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File Reference: 1102-100

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Financial Accounting Standards Board
By e-mail:
Director@fasb.org

Re: File Reference No. 1102-100

To Whom it May Concern:

I am writing in response to the Board's request for comments on the exposure draft, "Share-Based Payment".

While I agree with the Board's conclusion that stock based payments should be recognized in financial statements, I do not agree with the methodology proposed by the Board or with the Board's conclusion that the proposed accounting will simplify current accounting rules. Reliability, comparability and liability are big problems with the Board's proposed standard.

As one who has made a good faith attempt to apply the provisions of FASB 123 to real world situations, I maintain that the application of stock option valuation models to employee stock compensation does not produce a sufficiently reliable result required for financial reporting. While there are highly publicized examples of huge amounts of compensation resulting from stock awards, I can say that, at least based on my anecdotal experience and estimates, there are hundreds of examples of stock awards expiring worthless because of business failures or business results which are far less than expectations. At my own employer, we "recorded" huge amounts of pro forma expense under FASB 123, only to see almost every option grant become obviously and entirely worthless because of poor business results. (We also wasted a lot of time and effort, which could have been applied to improve our business results, computing pro forma stock option expense.) A study of historical disclosures by public companies comparing expense under FASB 123 to the actual value of options realized by employees would be useful and should be required to determine the reliability of option valuation models before the Board issues a final accounting standard which incorporates the use of such models. The proposed standard retains the requirement to use option valuation models; based on my experience, I therefore maintain that it will not produce a better result or a simpler method of accounting than either FASB 123 or APB 25.

Many expert commentators have observed over the past several years that Black-Scholes was never designed to apply to employee based stock compensation. I think most CPA's would agree that no two accountants or companies applying option valuation models such as Black-Scholes or lattice models to the same set of facts would come up with comparable conclusions regarding volatility of stock prices, estimated life of options, estimated forfeiture rates or any other assumption needed to compute stock compensation expense using the models.

I question whether accountants or most companies have adequate expertise and background to apply option modeling or for that matter to audit the results of option modeling performed by clients. This lack of professional expertise will introduce the potential for unnecessary legal liability for companies and auditors alike.

I agree that stock based payments should be recognized in financial statements; however, my proposal would differ from the Board's in that the timing of recognition and the amount recognized would be different. I propose that for public companies, the value (based on quoted market prices) of outstanding, vested employee equity instruments be recognized at the end of each reporting period by recording a charge (or credit) to Other Comprehensive Income and a corresponding credit (or charge) to a liability account, Stock Compensation Payable, net of tax effects. Amounts thus recorded in stockholders' equity would be reclassified to the regular Income Statement only as employees exercise options, take delivery of stock grants or otherwise recognize real value for the stock-based payment. The charge or credit to the Income Statement could adjust net income along with preferred stock dividends to arrive at net income or loss to common shareholders. No amount would be recognized for out-of-the-money instruments.

I believe such a method of accounting would have the following advantages:

1. My proposed method uses the most reliable measure of the value of stockholders' equity bargained away by companies and their boards to employees: fair market value based on quoted market prices. Readers and users would have a readily accessible location in the financial statements to find the current fair value of vested stock based payments. Users could readily understand how this value was determined.
2. Unlike the results of FASB 123 and the results I anticipate with the proposed standard, my proposal would not result in amounts recorded in the Income Statement based on complex and highly variable assumptions. Only value actually transferred to employees would be recorded in the Income Statement. This method prevents expenses from being recorded in the Income Statement before their amount can be reliably determined with a reasonable amount of effort and expense. While it can reasonably be argued that my proposed method does not result in proper matching of employee expenses to service period, it also does not result in the recording of liabilities based on thinly supported estimates of fair value using very imperfect valuation models. Stock Compensation Payable recorded would be a very real valuation of the amount of equity payable by shareholders to employees at a point in time.

3. My proposed method will produce a comparable result among companies' financial statements.
4. My proposed method seems entirely consistent with the Board's approach to other equally difficult problems of valuation and timing of recognition such as those involving derivative financial instruments and minimum pension liability. The days of the "clean surplus" theory seem to be long gone, so why not create another category of Other Comprehensive Income.
5. My proposed method provides full disclosure of the potential deduction from Stockholders' Equity for equity compensation. In addition to the recorded deduction for vested instruments in Stockholders' Equity, my proposal would require simple disclosure of the potential deduction from Stockholders' Equity (again based on fair market value using quoted market prices) as if all options or grants were vested as of the end of the reporting period.

In summary, I believe my proposed method would produce a reliable result, which would be much simpler and less costly to implement than any method proposed by the Board thus far. I believe the result would also be very comparable to the valuation of outstanding employee stock compensation determined in acquisition situations. This is ultimately a very good determinant of a company's worth.

Thank you for your time and consideration and good luck in coming up with an answer to this problem that all the interested parties can be comfortable with.

Very truly yours,

Douglas W. Sundby