

# ORIN S. KRAMER

Letter of Comment No: 3183  
File Reference: 1102-100

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Director of Major Projects—File Reference 1102-100  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: File No. 1102-100

Dear Director:

I am chairman of the New Jersey Investment Council, which sets policy for the state's \$67 billion pension system. The Council strongly supports the proposed rules reflected in the exposure draft, and we commend FASB for its commitment to act despite powerful countervailing pressures. The particular arguments below, however, are mine and are not necessarily shared by individual members of the New Jersey Investment Council.

There are two core arguments for FASB to act. The first is procedural: accounting standards should be drafted by FASB's independent experts, not by elected officials. Whatever the merits of different perspectives on the treatment of options, a world where the strongest political interests dictate accounting policy will ultimately reduce investor confidence and increase the cost of capital.

Second, the objective of accounting conventions is to present a fair and accurate picture of underlying economic performance. Artificial accounting constructs which distort business reality – e.g., the current treatment of options – should be eliminated. God created options to provide compensation, which is an expense, and which should be reported as such on the income statement during the period in which it was earned.

Numerous commentators have presented the case for FASB's specific formulation, and I would simply offer a brief reaction to the primary counterarguments.

The most common critique is that early-stage firms, especially in high-tech industries, depend on options to attract talent. Hence, "penalizing" the treatment of options will restrict the flow of talent and capital to these ventures, and expensing options is thus an assault on America's economic leadership. If this were true, it would be an indictment of capitalist theory. It is dubious

that promising ventures depend on the accounting fiction that the options granted to employees are not a form of compensation. It is equally doubtful that investors are too dumb to understand that employee options dilute the investor's ownership interest.

The second, and more intellectually defensible, argument is that there is no mechanism for reliably valuing options, and that the effort at expensing will create its own distortions. The argument has weight but rests on the faulty premise that good accounting gives a precise and accurate measure of the true economic performance of a business. Thus, accounting conventions which may produce misleading data should not exist. The reality is that critical features of accounting – accruals, reserves, etc. – are, at best, estimates. Determinations of whether a cost should be capitalized or expensed are subjective. Under the best of circumstances, accounting is a good-faith effort to estimate the financial condition and past performance of a firm. The fact that a particular accounting provision entails the possibility of error is regrettable but not disqualifying.

As a matter of policy, the New Jersey Investment Council has a preference for grants of restricted stock, where the accounting treatment is more straightforward, over options grants. But options can be a sensible means of compensation, and public policy should not be hostile to the concept of options. But public policy should also be clear that in real economic terms, options are a compensation expense, and FASB has presented a constructive vehicle toward that critical goal.

There are understandable reasons why many observers, including most institutional investors, will not give you cover on this highly charged issue. We are impressed by your fortitude and wish you success.

Sincerely,



Orin S. Kramer