

**Karen Salmansohn**

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**From:** Director - FASB  
**Sent:** Friday, January 31, 2003 9:01 AM  
**To:** Karen Salmansohn  
**Subject:** FW: File Reference 1101-001

**Letter of Comment No:** 120  
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-----Original Message-----

**From:** William Sahlman [mailto:wsahlman@hbs.edu]  
**Sent:** Friday, January 31, 2003 9:01 AM  
**To:** Director - FASB  
**Subject:** File Reference 1101-001

Financial Accounting Standards Board  
MP&T Director File Reference 1101-001  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856

Re: Invitation to Comment, Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, and Its Related Interpretations, and IASB Proposed IFRS, dated November 18, 2002.

Dear Sir or Madam:

I am pleased to have the opportunity to respond to the Financial Accounting Standards Board Invitation to Comment on this matter related to the expensing of employee stock options. I offer my perspective as a business economist, a professor of business administration and senior associate dean of the Harvard Business School, and a member of the board of directors of several companies.

It is fascinating to observe pundit after pundit come down strongly on the side of expensing employee stock options in the reported financial statements, as if that were the silver bullet for combating corporate malfeasance and resolving our corporate accounting problems. The proposals underway, most particularly the IFRS under consideration by the International Accounting Standards Board, may serve to palliate public outrage, but will not make shareholders better off in any way. In fact, expensing options may lead to an even more distorted picture of a company's economic condition than financial statements currently paint.

Moreover, even though stock options for executives certainly have been abused, such a mandate would do little if anything at all to solve the fundamental problems of unethical management, inadequate control and governance systems, and a frothy market in which so-called "experts" failed to do even the simplest reality check on reported cash flows. The current focus on the stock option expensing issue is deferring a much broader discussion that regulators, investors, corporate executives, accountants and other market participants need to have.

In addition to the general risks inherent in mandating a so-called solution that neither addresses the core problems nor serves investors, any requirement to expense employee stock options poses both practical and substantive barriers as well.

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To begin with, reporting an executive option grant as a cost item on the income statement does not add any reliable or useful information. FASB regulation 123 already requires companies to disclose data about option grants in the footnotes to their financial statements. A quick look at any publicly traded company's reports shows just what a wealth of information these footnotes provide, for example, how many options are outstanding, how many could be exercised, how many have been authorized but not granted, as well as the option terms in some detail.

Simply deducting the estimated value of the options from current income even if an accurate valuation model was available would create troubling distortions in the picture presented. Consider, for example, how the use of employee stock options affects cash flows. Companies that award management and employees with options are able to use them to recruit some of the best and the brightest when cash is tight, especially in young and entrepreneurial ventures. If management fails to improve the company's performance, then the share price will not rise, and the options will not be exercised. In that case, investors will be left with the same claim on future cash flows that they had at the outset, but they will have saved the cash they might otherwise have had to spend on recruitment and retention.

In the event that the team performs well and the options are exercised, the company can expect an inflow of exercise money along with a tax saving. Under current tax law, the tax benefit will be equal to the marginal corporate tax rate times the implicit total gain on the exercised options, assuming the company is paying taxes.

What is most interesting and curious is that the proposed expensing of employee options depresses income while increasing cash flows. One must question a policy that keeps the two from rising and falling in tandem.

Unfortunately, expensing options by subtracting their full Black-Scholes value from income in the year of the grant does not take into account any of the possible benefits of using stock options as a part of a human resource management strategy. Some accountants say that because it is difficult to predict many of the future benefits, it is wise to err on the side of caution by ignoring the benefits and taking the maximum hit. For this reason, the accounting profession has compiled an extensive record of treating many expenditures, such as R&D spending and staff training, that have the potential to improve expected performance over the long term as current-period expenses. Conservative dogma demands that the financial statements recognize only their cost.

Such treatment illustrates a fundamental problem in accounting that is particularly true when considering employee stock options. A decision to "invest" in a new employee involves both costs and benefits. If a company deducted from current income the estimated "value" of the stock options granted (and increase the number of shares outstanding), it would communicate only the maximum potential pain of the decision to grant options. The current savings and the prospect of increased cash flows in the future would be completely ignored. So here's the dilemma: should a company be forced to treat yet another investment as a period expense while ignoring the possible benefits of the decision to incur the expense? In contrast to investments in R&D and management training, granting stock options entails no current cash costs: indeed, using options typically lowers the current cash required. Moreover, under current tax laws, stock options will actually decrease future taxes (i.e., they have a positive effect on after-tax cash flow if they are ultimately exercised).

It seems unreasonable to estimate the value of the options given the obvious fact that they have absolutely no intrinsic value on the day they are received (i.e., when the current stock price equals the exercise price). Also, although the Black-Scholes model is well tested for publicly traded options, valuing private, long-term, non-transferable options with significant restrictions (e.g., performance-

based vesting requirements, right to terminate employment, unknown number of future shares outstanding) seems much harder and imprecise at best. Finally, the impact of options is already accounted for when fully diluted shares are adjusted to reflect in-the-money options.

Broad-based employee stock options plans are now omnipresent across U.S. companies. Unilateral punishment of current earnings via mandated expensing is misguided: it further distances accounting earnings from cash flows. Employee stock options have a positive, not a negative impact on potential after-tax cash flows. The proposed charge would go in exactly the opposite direction.

A better plan is to provide much more detail on the contingent ownership each shareholder might have under different scenarios. Such a system would help shareholders make better-informed decisions about investments. I also believe that the academic community needs to come up with more effective and accurate tools for assessing the value of employee stock options. Using Black-Scholes likely overstates the cost and muddies the picture for a variety of technical reasons.

I strongly advocate inserting in a dedicated footnote a simple description of the potential impact of the exercise of options on existing ownership. This could take the form of a chart showing how many shares would be outstanding at different stock prices. In short, shareholders should be given a simple and comprehensive picture of their future ownership rights under various pricing scenarios a much fuller picture than reducing the value of option grants to a single number on the income statement would provide.

Sincerely,

William A. Sahlman  
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