

Letter of Comment No: 113
File Reference: 1101-SCU
Date Received: 10/15/03

October 15, 2003

Robert H. Herz, Chairman
Financial Accounting Standards Board
401 Merritt VII
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Expensing Company Stock Options

I am writing to express my concern (and reasons therefor) over any hesitation in the principle that the "spread" between the cost to exercise a Corporation Stock Option ("CSO") and the fair market value of the stock purchased upon such exercise is anything but deductible by the issuing corporation for financial reporting purposes and should be reflected as an expense in its profit and loss statement that covers the time of such exercise. Admittedly, there may be a question as to timing (the "when deductible").

Deduction

Although I am sure it has been mentioned many times before, I think that the better way to arrive at the appropriate time for, and amount of, the deduction for the economic spread between the option price and the "fair market value" of the issuer's stock is at the time of stock option exercise and that is the proper time to account for the CSO as an expense item in the issuer's profit and loss statement.

Tax on Exercise

In most of the general discussions that I have read, I have not seen any attempt to explain why the Federal income tax rules should not be used and correlated with the issue of accounting.

I do not believe anyone criticizes the IRS for (i) taxing the employee recipient of the economic benefit "spread" between the cost of exercise of the CSO and the fair market value of the company stock on the date of option exercise as income and (ii) allowing to the issuing corporation a compensation deduction at the same time for the amount of the economic benefit "spread" described.

I disagree with Representative Anna G. Eshoo when she apparently has told the subcommittee that:

“. . . expensing stock options would harm rank and file employees, adding that senior executives will be compensated in one way or another.” (CCH Federal Security Law Reports for June 11, 2003)

I do not know whether Representative Eshoo expects to treat the recipient of the economic benefit “spread” as having received non-taxable income. I certainly hope not. I think she may be suggesting that companies will discontinue the practice of using an employee stock option program if the cost (economic benefit “spread”) of the stock issuance is reportable as a part of the profit and loss statement of the issuer. I doubt that many companies will discontinue their stock option plans.

Timing of The Deduction

There has been a great deal written about how to treat, economically, the so-called expense of the economic benefit “spread” each year during which the stock option is outstanding and unexercised. As I indicated above, I would handle the deduction issue and the income issue in the same year; thus correlating the deduction and income issue in the transaction at the same time.

Although not an exact comparable, consider the situation where a corporation has a lease and is expensing the annual leasehold cost of, say, \$10,000. Unfortunately, the corporation takes an early deduction (one year early) for the \$10,000 rental. However, that item will be a recurring item and the improper benefit derived by the corporation happens only once; namely, when the corporation claims the early deduction. Every other installment of rental will be in the same amount and if one adjusts year one by prohibiting the early deduction of rental, year 2 (the proper year for the deduction) will have two deductions unless you treat the early deduction in year 2 for year 3 as disallowed; thus, the inclusion, in year 2 of the \$10,000 (from year one) is offset completely and equally by the disallowance of the early deduction in year 2 for year 3 rental. Thus, economically, only the issue of timing the deduction is involved and then only in the year of the wrong early deduction and the 10th year of the lease when the last deduction should have been taken.

As to the stock option area, there is one aggregate amount that will be deducted by the issuing corporation; i.e., the economic benefit “spread”. The IRS is not going to permit the deduction of any part of the economic benefit “spread” prior to the year of the option exercise no matter how accurate the Black-Scholes formula approach might appear to be. It seems much better to wait until the option is exercised (if ever) by the employee and then treat the economic benefit “spread” as the compensation cost paid by the issuing corporation to the employee at that time.

Another way to look at the economics of the stock option exercise issue is to see whether there is any rationale in the way that warrants to purchase shares are treated. For example, assume that a corporation has a preferred stock issue and, coupled with that issue, there is the grant by the corporation of a warrant to purchase common stock at a set price (e.g., existing fair market value at the time the warrant is issued) for a period of, say, five (5) years. Because this is not an employer/employee arrangement (as is a stock option award), I believe that when the warrant is exercised, the transaction is booked at exactly the amount the corporation receives for the common shares purchased through the warrant exercise. There being no employer/employee relationship in the transaction, few, if any, would argue that the corporation had reportable amounts to deal with (fair market value and warrant exercise price) in each of the years that the warrants were unexercised and outstanding which should be adjusted each year including the year of exercise to the actual facts in existence.

As to the CSO, I think that the principal reason for the grant of an employee stock option by the corporation is to reflect what the employee has done historically over the period of his/her employment, not what the employer expects the employee to do in the future. This distinction is what supports the grant of employee stock options periodically (in most cases annually). This factor alone supports the better view that the expense to the employer occurs when the option is exercised since that is the time when all of the steps in the stock option exercise have occurred.

Conclusion

It is my conclusion that:

- (1) The "spread" between fair market value and stock option price is a compensation "benefit" conferred by the issuing corporation upon the holder of the option (generally, one of the issuing corporation's employee's).
- (2) The so-called "spread" at the time of stock option exercise is the preferred method of valuing the economic benefit received by the employee as well as determining the financial cost to the employer (the issuing corporation) (the IRS tax rule).
- (3) As to timing, the total value of the economic benefit should be reflected once, and that once is at the time of the option exercise.
- (4) To attempt to value a deductible amount of an outstanding option periodically using a method such as Black-Scholes – may be, in a sense, acceptable, but, from a practical standpoint, it creates nothing but confusion and arguments for and against the booking of an amount, as well as the periodic

Robert H. Herz, Chairman
Financial Accounting Standards Board
October 13, 2003
Page 4

determination of the size of the amount (employer cost) prior to the actual stock option exercise (if, indeed, the option is ever exercised).

Postscript

As a postscript, I should add that the issuing corporation should probably be required to set forth in its proxy statement, as well as its annual report, by calendar (fiscal) year a list of the number of outstanding (existing) stock options that are currently exercisable together with the weighted average price per share or by grouping the options by their respective exercise prices.

If you wish to reach me by phone, please call me at work (440-347-5353) or at home (216-921-8946).



Fred D. Kidder, Esq.