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**From:** Sue Bielstein  
**Sent:** Wednesday, June 30, 2004 4:55 PM  
**To:** Director - FASB  
**Subject:** FW: Response to FAS 123

-----Original Message-----

**From:** David Urbani [mailto:david.urbani@citrix.com]  
**Sent:** Wednesday, June 30, 2004 4:53 PM  
**To:** Sue Bielstein  
**Subject:** Response to FAS 123

David D Urbani  
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June 30, 2004

Ms. Suzanne Bielstein  
Director of Major Projects  
Financial Accounting Standards Board  
401 Merrit 7  
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Dear Ms Bielstein:

I appreciate the opportunity to respond to the Proposed Statement of Financial Accounting Standards, *Share-Based Payment, an amendment of FASB Statements No. 123 and 95.*

The concept of expensing employee stock options is bad accounting, bad finance, and bad mathematics. The compensation to employees is not only contingent, but impossible to determine when the option is granted. To include this compensation as an expense offset by additional-paid-in-capital fails to differentiate the operations of the company from its capital activities. The real cost to shareholders is actual dilution caused by stock issuances subsequent to the shareholders' individual share acquisitions. The proposed accounting standard requiring the expensing of employee stock options will be the most misleading change in accounting standards for the income statement since Statement of Financial Accounting Standards No. 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements.*

To be fair, there is a rationale for assigning an opportunity cost with option grants. Upon exercising employee options, the company issues new shares causing dilution, without receiving the same proceeds it would have if those new shares were issued to the market. This does cause an economic penalty to the shareholders. However, this is nothing more than a trading loss in the company's own stock which,

according to Accounting Principles Board Opinion No. 6, *Status of Accounting Research Bulletins*, should not be reflected in the income statement. In fact, shares are often purchased at the same time the options are granted and would realize a trading profit offsetting this trading loss in economic terms. This trading profit would not be reflected in the income statement, nor should it be appropriate to reflect either of these events in the statement.

### Accounting

In a March 2004 presentation, Commissioner Cynthia A. Glassman of the U.S. Securities and Exchange Commission (SEC) made a speech listing her Top 10 observations during her time at the SEC. Excerpted below are three which apply to this situation:

- ***We shouldn't write rules just because we can.*** Writing rules is easy. Writing good rules is hard. Writing no rules in this environment is even harder. We need to focus on whether a proposed rule is a real solution to a real problem, not window dressing and not form over substance.
- ***We can't legislate ethics, but we can motivate people to do the right thing.***
- ***Complexity and the lack of transparency hide problems.*** Not only is the result that people don't understand what is happening, we have also seen, in some cases, that they don't ask appropriate questions.

The proposed expensing of employee stock options seems to be in conflict with these observations.

If the proposed requirement to expense employee stock options is mandated, the utility of the income statement will be severely compromised. The conceptual value of an equity investment is the present value of future earnings per share. Generally speaking, recurring historic earnings is the starting point for determining those future earnings. Therefore, the income statement on historic results is arguably the most important financial schedule for the equity investor to make an investment decision. If stock options were to be included as an expense in the income statement, extensive further analyses would then be required in the form of balance sheet manipulation or pro-forma income statement preparation. As a result, understanding a company's financial statements becomes more difficult, especially for the individual investor.

The proposed rule seems to confuse two concepts that are contradictory. The number of options expiring worthless is assumed to be offset by other issued options being more valuable than the assumed cost. Yet when it comes to the tax benefits created by employee option exercises, statistical concepts are no longer adequate and each actual transaction must be accounted for separately. In the event that the actual gain is less than originally assumed, the transaction would negatively impact the issuing company's income statement. Conversely, it would increase additional paid in capital when better than assumed. This "heads I win, tails you loose" approach causes yet more distortion for readers of financial statements.

Paragraph 12 of Accounting Principles Board Opinion No. 6, *Status of Accounting Research Bulletins* addresses Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research* and establishes the guidance prohibiting a company trading in its own stock from reporting any of those gains or losses in its income statement. It is misleading at best and creates an extreme negative feedback loop that clearly distorts reported operating results. There have been indirect violations of this principle in the past such as the reverse treasury method of calculating fully diluted shares outstanding. However, expensing employee stock options would be a material, direct violation of this principle since the fair value of options as calculated before they are actually exercised is dependent primarily on the current stock price and can be shown to be equal to trading profits and losses resulting from executing trading activities under an option pricing model's hedging process.

