

**Stacey Sutay**

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

**From:** LFNolanII@aol.com [mailto:LFNolanII@aol.com]

**Sent:** Wednesday, March 26, 2003 5:52 PM

**To:** Director - FASB

**Subject:** File Reference No. 1102-001

Gentlemen:

I appreciate this opportunity to comment regarding how a publicly traded corporation ("reporting company") should account for incentive stock options. The following discussion assumes that the true compensation expense attributable to an incentive stock option is the price of the reporting company's stock when the option is exercised minus the option's strike price or, if the option is not exercised, zero.

It is apparent that reporting companies soon will be required to derive the value of incentive stock options using a modified version of the Black-Scholes Option-Pricing Model. Presumably, reporting companies will be required to expense the entire amount of this compensation in the year the option is granted. It is equally apparent, however, that the derived value of an incentive stock option is merely an estimate of the amount of compensation that will be received when the employee exercises his or her option. Thus, even if the option is exercised, it seems that the reporting company usually should need an adjusting entry in the year the option is exercised because the estimated compensation expense is unlikely to equal the actual compensation expense. See Example 1 below.

Notwithstanding the "precision" provided by option-pricing models, I recommend requiring reporting companies to use mark-to-market principles ("MTM") to compute the compensation expense. First, MTM will produce a compensation expense that equals the price of the reporting company's stock when the option is exercised minus the option's strike price or, if the option is not exercised, zero. Second, MTM will be easier to use because it does not require the modification, and use, of an option-pricing model. Third, MTM will be less susceptible to manipulation because it does not require judgments regarding the variables used in option-pricing models (e.g., volatility of reporting company's stock, estimated dividends). Fourth, MTM will enhance income-statement comparability because all reporting companies will have to compute compensation expense using the same formula (i.e., year-to-year change in the price of the underlying stock). Finally, MTM generally will assign the compensation expense to the period the employee earns or forfeits (in whole or in part) his or her compensation, which also can benefit reporting companies because they will not have to report a potentially income-distorting expense in the year the option is granted. See Example 2 below.

Regardless of your final decision, I am encouraged that FASB is moving forward in this area.

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P.S. Here are the two examples.

**Example 1:** Assume the following facts.

	When Granted in <u>2003</u>		End of <u>2003</u>	End of <u>2004</u>	When Exercised in <u>2005</u>
Market value of stock	\$100	\$110	\$125	\$120	
Strike Price	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>	
Amount "In the Money"	\$ 0	\$ 10	\$ 25	\$ 20	

The following journal entries are based on assumption that an option-pricing model shows the stock option to be worth \$22 at issuance:

2003	Debit	Credit
Compensation Expense	\$ 22	
Incentive Stock Options Granted		\$ 22

To record the estimated compensation element of stock option.

2005

Cash	\$100	
Incentive Stock Options Granted	22	
Compensation Expense		\$ 2
Common Stock		120

To record the issuance of common stock for \$100 when its FMV is \$120 and to reverse the excess of estimated compensation expense over actual compensation expense.

Summary:	<u>2003</u>	<u>2004</u>	<u>2005</u>
Current-year expense	\$22	\$0	\$(2)
Cumulative expense	\$22	\$22	\$20

**Example 2:** Assume the same facts as Example 1, except that the compensation expense is computed using mark-to-market principles.

2003	Debit	Credit
Compensation Expense	\$ 10	
Incentive Stock Options Granted		\$ 10

To record the compensation element of stock option.

2004

Compensation Expense	\$ 15	
Incentive Stock Options Granted		\$ 15

To record the compensation element of stock option.

2005

Cash	\$100	
Incentive Stock Options Granted	25	
Compensation Expense		\$ 5
Common Stock		120

To record the issuance of common stock for \$100 when its FMV is \$120 and to reverse the excess of estimated compensation expense over actual compensation expense.

Summary:	<u>2003</u>	<u>2004</u>	<u>2005</u>
Current-year expense	\$10	\$15	\$(5)
Cumulative expense	\$10	\$25	\$20