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**Letter of Comment No: 5295**  
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Dear Director of Major Projects – File Reference No. 1102-100

**RE: Stock Option Expensing – There’s A Better Way**

The proposed Statement of Financial Accounting Standards regarding share-based payments is poorly thought-out from a pure accounting perspective and without a clear understanding of the potential consequences.

Fortunately, there is a simple fix – a better way. One of the primary financial statements that public accountants certify to is the Consolidated Statement of Comprehensive Income (“CIS”). The CIS presents to users of financial statements items that the Financial Accounting Standards Board (“FASB”) has decided are too controversial to include in the Consolidated Statement of Income (“P & L”). Examples include adjustments in the Consolidated Balance Sheet for remeasurement of foreign currency fluctuations resulting in translation gains and losses, as well as unrealized gains and losses on certain investments in marketable securities that are judged to be temporary in nature.

Where the accounting result has been highly questionable, as is the case of stock option expensing, the FASB has in the past compromised by putting the questionable result in the CIS.

*Issue 4(a): Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective applied with reasonable consistency? And Issue 4(b): Do you agree with the Board’s conclusion that the fair value of employee share options can be measured with sufficient reliability?*

I do not agree. The FASB has given up on developing one method to value employee stock options (i.e. “share-based payment transactions”) and mandated a highly questionable “option-pricing model.” The FASB was not able to find one suitable model although they extensively assessed the Black-Scholes and other binomial models. Companies are instead being asked to develop a suitable method even though the FASB, with access to significant resources and experience, could not develop one after years of discussion. From an accounting perspective, this puts companies and their auditors in an impossible position, as class action attorneys wait in the wings. The CIS, not the P & L, is the best place to put such a questionable calculation.

The “option-pricing model” the FASB proposed places substantial value on “volatility” as defined. The higher the volatility, the more the market value of the shares under option can be expected to vary – up or down. Since historic and expected volatility is the key driver of the “option-pricing model,” tremendous judgment comes into play. Companies in mature industries

will generally have low volatilities and, therefore, will place very little value on their options. Why do you suppose Coca Cola was so quick to adopt option expensing? Companies like Intel or others in the technology sector will generally have high volatilities and, therefore, calculate very large expenses. How much does volatility influence the outcome? A company with relatively low volatility of 20% would value a 10-year option to buy for \$50, a stock trading at \$50 on date of grant, at \$11.83 while another company having higher volatility of say 80% would value it at \$32.40, all other assumptions being equal (see Exhibit I). That's almost a 175% difference. It's easy to see how the earnings of many technology stocks will be eliminated for many years to come unless technology companies stop granting stock options while the low technology companies, like Coca Cola, don't really care. This is **BAD accounting** and **BAD economics!**

All other things being equal, the "option-pricing model" the FASB proposes would double value of a stock option for the same company if the market price of its stock doubled (Exhibit II). If a company that had no change in its earnings per share ("EPS") in a two-year period saw its price go from \$25 to \$50 (i.e., if a company had \$1.67 in EPS in both periods) then a \$50 option would be deemed by the FASB to have twice the value as a \$25 option. This doesn't make sense and is **BAD accounting!**

*Issue 4(d): Do you agree that those methods give appropriate recognition to the unique characteristics of employee share options?*

I do not agree. The FASB proposal ignores the accounting effect of the fact that employee stock options are rarely marketable instruments. An employee cannot sell his or her options to someone else. Historically, non-marketable securities are valued at a 15% - 30% discount to markets. This is **BAD accounting!**

*Issue 13: Do you agree with the transition provisions of this proposed Statement?*

I do not agree with the FASB proposal to adopt what is called the modified prospective method to initiate the expensing of employee stock options. In essence, the FASB had three choices: (1) prospective for new options only, (2) prior years restated for comparability and (3) modified prospective methods. The latter accounts for all or a portion of unvested options outstanding and all stock options granted in the future as expenses prospectively. This method will lead to the most exaggerated distortion of prospective financial statements compared to historic non-restated financial statements. In essence, five-year P & L's will not be comparable for at least the next five years. Very few analysts and investors will have the experience and the time to reconstruct comparability. This is **BAD accounting** and is materially misleading to investors!