The SEC is concerned about the transparency of financial reporting as well. In a September 16, 2003 Speech, Commissioner Glassman said, "As economists, we all know the importance of financial reporting to our capital markets. Investors, creditors, regulators, and other market participants rely on getting accurate, timely and comparable financial information from public companies. The efficient allocation of capital depends on financial reports that provide a realistic picture of firms' past performance and future prospects.

"When information provides a misleading picture, the results can be devastating, as we have seen in recent corporate reporting scandals....

"...As economists, you should be concerned if accounting standards are not well suited to their intended function of communicating information to end-users, and if preparers of financial statements do not do their best to communicate relevant information as well." Further, in a September 3, 2003 speech, Commissioner Glassman stated, "The standard-setting process itself can be subject to political pressure and other external influences, with the end result being standards that may not reflect the economics of a transaction in a neutral, unbiased manner. If that is the case, then we have essentially lost the game before it even started, because the standards themselves contribute to a lack of transparency...

"...Another problem is that standards that incorporate too many detailed rules and requirements can be too complex, and also can fail to capture a transaction's economics.

"...However, even if analysts and investors ultimately can parse through to the important information, there is an increased cost as more decryption and interpretation becomes necessary. Less transparency often leads to a greater divergence of opinions regarding the valuation of a company's securities, which itself raises the uncertainty and costs surrounding a decision to commit capital."

The lack of transparency is particularly appropriate to Citrix Systems, Inc. If options had been required to be expensed, Citrix would have posted a loss every year of our eight-year history since our initial public offering. However, in that time period over \$1.5 billion has been generated; \$500 million of which has been spent on stock buyback activities and another \$500 million spent on acquisitions of companies and technology. There would be a huge disparity between the information contained in the income statements that include stock option expense and our actual financial condition. The issue shareholders should be concerned with is dilution, not expenses.

While Citrix has been traditionally a broad-based option issuer, dilution management is a serious concern for executive management and the board of directors. Share repurchasing activities began in mid-2000. As of December 31, 1999, there were 32 million options outstanding and 181 million shares outstanding. Between December 31, 1999, and December 31, 2003, 21.5 million shares were issued as a result of stock option exercises and employee stock purchase plan participation. Also during that time, the company received an aggregate \$379 million from employees for stock option exercises and stock purchase plan issuances, as well as stock option-related tax benefits. The company's repurchase activities during that period consisted of the repurchase of 38 million shares now included in Treasury and at the actual average cost of acquisition of \$16.28 per share, it cost the company \$350.5 million to buy back the 21.5 million shares to counteract the dilutive effect of stock options issued and exercised. Without causing any actual dilution, the employee stock option program actually contributed cash for general corporate purposes of over \$28 million! Our actual trading gains have exceeded our actual trading losses and have properly been reflected on the balance sheet.

This economic impact is not the result of speculative activity. Our objective is to prevent actual dilution from our employee stock option program and many companies with active dilution management programs could probably demonstrate similar results. How can this information be communicated to investors when the income statement reflects losses? What is to be gained by requiring the negative side of de facto trading gains and losses in the income statement while prohibiting the positive side of trading gains and

losses from being reported in the same manner?

## **Finance**

Option pricing models were developed to enable a trader to achieve a risk free return by holding a combination of an option on a security as well as the underlying security. This risk free return is accomplished through the management of a hedge ratio. With this process, a trader is exposing himself to changes in volatility and interest rates, not the price of the security. Since the trading algorithms are well known, any option value that is the result of views on the future price of the underlying security will be immediately arbitrated by the trader down/up to the trading value calculated by option pricing models.

In this way, the fair value of an option is similar to the forward value of a currency. In both cases, there is a trading strategy that will produce the market value of the instrument. In the case of forward currency rates, it is simply borrowing one currency for a specific time period while investing in the other currency for the same time period. There is no predictive quality of the resulting forward price; it is simply a calculation. When consolidating foreign operations, companies are not permitted to use forward rates with the rationalization that the errors will even out over time. This alternative method would eliminate the need for companies to engage in hedging transactions in order to manage currency variances produced by those foreign operations.

Estimates are often used to affect the "matching" principle in accounting theory. The matching principle enables a company to present a better representation of its financial status. Estimates are used by companies when future events and their effects cannot be perceived with certainty. Since the fair value of an option calculated by an option-pricing model is simply the expected trading gains and losses incurred by the delta hedging process, there is no concept of this value being the "best estimate" of the actual eventual option value if held for the assumed time period. In fact, the math that describes the behavior of share price distributions can have an undefined expected value.

