Letter of Comment No: 5300 File Reference: 1102-100



College of Business Administration

C. Terry Grant, Ph.D., CPA Professor of Accounting

California State University San Marcos San Marcos, California 92096-0001 USA

Tel: 760-750-4226 Fax: 760-750-4250 Email: tgrant@csusm.edu Web Page: www.csusm.edu/tgrant

June 24, 2004

FASB Director of Major Projects 401 Merritt 7 P. O. Box 5116 Norwalk, CT 06856-5116

Re: Comments on Share-Based Payment Exposure Draft, an amendment of FASB Statements No. 123 and 95; File Reference No. 1102-100

## Dear Director.

Thank you for the opportunity to comment on the share-based payment Exposure Draft. I strongly support most of the proposal. In general, adoption of the exposure draft would greatly improve relevance, reliability, transparency, comparability, and credibility of financial statements due to consistent recognition of employee compensation expense regardless of form of payment for those services.

Here are some comments targeted to specific issues summarized in the preface, "Notice for Recipients of This Exposure Draft."

Issue 1: I strongly support the requirement that compensation expense for all employee services received in exchange for equity instruments be recognized in the financial statements. As stated in paragraph C35, "The accounting under Opinion 25 treats most fixed share options as though they were a 'free good,' which implies that the services received in exchange for those options are obtained without incurring a cost." Of course, nothing could be further from the truth. The relevance, reliability, and comparability of financial statements are greatly impaired without consistent expense recognition for all employee services.

Issue 2: I strongly support the elimination of the current option under Statement 123 that permits enterprises to use Opinion 25's intrinsic value method as long as supplemental disclosures, pro forma net income, and pro forma earnings per share information is presented as if fair-value-based accounting had been used. As noted in paragraph C31, some respondents have commented "that mandatory recognition of the cost of employee services received in exchange for employee share options would inappropriately 'double count' the effect of granting share options. They note that the dilutive effect of in-the-money share options is included in the denominator of diluted earnings per share." As noted in paragraph

C32, "no expense (cost), revenue, or other element of financial statements is 'recognized' by including its effect only in earnings per share."

The argument that the dilutive effect of options is fully captured in the denominator of dilutive earnings per share has been pervasive by opponents to changes in share-based compensation accounting. In the past few years, the White House Council of Economic Advisors sought my views and those of other academics regarding this issue as political pressure mounted to intervene in accounting standard setting. Not only do I agree that dilutive earnings per share does not result in "double counting," in my view, whether or not expensing of share-based compensation is required, dilutive earnings per share is an unreliable measure of the impact of in-the-money share options.

In many cases, the treasury stock method fails to capture actual dilutive effects of stock options. In the calculation of dilutive earnings per share, the treasury stock method calculates the theoretical incremental increase in the number of shares outstanding as a result of potential exercise of in-the-money stock options. The methodology assumes that all proceeds from option exercise will be used by the enterprise to minimize the dilutive effect of option exercises through the purchase of treasury shares. My co-authors and I recently published a study that provides evidence that many companies, particularly those that rely most heavily on stock options, typically do not repurchase any shares (see "Impact of Employee Stock Options on Cash Flow," Ciccotello, Conrad S., C. Terry Grant, and Gerry H. Grant, Financial Analysts Journal, Vol. 60, No. 2, March/April 2004, pp. 39-46). We find that NASDAQ 100 companies tend to meet stock option exercises the most dilutive possible way—with previously unissued shares. The median NASDAQ 100 firm did not repurchase any shares during the 1999-2001 time frame. The median NASDAQ 100 company added almost 11 million shares outstanding from the excess of option exercises over repurchases during this time, an increase in outstanding shares of 5.2%. The study finds that NASDAQ 100 firms would have had to spend an alarming 39 cents of every dollar of revenue over the 1999-2001 time frame to fully fund option exercises and avoid increasing the number of shares outstanding. These findings demonstrate the high economic cost of stock options and illustrate the inability of the treasury stock method to present future dilutive impacts in a relevant and reliable manner.

In addition, the Exposure Draft defines proceeds from option exercise in a peculiar way. Per Appendix A of the Exposure Draft, paragraph 50, assumed proceeds are the sum of the exercise price that the employee must pay, the amount of compensation cost attributed to future services and not yet recognized, and the amount of excess tax benefits. Why is "the amount of compensation cost attributed to future services and not yet recognized" classified as part of assumed proceeds?

Issue 3: I strongly support the grant-date as the relevant measurement date; however, there should be an opportunity to revalue the eventual actual cost of the transaction. The proposal states that compensation cost will not be adjusted for either increases or decreases in share prices subsequent to the grant-date measurement. Paragraph C20 states that "No additional compensation cost is recognized subsequent to vesting because the exchange transaction has been consummated; the requisite service has been rendered by the employee and equity instruments have been issued by the entity—the exchange transaction is complete. The effect is similar to a warrant issued by a company for cash that expires worthless; the company

retains the premium received (in this case, services) and an increase in paid-in-capital, even though no shares ultimately were issued."

In my view, the transaction is more analogous to the accounting for warranty expenses or bad debt expenses than to the issuance of a warrant. The company only issues options at the grant date. No shares are issued until the options are exercised. Consequently, the actual cost of the transaction is unknown until the options are exercised, forfeited, or expire. Similar to the accounting for bad debt or warranty expenses, the matching principle appropriately dictates that an estimate of the expense be matched to revenues (in the case of options, typically expensed over the vesting period). But, in the case of bad debt expenses, warranty expenses, and other estimated costs, companies make adjustments to accrued estimates if actual costs materially differ from original estimates. Why should the accounting for stock options be any different? Stock prices can change dramatically before the options are exercised resulting in substantially different costs to the company to provide those shares when options are exercised. Due to interpretative difficulty, maybe the adjustment of previously recognized compensation expense would be best handled as part of comprehensive income rather than flowing it through the Income Statement. However, to ignore the differences between actual cost and estimated cost of stock options renders financial statements less reliable.

Issue 16: I strongly support the reclassification of excess tax benefits as a financing cash inflow rather than as an operating cash inflow. Classification of tax savings as operating cash flows can greatly distort the interpretability of the Statement of Cash Flows since these cash flows are not generated from the company's primary operations. In the previous referenced Financial Analysts Journal research paper, we demonstrate that the cumulative median (mean) option exercise tax savings for NASDAQ 100 companies as a percent operating cash flows is 13% (20%) for the period 1999-2001. For some companies, operating cash flows would have been negative without the benefit of the tax savings due to option exercise. These tax savings are much better understood if classified as a financing transaction. Operating cash flows are generally regarded as being generated from a company's central operations such as those generated from selling goods and services.

Impact of Exposure Draft on EITF Issue No. 90-7: I strongly support the nullification of FASB Interpretation No. 44. Numerous companies, including Worldcom, used the provision in FASB Interpretation No. 44 that permits companies to avoid variable accounting for repriced stock options by simply waiting at least six months and one day before replacing underwater stock options with new lower priced replacement options. See "The Stock Options Accounting Subterfuge," Grant, C. Terry and Conrad S. Ciccotello, Strategic Finance, Vol. 83, No. 10, April 2002, pp. 37-41.

Thank you for adding this project to your agenda. I strongly encourage adoption of most of the provisions in the share-based payment Exposure Draft.

Respectfully,

Temy Grant
C. Terry Grant