

ikon

Letter of Comment No: 5452  
File Reference: 1102-100

**From:** Chris Davitt [cdavitt@delta-trust.com]  
**Sent:** Monday, June 28, 2004 2:54 PM  
**To:** Director - FASB  
**Subject:** File Reference No. 1102-100 – Share-Based Compensation

File Reference No. 1102-100 – Comments Regarding Share-Based Compensation

According to an op-ed piece written by Lawrence Lindsey and Marc Sumerlin in the June 21, 2004 edition of *The Wall Street Journal* regarding the expensing of employee stock options, “FASB is responding to the new political environment in which a premium is placed on any changes that appear to be ‘tough’ on corporate America.” The former directors of the President’s National Economic Council go on to argue, “The prosecution of wrongdoing is essential to the clean-up process, but history suggests that when political institutions run out of wrong doers, they often turn to ill-conceived systemic changes...[that] undermine sound economic activity with little impact on wrongdoers.” Messrs. Lindsey and Sumerlin could not have used a more appropriate description—“ill-conceived”—to describe the recent movement to expense employee stock options.

First and foremost, firm expenses—cost of revenue, operating and administrative, R&D, you name it—all share one common characteristic: they all reduce net income and, thus, the current value of the firm. Employee stock options do no such thing. Profits remain unaltered. The same is true with regard to the value of the firm and in some cases, as is often the case with many firms that issue non-publicly traded stock, firm value actually *increases*. Issuing employee stock options does, however, reduce each current shareholder’s current allocation of profits, diluting the value his/her shares, an effect reported on the income statement as diluted earnings per share. Expensing employee stock options would, in effect, penalize firms for issuing them, “double counting” their effect on earnings per share by both reducing the earnings component of the numerator and increasing share component of the denominator. If employee stock options are never exercised, as is the case on more occasions than not, what then? The firm’s bottom line has already taken a hit as a result of the expense although no transaction has taken place. It as if the options were never even granted in the first place. This is a step backward in pursuing the goal of presenting reliable and accurate accounting information. If employee stock options are never exercised, net income and earnings per share become *distorted*, not more dependable.

A second complication with expensing employee stock is valuation. How does one value a financial instrument for which no market forces exist to establish a “fair” market price? Black-Scholes and the other option pricing models contain inappropriate assumptions when dealing with employee stock options, mainly liquidity. Because many employee stock options contain vesting periods and the other limits on the realization of any immediate benefit derived thereof, one can throw the liquidity assumption out the window. As Lindsey and Sumerlin put it, “FASB is violating its own Statement of Financial Accounting Concepts No. 5, which states that ‘revenues and gains are realizable when related assets received or held are readily convertible into known amounts of cash or claims to cash.’” Furthermore, allowing companies to choose the valuation method by which they “price” their employee stock options opens up the door for more earnings manipulation by corporate accounting and financial officers. Granted, income statements and balance sheets are full of estimates (e.g., depreciation, allowance for doubtful accounts, LIFO/FIFO, etc.) whose purpose is to provide users of financial information with more accurate and realistic accounting information. However, given the wide range of assumptions inherent in option pricing models and the restrictions on the options themselves, the expensing of employee stock options would almost certainly create an even more obscure and less reliable picture of corporate earnings and firm value. As mentioned before, far from forward progress, this is a step backward in the pursuit of more dependable and accurate accounting information.

Therefore, I urge that the Commission continue its current treatment where by there is full disclosure of “somebody’s current guess as to the value and impact of the options” in the footnotes to the financial statements and continue to reflect the full impact of the potential dilution by way of disclosure of fully diluted shares outstanding in the presentation of the income statement.

Cordially,

6/28/2004

J. French Hill  
Investor

JFH/cd

This email message is for the sole use of the intended recipients and may contain privileged and confidential information. Any unauthorized review, use, disclosure, or distribution is prohibited. If you are not the intended recipient, please contact the sender by reply email and destroy all copies of the original message. Although this email and any attachments are believed to be free of any virus or other defect, which might affect any system into which it is received or opened, it is the responsibility of the recipient to ensure that it is free from virus. Delta Trust & Bank accepts no responsibility for any loss or damage arising in any way from its use.

6/28/2004