The irrationally exuberant market of 1999-2000 can provide some excellent examples of the anomalies between held options and hedged options. Specifically, the common shares of Citrix Systems, Inc., were trading at about \$32 per share in October 1999 and were reasonably priced based on reported earnings and expected growth. Options granted at that time would have been priced at fair value at about \$18 per share by the Black-Scholes-Merton model. By March 2000, the shares were clearly overvalued, trading at prices in excess of \$100, but options granted at that time would have been priced at fair value at about \$56 by the Black-Scholes-Merton model. If you assume that the \$32 (from October 1999) was still a fair price for the stock, and that an option struck at \$100 would be considerably "out-of-the-money", the fair value of this option would have been calculated to be \$9.00 by the Black-Scholes-Merton model. Obviously, there is no way to tell if the shares are under-, fairly-, or over-valued at the time of the option grant.

While it seems absurd to pay this amount for the option when the expectation is that the underlying security is overvalued, from a trading perspective, the \$56 price was not only rational but profitable. A trader buying the call for \$56 and engaging in hedging activities prescribed by an option pricing model like the Black-Scholes Merton model over the next six months would have realized \$58 in trading receipts giving him a small net profit. This profit resulted from the actual volatility being higher than the volatility assumed in the calculation of the \$56 price.

Conversely, in July 2002 CTXS was selling for \$5 and, clearly under-valued. At that time, the fair value of an option with a \$5 strike price calculated by the Black-Scholes-Merton model would have been \$2.00, but its actual value would have been much higher than that to option grant recipients. However, the trader selling the option for \$2.00 and hedging his exposure would have trading receipts of \$6.25 in this case, resulting in a net profit of \$4.25. This is significantly less than the profit for an option holder who waited a year to exercise. An exercise and sale at this point would have produced a profit of \$17.

The extremely high value of the 2000 option is not offset by the extremely low value of the 2002 option. Since the values are not forward-looking, it would be coincidental if they offset each other and would only hold true for a short period of time.

This calculation of a traded option's fair value at any given time is different from the prediction of profits produced by a held option. For the held option, the price trend of the underlying security is the single most important input to the value, not the volatility. This difference has been tested on actual trading data for various stocks and two observations can be consistently made. Hedged option profits tend toward zero and have small variances, while the intrinsic value of held options are biased toward profit or loss with a variance at least three times as large as the variance of the hedged option profits. This underscores the fact that option-pricing models were created to provide a risk free (with respect to the price movement of the underlying security) return to the holder of an option who hedges the position. They are not unbiased predictors of the future profits of option holders. This violates one of the SEC's points mentioned above.

Over the past ten years, companies have engaged in an extensive amount of work to manage the dilution created by broad-based employee stock option programs. One little known fact is that over time, the combination of a significant share repurchase program and broad-based employee option programs have very little impact on return to the shareholders. In fact, even the dilution calculated by the reverse treasury method overstates the impact of stock options to shareholders of these companies, as shown above by the example of Citrix Systems, Inc.

Financial modeling shows that the process of granting options, repurchasing shares, and the subsequent option exercising, would have an impact on shareholder returns in certain cases. However, it can be demonstrated that there is little impact to shareholder returns if a company is profitable, limits option grants to less than 5% of the company's outstanding shares, and that, on average, the market price is the present value of expected future earnings. This is true in steady state growth assumptions as well as cyclical performance assumptions.

### Mathematics

The underlying assumptions of option pricing models are that stock price changes are independent random events. In the case of the Black-Scholes-Merton model, the price changes are assumed to be log-normally distributed, and in the case of lattice models, binomially distributed. Both distributions are classic bell-shaped curves and the models give similar option values. Unfortunately, share price movements are not independent random variables but instead occur due to non-linear feedback processes, the results of which, although they appear to be random and bell shaped, are not. Long trends in price increases or decreases and events like the 20% drop in the Standard & Poor's Index which occurred on October 19, 1987, would never occur otherwise. If normally distributed, the changes that occurred on this day would have been a 22 standard deviation event, which is almost impossible. However, this data point fits perfectly if the price movement is described by a Pareto distribution.

The utility of the option pricing models is that they work reasonably well in the short term most of the time. They clearly don't work when non-normal events like October 19, 1987, occur, or over long time periods when other mathematical limitations have time to surface.

