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**Sent:** Wednesday, June 09, 2004 10:14 AM  
**To:** Director - FASB  
**Subject:** File Ref. No. 1102-100 - Comments on Exposure Draft for Expensing Stock Options



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In response to the recent exposure draft, "Share-Based Payment, an Amendment of FASB Statements 123 and 95", I offer an alternative approach to expensing stock options in addition to commenting on the approach offered by the exposure draft. I believe my proposed accounting treatment would be significantly simpler to implement and understand and offers a more appropriate treatment of stock options.

My proposal would use a modified version of the variable accounting approach in that a liability would be recorded to the extent that the options are in the money as of the balance sheet date; however, the offsetting debit would be recorded against other comprehensive income (OCI) within equity and not against the income statement. The current period impact of stock options could then be assessed through the reconciliation of net income with comprehensive income. If the outstanding options fall out of the money, then the liability and the debit to OCI would be reversed. The entries to record the exercise of the option would differ depending upon the method the company uses to satisfy its obligation:

1. If new shares are issued, the company would debit cash for the actual cash received, debit the liability for the difference between the market price and the exercise price (zeroing out the liability) and credit common stock for the current market value of the shares; or,
2. If the company buys shares on the open market to give to the option holder, cash would be credited for the net difference between the price paid and the strike price, the liability would be zeroed out and the debit balance in OCI would be adjusted to balance out the entry as necessary.

In either case, the balance in OCI at any point in time would include a realized piece for those shares exercised and an unrealized piece for those outstanding options currently in the money, as applicable.

The use of OCI is consistent with accounting treatment of other valuation issues, including the minimum pension liability and derivatives.

This proposed treatment recognizes the fact that a company only has an obligation when the options are actually in the money. Absent an active market, an employee typically cannot sell his options for some theoretical value. He cannot cash them in for the expected cash flow over their term. The value an option can generate at any point in time is limited to how much the options are in the money (if at all) and therefore that is what the company's liability should be. This is consistent with the fair value treatment as defined by Statement No. 107. There are no willing parties that will pay the theoretical fair value of an option as calculated under any model.

My proposal would also call for the footnotes to be revised to include a schedule showing the potential charge to OCI over a relevant range of share prices out over the next five years. This would allow investors to see the impact of the currently outstanding options as they vest over time at varying share prices. The range should be explicitly determined as set percentage movements off of the current share price and/or the previous twelve-month high. The policy footnote would be expanded to discuss whether the company issues

new shares or buys shares in the open market to satisfy exercised options. For those companies that issue new shares, the stock footnote would then include a calculation of the potential cash the company would receive if all vested in-the-money options were to be exercised. By reviewing OCI and a portions of the footnotes, an investor can easily determine what the impact of prior option exercises was, what the impact of options currently is and what the potential impact in future years may be.

My proposal would retain the majority of the current stock option disclosures (excluding the Black-Scholes or other fair value calculations). One open issue with my proposal is whether the obligation for in-the-money options should be construed as a liability or as a component of equity. Valid arguments can be made either way.

This proposal would apply to options granted to all executives, other employees, board members or outside third parties. The economics of an option are the same regardless of who the holder is and there should never be separate methods of accounting for options based upon the option holder under any accounting model.

The use of OCI is also a compromise to those who do not believe that a stock option should create an expense. The argument, however, for expensing stock options is flawed:

1. The only potential expense an option creates is an opportunity cost in that the company in theory could have received a higher dollar amount for the shares covered by an option if they had issued the shares on the open market. However, in order to raise that same cash from selling shares in the market without the benefit of an option plan would require a company to have a registration statement in place (and the associated cost) and incur transaction and administrative fees. So what then is the true opportunity cost and therefore option expense?
2. Expensing options is inconsistent with the treatment of new stock issuances. Under a new issuance, the net proceeds usually are lower than the current market price due to discounts, commissions and fees required to bring those shares to market. However, this spread between the net share price realized under the new offering and the current market price is not recognized as an expense. How is this different than expensing the spread on an option when new shares are issued?
3. The impact of options is already recorded in the financial statements. Outstanding options already affect diluted earnings per share while the exercise of an option can be dilutive or accretive on the book value per share. What benefit then is there to penalize a company with a theoretical expense in addition to these impacts?
4. An overlooked factor with options is that they generate positive cash flow when they are exercised if new shares are issued. It would seem inconsistent with other accounting flows to charge an expense for generating cash flow.
5. Options are often granted based upon prior performance, even if there is a future vesting period. Therefore, the proposed expense would not necessarily match the period benefited.

In addition to the above, there simply is not an efficient or effective method for calculating the value of an option and therefore the annual expense. Option valuation models, including Black-Scholes or binomial models, are cumbersome to implement, difficult for a company and a reader of the financial statements to understand, and flawed. Absent a true market for employee stock options, why pretend that a theoretical model can accurately replicate all of the market forces necessary to determine a fair value? People exercise their options for a variety of reasons to fund the purchase of a home or a car, to pay for college tuition, medical bills or a vacation, etc. that cannot necessarily be calculated by a theoretical model. These are individual decisions that are not necessarily predicated on interest rates, dividend yields or even the remaining life of the option or other financial factors that go into building models. With relatively small populations of option holders within a company, these individual decisions can cause distortions and it would be difficult for any theoretical model to accurately predict, capture and reflect these types of decisions in its future fair value calculations.

The valuation models are dependent upon the company's assumptions about future events, making it rather difficult to audit and to compare the reported impact from one firm to another even if disclosures were expanded.

The valuation models also smooth out the expense over time and they calculate an expense for options that may eventually expire worthless. The use of these models could require a company to record an expense in a year when the stock price declines and all of its options are out of the money. How does this distortion help an investor and how can companies adequately explain that phenomenon to its shareholders?

In summary, I believe that my proposed treatment for stock options would eliminate the inconsistencies and flaws of using a model to value options and charge a smoothed out theoretical expense to the income statement for an opportunity cost. My proposal would capture the true economics of the outstanding options as well as the impact of previously exercised options. This accounting treatment, plus the supplemental footnote information, would be relatively simple for a company to implement, for an investor to understand and consistent across all companies.

As a result, I strongly urge the commission to consider my comments on the issues created by using fair value models to expense stock options and to evaluate this proposal as an alternative to the expensing of options as described in the exposure draft.