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Letter of Comment No: 5465
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From: Len Tatore
Sent: Wednesday, June 30, 2004 9:05 AM
To: Stacey Sutay
Subject: FW: Accounting for Employee Stock Option Compensation on the Cash Flow Statement

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

From: Fred Love [mailto:fllove@qwest.net]
Sent: Tuesday, June 29, 2004 7:11 PM
To: Stacey Sutay; George Batavick; Mike Crooch; Robert Herz; Gary Schieneman; Katherine Schipper; Leslie Seidman; Edward Trott
Subject: Accounting for Employee Stock Option Compensation on the Cash Flow Statement

Dear FASB Board Members,

Thank you for all your steadfast work on moving towards more transparent accounting by proposing that companies expense stock options on the income statement. I am 100% in favor of this. Regarding accounting for employee stock option compensation on the cash flow statement, I sent the italicized letter below in February, and would like to make some additional comments.

It appears that your March, 04 proposal would require that companies remove the tax benefit from exercise of stock options from cash flow from operations on the cash flow statement, but not require companies to remove the actual stock option expense that created this tax savings from cash flow from operations. However, in my opinion, issuing stock options to employees should be viewed as a two-part transaction that is economically equivalent to the company selling stock options on the open market, and then turning around and compensating the employees with the proceeds from the sales of these stock options. Hence, there is a **cash flow from financing activity** as well as an employee compensation activity. Therefore, it is my strong belief that any ruling from the FASB requiring companies to expense stock options on the Income Statement, should also require companies to add this non cash compensation expense back to "**Cash Flow from Financing Activities**" on the Cash Flow Statement rather than add the non cash stock option compensation expense back to "Cash Flow from Operations" on the Cash Flow Statement. The tax benefit from exercise of stock options, which is really just the tax savings resulting from the stock options expense as measured by the IRS at time of exercise, should be left as part of cash flow from operations. Or in other words, both net income and cash flow from operations should be a figure net of taxes associated with operations.

Here is my original letter concerning this issue:

I trust you are continuing to make significant progress toward requiring expensing of stock options on the Income Statement. Further regarding this issue, it is my belief that many companies are already positioning themselves to ask investors to ignore reported net income in the event the FASB is successful in requiring companies to expense stock options on the Income Statement, and are instead planning on pushing investors to focus on reported "Cash Flow from Operations". It is my strong belief however, that reported "Cash Flow from Operations" for many companies has a serious flaw in it, just like reported net income has a serious flaw in it. Indeed, when the FASB requires companies to expense stock options on the Income Statement, many companies are simply planning to add the non cash stock option compensation expense back in to "Cash Flow from Operations" on the Cash Flow Statement, so there will be no change for "Cash Flow from Operations" over where it stands were the FASB not to require companies to expense stock options on the Income Statement in the first place.

However, this is incorrect accounting in my opinion; the non cash stock option expense should be added back in to "Cash Flow from Financing Activities" on the Cash Flow Statement rather than be added back in to "Cash Flow from Operations" on the Cash Flow Statement. In my opinion, issuing stock options to employees should be viewed as a two-part transaction that is economically equivalent to the company selling stock options on the open market, and then turning around and compensating the employees with the proceeds from the sales of these stock options. Hence, there is a cash flow from financing activity as well as an employee compensation activity. Therefore, it is my strong belief that any ruling from the FASB requiring companies to expense stock options on the Income Statement, should also require companies to add this non cash compensation expense back to "Cash Flow from Financing Activities" on the Cash Flow Statement rather than add the non cash compensation expense back to "Cash Flow from Operations" on the Cash Flow Statement.

If the FASB fails to include a ruling to require proper handling of the accounting for stock option compensation on the Cash Flow Statement, it is my strong belief that companies may successfully make a mockery of the new ruling requiring companies to expense stock option compensation on the Income Statement, by persuading investors to ignore reported net income, and instead focus on "Cash Flow from Operations" where there will be no change.

6/30/2004

Thank you very much for considering my opinion. If any of you have any comments concerning this issue of accounting for employee stock option compensation on the Cash Flow Statement, or can point me towards some FASB research on this issue, I would be very interested in hearing or viewing the research.

With best regards,

Fred Love
President
Mariner Artemia, LLC