Because price change distributions are not independent, normally distributed, random variables, the assumption that the volatility (the standard deviation of those price changes) scales with the square root of time as discussed in accounting literature will not be true. In fact, the dispersion of five-year returns, or volatility, is significantly lower than that produced by extending the daily volatility to five years and strays even farther from being bell-shaped. Since we know the utility of the pricing models for trading purposes diminishes after one year, and that there is no predictive value of pricing models in any time frame, and that volatility does not scale with time, what meaning can any five-year option value calculation have?

## Message

## Comments on specific issues requested by FASB

Issue 1. Disagree. Options should not be considered compensation expense due to the fact that they have no recognizable value at the time of their grant. The effect of options and their respective values subsequent to issuance is more appropriately addressed in the fully diluted earnings per share computation as prescribed in Statement of Financial Accounting Standards No. 128, *Earnings per Share*. This computation considers current market values of the outstanding options as well as its impact on earnings available to common shareholders.

Issue 2. Disagree. A pro forma disclosure is appropriate when the topic covered is not universally accepted by the readers of the financial statement as useful in the determination of value for the issuer's security. The whole presentation of Statement 123's fair value approach was flawed from the beginning. Readers of financial statements know this and have appropriately ignored it

Issue 3. Disagree. The value of options cannot be forecast and is only contingent compensation. The reason option pricing models are valuable is that they show how options can be traded and hedged without any concern for the price of the underlying security. The value of an employee option to an employee is **only** dependent upon the value of the underlying security, and therefore the intrinsic value of the option.

Issue 4(a). No. Since options pricing models depend almost equally on the grant price (assuming they are granted at market) and the volatility as the most important inputs, two problems arise. First, there is no correct value for volatility. It is the kind of variable that has infinite mean and variance, that is, it has no average or dispersion that can be measured. There is no good answer since the average volatility is undefined. No observation period is any more meaningful than another. Implied volatilities may seem to be better since they are set by the market, but in fact, suffer from the same problems as observed volatility and cannot be extended for long-term options.

Second, since the value of the option calculated is dependant on the grant price and its relationship to the market price on the grant date, there is a significant negative feedback loop into the income statement and, as a result, the price of the stock. Good earnings produce a high price; high price produces bad earnings, bad earnings produces low price, etc.

Issue 4(b). Disagree. The fair value of an option cannot be measured with sufficient reliability for all the reasons mentioned earlier in this document. Using lattice models allows for better flexibility but only compounds the comparability problem. Lattice models enable individual companies to engage an investment bank to develop a myriad of probabilistic assumptions, making the results even more difficult to compare among companies.

Issue 4(c). Disagree. For all the above reasons no specific method will accomplish what the board intends to do.

Issue 4(d). Disagree. Option valuation models were not intended and do not pretend to give a fair value to the employee. They only provide a calculated fair value, which is independent of the future value of the stock, and will allow an options trader to achieve a risk free return by hedging accordingly

Issue 5. Disagree. The intrinsic value will only postpone the quantification of the trading loss.

Issue 6. Disagree. Employee stock ownership programs are designed to create employee/owners of the company. Again, it is a capital transaction not an income statement transaction, with dilution being the primary issue.

Issue 7. No Comment

Issue 8. No Comment

Issue 9. Disagree. This accounting treatment is needlessly complicated without providing any accuracy.

Issue 10. Disagree. Consider the moral hazard presented by this treatment: "If we fire Joe we can print an additional \$.03 per share this quarter."

Issue 11. Disagree. Considering the tax impact of each individual transaction is needlessly complicated and is biased toward reporting a lower effective tax rate than will be appropriate. The tax accrual should be maintained at the effective rate until all options have been exercised or cancelled.

Issue 12. Disagree. The additional disclosure should address dilution management activities undertaken by the company. It should include the number of options (and underlying shares) were exercised along with tax benefit recognized, how many shares were repurchased by the company, and related cash flows for each item during the period. This type of disclosure would provide information to investors regarding the impact of employee stock options on their investment.

Issue 13. No Comment

Issue 14(a). No Comment

Issue 14(b). No Comment

Issue 15. No Comment

Issue 16. Agree. The cash flow generated by exercising of options would correctly be classified as a financing cash inflow.

Issue 17. No Comment

Issue 18. No, I do not believe this proposed statement supports the objective set forth by the Board.