

Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CN 06856-5116

Letter of Comment No: 5754  
File Reference: 1102-100

To: Director, FASB  
Re: Exposure Draft for Options Expensing, No. 1102-100

Disclaimer: The opinions presented in this letter are mine and do not represent the opinions of my employer or associates.

Respondent background: I am an equity research analyst at a mutual fund organization.

Dear FASB:

I am strongly in favor of the proposal to recognize stock options as an expense on the face of the income statement. My comments are broken into three sections, discussing rationale, methodology and implications for corporate governance.

**Rationale:**

I have read several of the responses posted on your website regarding this issue, many from employees of various firms who are in favor of stock options. Like them, I strongly believe a company's employees deserve to be compensated for their efforts. However, I also believe that a company's owners (i.e. shareholders) deserve to be told how much their employees are being paid, and in what manner.

Since financial statements exist for the specific purpose of communicating key financial information to owners and other interested parties (and are already the means of communicating other types of compensation expenses), financial statements are also the appropriate place to report option-based compensation expense. At this point a problem arises. Namely, how should we tell owners what employees are being paid when some of the payment is in the form of options? This issue involves two questions. First, do options contribute anything to the compensation (do they have ANY value)? And if so, how should that value be reported?

**1. Do options have value?**

I submit that they must, because:

- a) People wouldn't accept them as compensation otherwise.
- b) Options would not be useful as incentives otherwise.
- c) The possibility of a gain must be worth more than having no possibility of gain.
- d) An option provides an alternative source of liquidity in obtaining shares, which is valuable for illiquid stocks or for corporate control disputes (i.e. even out-of-the-money options can have value – even at expiration – because they enable the holder to obtain shares that might otherwise be unavailable).

- e) Stocks generally go up over time, as demonstrated by long-term stock market returns of roughly 10% or so.
- f) Numerous employees (including respondents to the FASB proposal) say so.

2. Since options have value, what value should be reported in the financials?

There is great debate on this issue, but fundamentally we have only two choices:

- a) No value (the "intrinsic value" method, or status quo)
- b) Some value (probably estimated in some way).

Opponents of options expensing argue that the inability to accurately measure the value of an option makes it undesirable to incorporate estimated values into the income statement, and that expensing should therefore not occur at all. However, I submit that using an estimated value of zero (i.e. not expensing) will always be a less accurate approach than using a nonzero estimate, since we've already determined that options have SOME value. Using an estimated value of zero (i.e. not expensing) will ALWAYS be inaccurate, whereas a nonzero estimate can at least be close. Furthermore, standardization of the valuation methodology (an action I would support) would facilitate comparability between firms with different option plan structures.

It is worth noting that the current policy of not expensing options functions as a mandatory expensing policy in which all options are assigned the same statutory value (zero) regardless of option quantity, plan structure, vesting periods, stock volatility, contract life, or any other terms. Therefore, any new expensing policy with a standardized valuation procedure is unlikely to be LESS accurate or offer LESS comparability than the policy currently in place.

I therefore reiterate my recommendation FOR expensing of stock options, and further recommend standardization of the valuation method.

Methodology:

To me, the primary concern is for option grants to be expensed SOMEHOW, and a secondary concern is the determination of the valuation method(s) to be used. That said, my ancillary opinions and suggestions regarding valuation methodology and disclosures are summarized below.

First of all, I think the option disclosures currently in use are good. I recommend the following changes/additions, however (a discussion of each follows the list below):

1. Require the "option life" assumption to be equal to the remaining contract life of the option being valued.
2. Standardize the risk-free rate assumption.
3. Require the company to disclose the total and annualized share price appreciation implied by the option valuation assumptions. Alternatively, companies could disclose the contract terms and calculated value of the longest-maturity option currently outstanding.

4. I am also in favor of the additional disclosures suggested by Capital Guardian Trust Company in Letter of Comment #2026, dated April 29, 2004 (as seen on your website).

Discussion:

1. Requiring option life to equal the contract life for valuation purposes.

I think this is a key requirement for any valuation method, since the length of time an option is good for is a core component of the option's value.

