Michael P. Bohan

2355 Lalemant Road University Heights, Ohio 44118 216-381-9141 Email MichaelPBohan@aol.com

January 30, 2003

MP&T Director—File Reference 1102-Financial Accounting Standards Board 401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Letter of Comment No: 63 File Reference: 1102-001 Date Received: 1-30-03

Dear MP&T Director

Re: Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, Accounting for Stock-Based Compensation, and Its Related Interpretations, and IASB Proposed IFRS, Share-based Payment.

I am pleased to see that the Financial Accounting Standards Board ("FASB" or "Board") is reconsidering FASB Statement No. 123 ("SFAS 123") with an eye on harmonization with the forthcoming international standard on the same subject. However, I was very disappointed to see that the FASB and the International Accounting Standards Board (IASB) both continue the use of the grant date to measure the ultimate compensation under such plans.

Clearly, the FASB took a practical approach in SFAS 123 in not requiring the recognition of compensation expense under the so-called pure vanilla stock option plans and in permitting the measurement of compensation under such plans by use of the fair value of the option on the grant date. I say practical in that the former decision was taken to avoid the political ramifications of mandating the recognition of compensation expense under such plans and the latter decision was to assuage the concerns that the ultimate measurement of compensation would vary based on future events.

Grant Date Based Accounting is Flawed

In the years following the issuance of SFAS 123 the financial reporting of enterprises has faced severe criticism as being too inclined to support the objectives and desires of management and too cookbook in nature. The FASB and the IASB have an opportunity to respond to such concerns and issue standards that are transparent and reflect the substance of transactions.

Continuation of the use of a grant date measurement approach for such stock-based compensation plans doesn't do the job. I ask that the Board reconsider the approach, instead of dismissing reconsideration, as they apparently do in the last sentence of the paragraph from page 9 that concludes on page 10 of the Invitation to Comment.

Recognition of a fixed amount of compensation at the date of grant for such plans fails to recognize that these are in substance variable compensation plans and that the grant of an option is the inception of a transaction, not the settlement of a transaction.

The use of the grant date measurement approach has only one beneficial aspect, and that is only a perceived benefit—the determination of a fixed cost at the inception of the transaction. Unfortunately, this perceived benefit is at the cost of relevance and representational faithfulness of the measurements recognized in the financial statements. Grant date measurement locks in the ultimate recognition of expense based on a highly subjective approach that estimates future events without subsequently adjusting the amount to reflect what actually transpires. While many transactions are initially recorded based on estimates of future events and costs (pensions being a prime example), those estimates are ultimately adjusted to the actual amount based on the settlement of the transaction. However, under the grant date measurement approach there is no so-called truing up to the actual cost of the transaction.

In reality, a stock-based compensation plan is a contingent variable compensation plan, the cost of which mimics the volatility of the underlying security to ultimately be issued under the plan. That reality should not be obfuscated by the accounting employed. Neither the relevance requirement nor the representational faithfulness requirement is satisfied by adopting an accounting convention that ignores the underlying substance of the transaction.

An option pricing model is just that, a model. Just as actuarial assumptions are assumptions not final facts. Both form a basis to make economic decisions and to establish initial accounting for transactions, but the final accounting should recognize what has transpired.

Exercise Date Accounting Provides Requisite Representational Faithfulness

The ultimate measurement of compensation under such plans should be based on the excess of the market price over the exercise price on the date that both the enterprise and the individual have unequivocally met their obligations to the other party to the transaction (for the sake of simplicity, the term "exercise date" will be used in this letter to represent this event, qualified with the understanding that delivery of notes by the individual in exchange for the equity security is not an unequivocal settlement). The enterprise is obligated to deliver a specified number of equity units (usually common shares) to the grantee for a stated price during a specified period of time. The individual is obligated to provide services or deliver goods to the enterprise over a given period of time and to pay a specified amount to the enterprise in exchange for a specified number of equity units.

The marketplace has been clamoring for recognition of expense under share-based compensation plans. And, for a period of time (especially given the currently declining market) the marketplace may not notice that the grant date accounting does not deliver the answer that they expect. At first blush, many may think that the grant date method does the job, because expense is now being recognized. But as time passes I believe there will be a cry to reassess the grant date approach because it will result in:

- recognizing compensation expense when in some cases there
 ultimately is none (e.g., cases in which the market price is such that
 the option is never exercised as it is never in the money), and
- understating the ultimate compensation expense when there is a
 considerable excess of the market price of the equity units on the date
 of exercise over the exercise price when compared to the amount
 attributed to expense using the grant date option pricing approach.

I believe that the relevance and representational requirements are best met by the use of the exercise date approach. For interim reporting purposes under this approach the accumulated cost of such plans for outstanding options would be the excess of the period end market price of the underlying equity securities over the exercise price. Clearly, this will result in volatility/variability of the costs reported in the financial statements, but that is the substance of these plans. Locking in on a fixed amount under the grant date approach fails to recognize that variability and volatility are inherent aspects of such plans and as such provides misleading measurements in the financial statements.

Additionally, the use of an exercise date approach for the ultimate measurement of compensation is evenhanded because it provides the same charge to earnings whether the obligation is ultimately settled by the delivery of the underlying securities or is settled in cash.

Scope of Response Limited

I am not responding here to the detailed questions in the Invitation to Comment, because I feel that the use of the grant date measurement approach is so flawed that fine tuning it will not provide a substantially better measure than is currently in place.

I previously provided detailed comments in my December 13, 1993 letter to the FASB in response to the then proposed standard on stock-based compensation; in my remarks at the March 7, 1994 FASB public hearings on this subject; and in my March 8, 1994 letter to Timothy S. Lucas following up on my remarks at the FASB public hearings. While I have subsequently modified some of my implementation views contained in those materials, the substance of my position is unchanged. If the FASB concludes to adopt an exercise date approach, such position will be the subject of an exposure draft and I will be happy to provide my views at that time.

Restore Public Confidence in Standards Setting Process and Financial Reporting Model

To be credible and restore public confidence in the establishment of accounting standards in the private sector, the FASB should reconsider the stock-based compensation measurement principles it has heretofore espoused and adopt the exercise date as the ultimate measurement approach as described above. I'll be happy to expand on my views, if the Board wishes further input in this regard.

Very truly yours,

Michael P. Bohan