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Suzanne Bielstein  
Director of Major Projects  
File Reference No. 1102-100  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

Letter of Comment No: 5445  
File Reference: 1102-100

Dear Ms. Bielstein:

**Overview (Summary)**

These are three written comments to the

**EXPOSURE DRAFT  
Proposed Statement of Financial Accounting Standards  
Share-Based Payment  
an amendment of FASB Statements No. 123 and 95**

1. The lattice structure is excellent. The accuracy of the model, however, is quite dependent on the accuracy of the inputs. Estimating and representing the uncertainties of the future are, at best, difficult. Many companies would be better served by using a closed-form model.
2. Options use has two economic factors, the compensation cost and the financing cost. It is important to clearly present the economic impacts of the financing decisions somewhere in the financial reporting structure. At a minimum, these economic effects should be presented as notes to financial statements.
3. There exists an anomaly in the proposal, resulting in different accounting treatments for two alternatives that will always have exactly the same cash flows, risks, etc. This needs a resolution.

**Framework**

When options are used in compensation packages to employees, a company must decide on the terms of the options. Many parameters must be fixed (e.g. number of shares, duration, vesting period, exercise prices, service conditions, etc.).

Another major decision (set of decisions) facing the company is , **how is the option going to be financed?** This can be accomplished in many ways (e.g. cash settlement, buying the stock on the open market, issuing new stock). By using derivatives and market timing strategies, the company can dramatically change the risk (cost) characteristics of these alternatives.

**Care should be taken to separately identify (and account for) the compensation costs and the financing costs of the options.**

### Comment 1

The underlying concept behind the EXPOSURE DRAFT is that the compensation cost can be determined at grant date by using a fair value approach to compute the economic worth of the options being granted. **The use of a lattice structure allows for great flexibility and accuracy in valuing options. But a word of caution! Modeling is a difficult art and has numerous potential pitfalls. Using past experience (i.e. historic data) to stochastically describe future employment termination behavior, employee exercise behavior, stock volatilities, dividend rates, etc., is often incorrect (e.g. as a young company matures employee behavior patterns will likely change, changes in the underlying economic climate usually cause major changes to the model inputs). In addition, as the models become more complex, it is much easier to manipulate the numbers, and much harder to audit the results. Often it is better to use simpler (but less accurate) models (e.g. Black-Scholes-Merton) because the reduced accuracy is (more than) balanced by the increased transparency!**

### Comment 2

**There is a need for a reporting structure to represent the financing costs of the options?** If a company's stock goes up, the not-yet-exercised options become more and more valuable (and costly). If the company buys stock on the open market it incurs a real cost. If the company issues new stock, then the current shareholders interests are almost always diluted. These are real financing expenses (that can be hedged). There is no recognition of these effects in the current proposal (except when liabilities are established). **At the very least, some mention of these changes in economics of the firm should be in a note to the financial statements or in a proxy statement.**

### Comment 3

In addition there is a need for consistency. Consider the following two alternative structures:

- **CSAR** A company grants a Cash-Settled Share Appreciation Right to an employee with a given set of conditions. The employee exercises the CSAR at the end of 5 years at a net price (share price = \$50, exercise price = \$20) of \$30 per share.
- **OPT-OPENMARKET** A company grants a Share Based Option to an employee with the exact same conditions as the CSAR. The employee exercises the OPT at the end of 5 years and pays in the \$20 per share (exercise price). The company, following policies developed by the Board, purchases (in the open market) the shares (to deliver to the employee) on the exercise date at \$50 per share.

**The cash flows (and the real economics) are exactly the same for both alternatives (and will be for all scenarios).** The fair value of the options is exactly the same for both alternatives (so the employment cost is exactly the same on grant date). However the other aspects of the accounting procedures seem to differ greatly. In alternative **CSAR**, a liability is established which gets marked to market every quarter; the total employment compensation cost is impacted by the price of the stock on the exercise date (as well as the grant date fair value). In alternative **OPT-OPENMARKET**, no liability is established; the compensation cost only depends on the fair value calculation. **Why should the accounting treatments differ when the economics are identical?**

Sincerely,

Robert E. Blau \*

\* My background includes the following:

1. Ph.D. in Operations Research from Cornell University (1975)
2. 20 year on-floor experience trading options on the American Stock Exchange (1977-1997)
3. Full time lecturer at Baruch College (CUNY) teaching courses in mathematical modeling (2000-date)