Under the current policy, the "option life" assumption used for valuation of an option is permitted to be materially different from the option's contract life on the basis of vesting periods, expectations regarding holding periods, or other considerations. I contend that intermingling these considerations with the valuation of the option itself is entirely inappropriate.

Just as the value of a share of stock does not change based on vesting periods or the expected length of time before the holder sells it, the value of an option is not changed either. The liability incurred by granting the option is the same in any case. Variations in vesting periods only affect the timing with which that liability attaches to the company. Similarly, variations in holding expectations should impact planning in preparing to pay out the liability, but do not alter the value of the liability.

Under the current policy, a company could offer identical 10-year options to two executives (say A and B, respectively) with different vesting periods (say 3 and 6 years, respectively). If the company chooses to value the options based on vesting period, then the options granted to executive A (with 3-year vesting) are appraised as "less valuable" than the identical options granted to executive B (with 6-year vesting). This conclusion seems backward. I submit that the options with the earlier vesting date are actually MORE valuable, since their value can be realized sooner AND they offer a greater window for exercise (i.e. 10-year options with 3-year vesting can be exercised anytime in a 7-year window, versus the 4-year window available under the other vesting schedule). Thus, the current treatment seems inappropriate.

I therefore recommend that all options be valued only on the basis of their contract terms, and that vesting and all other considerations regarding the options be handled separately, as with any other contractual liability.

It is worth noting that the cost to shareholders incurred with a company-issued equity option does not disappear when the option is exercised. Rather, the cost is merely translated into a different form – from the form of "option value" to the form of a new share of ownership. The resulting dilution (i.e. cost to prior shareholders) lasts forever. Even if the company repurchases the share, the shareholders still lose that value (in the form of cash) for the rest of time. Thus, any option granted with the expectation that it will eventually be exercised represents a deliberate and permanent wealth transfer from the existing shareholders to the option recipient. (Note that this is different from options written by third parties against shares in the secondary market, in that third-party options

do not dilute shareholders upon exercise.) The cost to shareholders due to company-issued options is therefore the same regardless of when the option is exercised, further suggesting that vesting and other concerns should not be part of valuing the option.

2. Standardize the risk-free rate assumption.

I recommend specifying which risk-free rates are to be used for option valuation so that option values reported by different firms will be calculated within the same rate context.

3. Disclose the option-implied share price appreciation, or the contract terms and calculated value of the outstanding option with the longest maturity.

Since an option value generated by whatever means implicitly incorporates a kind of "probable price appreciation" of the underlying security, I'd like to be told what that implied appreciation rate is. This disclosure would be especially helpful if firms are to be permitted to construct their own valuation models, as this measure will condense the valuation into a single number that can be compared to other firms and market indices. Alternatively, the firm could simply disclose the contract terms and calculated value (per the firm's valuation method) and let the user interpret the implication independently.

For example, if a company's stock is \$10 and that company issues a 10-year option at-the-money and calculates the value of that option as \$6, the implication is that the stock price is expected to appreciate 60% within the 10-year time frame, and so the annualized share price appreciation implied by the option value is  $4.8\% = [(1.6)^{0.1} - 1] \times 100$ . This is an easily interpretable and easily comparable number.

Implications for Corporate Governance:

The unifying theme among proponents of option expensing seems to be that the absence of expensing leads to inappropriately high quantities of option grants. I offer no new thoughts on this debate except to recommend examination of the Letters of Comment you have already received.

Many of the existing responses to the expensing proposal (already listed on the FASB website) are from employees who oppose option expensing based on their sincere belief that their option plans will be curtailed or discontinued. This belief begs the question: Why do employees believe that options will be discontinued if they are expensed? The very assertion that fewer options will be issued if expensing is required presupposes that the benefits of options will be perceived as inadequate when directly compared to the costs. Given that so many option recipients sincerely assert that option grant reductions are inevitable if expensing is required, I am inclined to believe them, and therefore reiterate my recommendation FOR expensing of stock options.

Sincerely,

/s/ Dogan Sahin

Dogan Sahin