement in place.

With that said, however, we find that your proposal could be strengthened. As you may recall, we sent a White Paper to the board in August 2003 that analyzed the alternative treatments of options under APB Opinion 25 and Statement of Financial Accounting Standards 123 and found them both inferior in their ability to transmit useful information to financial statement users. That paper also outlined the liability method that we consider to be superior, primarily because it reports everything that happens when it happens and in full, beginning with their issuance and continuing until they are exercised or lapse. At the heart of the method is the observation that options are derivative liabilities that obligate employers to sell shares to option holders at a discount and upon their demand. For your convenience, we have attached an updated version of the paper.

It describes the inadequate messages generated by the proposed method's use of the grant date measure and the vesting period for allocating that value. It also shows how that method is fundamentally an application of matching and thus inconsistent with the Conceptual Framework's asset/liability theory. As a result, it presents only some of the relevant facts and does not provide fully useful information to financial statement users.

We also want to describe four specific points in the Exposure Draft that we believe also contribute to this shortfall.

The first is the continuation of the incomplete recognition of the tax consequences of using options as compensation. As you know, the proposed method causes the full tax savings created at exercise to be omitted from the issuer's income statement, with the result that the total recognized tax expense over the options' life does not equal the taxes actually paid in the same period.

The second flaw is found in the same area. Specifically, we challenge the proposed requirement that the tax benefit from exercise be reported on the statement of cash flows as a financing inflow. While we see that this treatment is somewhat consistent with treating the exercise of options as issuing equity, we are perplexed by the notion that the cash flow statement should report a financing inflow when what has really happened is an accounting misrepresentation that causes the cash paid out for taxes to be less than the reported tax expense. In effect, you have proposed treating an unreported operating cash savings as a financing inflow. We are put in mind of the adage that "two wrongs don't make a right." That is, the basic treatment of the savings is flawed, and we are convinced that it cannot be wise to follow it up with another flawed representation on the cash flow statement. Rather, we urge you to require full and complete recognition of the tax consequences of exercising the options by reducing the tax expense down to the amount that is actually paid over the options' lives without crediting additional paid-in capital. Doing so would effectively eliminate the disconnect between the reported expense and the cash flows, thereby improving both the income statement and the cash flow statement.

Our third point concerns the intrinsic value method proposed as an alternative to grant date accounting for nonpublic companies and for managers who have difficulty estimating the market value of newly issued options. We find that it is partially consistent with the liability method described in our white paper with the exception of the valuation placed on the options throughout their lives and the classification of the balance sheet account as equity instead of a liability. On the one hand, we favor the intrinsic method over the grant date method simply because it eventually gets the full cost of the options into the issuers' income statements. On the other hand, we fault this method because it inevitably understates the expense in each year leading up to the final transaction and misrepresents the liability on the balance sheet.

While we do not encourage the board to mandate the intrinsic value method, we do encourage you to consider adding a requirement for disclosing the intrinsic value of all outstanding options. As stated in our paper, we also encourage full disclosure of the current market values of all outstanding options in order to allow financial statement users to apply their own versions of the liability method with greater confidence. We believe these disclosures respond to users' needs for more useful information.

Our fourth point addresses the Exposure Draft's theoretical rationale for the grant date/vesting period attribution method. Contrary to the argument and assertion that this treatment is consistent with the asset/liability method, we see the proffered reasoning as nothing more than an effort to justify a matching process. We also suggest that relying on this strained interpretation of the Conceptual Framework weakens the board's case rather than strengthening it. If you're going to apply matching, it would be far more transparent to explain that the proposed method creates an off-balance sheet asset with a cost that is slowly amortized over the vesting period. There is no validity in your suggestion that the passage of time creates a series of infinitesimal assets that are instantaneously consumed, thereby creating an expense. The proposed method merely defers a cost and systematically matches it with future revenues to be earned over a chosen period. These practices are in accordance with matching and cannot be justified with the asset/liability theory.

In closing, we again congratulate you for building a consensus in support of mandatory expensing. Although we're with you on that point, we believe your proposed method will fall short of providing as much useful information as would be provided by accounting for options as derivative liabilities, marked to market at each reporting date, and reported on the balance sheet as liabilities payable on demand.

Sincerely,

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