In addition to the above, the proposed Statement is **BAD accounting** because:

- This proposed Statement creates an inconsistency between the P & L and the Consolidated Statement of Cash Flow. When it comes to the latter statement, the money received from the exercise of stock options is viewed as raising cash through "financing activities" not as a cash flow resulting from "operating activities." So which is it? Is an employee stock option an "operating" or a "financing" activity? This inconsistency is **BAD accounting!**
- The proposal to expense employee stock options leads to a double charge in computing EPS. Fully diluted EPS already acknowledges the economic value of options outstanding using what is known as the Treasury Stock Method. Since fully diluted EPS is the

primary gauge used by Wall Street to value a company, this “double deduction” of the economics of the employee stock options distorts this calculation. This is ***BAD accounting!***

- This proposed Statement will lead to an acceleration of expensing when options vest as the stock value increases. The accounting for this is already being reflected in fully diluted shares outstanding. As such, options designed to reward management only if the company’s shareholders also win, with stock value appreciation, have exaggerated unfavorable results from an accounting perspective. This is ***BAD accounting and BAD business economics!***
- This proposed Statement does not correlate at all to the tax implications of granting a stock option. In essence, a high-risk venture with substantial volatility will ascribe a high value to the option under the FASB stock option expensing model, even though these options have a higher probability of never being exercised if a young public company or IPO venture does not live up to expectations. An option never exercised has no tax expense implication.
- This proposed Statement could lead to many companies going into default under various credit agreements. Such defaults could lead to bankruptcy and/or work outs for some companies. This could easily have a negative effect on the U. S. economic recovery. It is also contradictory since exercised stock options are good for business cash flow because they raise cash, yet the FASB accounting will create the appearance of declining operating results by lowering operating margins, EPS, return on assets, return on equity and fixed charged coverage. This is ***BAD accounting and BAD economics!***

I believe the FASB has not fully explored the potential disastrous economic consequences of its actions – consider:

1. There is a very substantial risk that unless Wall Street abandons or modifies EPS, PE and PEG (PE ratio divided by Earnings Growth Ratio) ratios, the economic consequence of the FASB proposal, which will over several years lead to a 10% reduction in EPS, will devalue U. S. businesses following historic PE valuation ratios by \$1.5 - \$2 Trillion. It is estimated that the FASB proposal will negatively impact the EPS of the S & P 500 about 6% - 7%. Including small and mid-cap and without duplication NASDAQ companies, the EPS reduction could easily exceed 10% for all U. S. stocks. The technology laden NASDAQ uses options more extensively and because of this and much higher volatility factors, they will see their earnings dramatically reduced and even wiped out for years to come. This is ***BAD politics and BAD economics!***
2. This proposed Statement appears to assume that employee stock option abuses and stock option accounting combined to lead to the Enron fiasco. Nothing could be further from the truth. Good stock option plans align management and shareholders as opposed to dividing them.
3. Adoption of the proposed Statement will discourage the use of employee stock options. On a global basis the U. S. will be on an uneven playing field. India and China, which are accelerating the use of options, will be able to attract better talent. They will win the technology jobs. In essence, the FASB will be assisting in the export of U. S. jobs.

4. The FASB appears to be trying to discourage the use of stock options. Many CEOs and CFOs will try to protect shareholder value by attempting to find ways to continue to achieve earnings targets. While stock option plans will undoubtedly change, much of the gap in earnings (i.e., the gap caused by stock option expensing), will be achieved by expense reductions in other areas. I believe this will include outsourcing or exporting U. S. jobs to countries like China and India. This is *BAD economics!*

### Conclusion:

I strongly recommend the FASB assess the implications of their proposal from a pure accounting perspective. Making the P & L more confusing and unreadable is not in the best interest of users. As indicated above, there are inherent weaknesses in the proposed "option-pricing model" and expensing proposal which, among other things: (1) the FASB itself couldn't agree on an accurate method to calculate, (2) it doesn't consider lack of marketability, (3) it penalizes small to mid-cap companies and particularly technology companies via the volatility weightings ascribed to their option values, (4) it values an option priced when the stock has a higher PE as being more valuable than when its PE is lower, (5) it is inconsistent with the cash flow statement, (6) it sacrifices comparability of the P & L for five years or more and (7) is designed to maximize the write off over the next several years. These inherent weaknesses should be recognized and the proposal amended to include these highly questionable expenses in the CIS not the P & L. This way sophisticated readers will be able to give the proper valuation of the overhang caused by stock options (something they already do), and they will not have to attempt to reconstruct the P & L to make it intelligible. A P & L that no one really understands, including the CEOs and CFOs asked to provide executive certifications on it, is just not useful to anyone. I am hopeful that the FASB will reconsider and prevent this disaster.

Thank you for your consideration. I welcome your feedback and can be reached at (925) 460-3621 or e-mailed at [rfolden@cooperco.com](mailto:rfolden@cooperco.com).

Very truly yours,

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Corporate Controller

REF/bev

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