

**Stacey Sutay**

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**Subject:** FW: Senator Enzo's letter to FASB

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

**From:** Jack Adamo [mailto:jack@jackadamo.com]**Sent:** Monday, March 17, 2003 9:33 PM**To:** Robert Herz**Subject:** Senator Enzo's letter to FASB

March 17, 2003

Dear Mr. Herz:

The Financial Accounting Standards Board is now at a crossroads at which it must decide whether it will be an organization that is taken seriously as a watchdog of the accounting profession, or whether it will be the lapdog of powerful corporate executives who deceive shareholders for their personal gain.

Senator Enzo and 14 other senators have recently taken up the crusade to prevent FASB from requiring companies to show the cost of their executive stock option programs. Their arguments follow the usual four thrusts, one of which has been widely addressed in the media; the others – to my continuing amazement – have not been addressed at all.

Here, is a list of the arguments made against expensing stock options, followed by the refutations of those arguments.

- 1) Stock options are not an expense.
- 2) It would cost companies too much money to expense stock options.
- 3) The cost of stock options is already reflected in diluted earnings per share.
- 4) There is no clear way to determine the exact cost of stock options.

*Options not an expense:* GAAP requires that when any asset is given to an employee, or sold to an employee at below fair market value, the difference between the purchase price and FMV be recognized as expense to the company, and income to the employee. The rationale is clear: If you relinquish company assets at below FMV, shareholder value is diminished proportionately.

Although by accounting convention, a company's own stock is considered equity, not an asset, clearly – in real economic terms – a company's stock is an asset, just as it is an asset on the balance sheet of any other company owning it. In fact, a company's stock has a more readily determinable market value than any other asset it possesses. One would be hard pressed to find on a daily basis, a generally agreed upon market price for a used delivery truck, machine tools, or a patent. For stocks, this is easily done.

When stock options are converted into stock and given to executives at below FMV, shareholders have lost the amount of market value the company did not receive. They deserve to know those figures. FASB understands this, and has attempted to address this issue in the past. However, so far, it has allowed this egregious exception to the logic and purpose of GAAP because of great pressure from certain corporate interests and the politicians over whom they wield influence.

*Cost too great:* This claim is a diversion. As any accountant knows, there is *no* cost to *reporting* stock options expense. The cost is the stock options themselves. Reporting the expense has no economic effect whatsoever, except exposing how option grants are being abused. This exposure will have the effect of reducing the abuse. The proponents of not recognizing option expense go beyond "What they don't know won't hurt them." They claim that it isn't the expropriation of shareholder wealth that is damaging to them, it is their finding out about it. The

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argument is absurd, prima facie.

*Cost already reflected:* While it is true that the options exercised in the current year dilute current EPS, it is grossly inaccurate to say the cost of the stock option is fully reflected therein. A share of stock is not purchased solely for its earnings in the current year; if it were, all stocks would sell for less than one-times forward earnings.

A share of stock represents a stake in a company's earnings for all future years. The true cost of an option is the present value of the discounted cash flows of all the future earnings for which the grantee did not pay, and undertook no risk. That cost is reflected in the difference between the market value of the stock on the day of exercise, and the amount the grantee pays for the stock.

*No exact way to determine cost:* This specious argument requires some explanation to fully dismiss it to a layman's satisfaction, but it is about time someone made the effort.

The *exact* cost of non-qualified executive stock options (the kind we're discussing here) is calculated for the IRS every year when companies file their tax returns. The compensation expense rightly recognized by the IRS is the aggregate dollar difference between what the grantees paid for their stock, and the FMV of that stock on the date it was issued.

I had an email exchange regarding this matter about 18 months ago with Jack Ciesielski of *The Analyst's Accounting Observer*. Jack has recently been appointed to FASB's Emerging Issues Task Force considering the stock option issue. I have every reason to believe he is an honest and very capable accountant. I asked Jack why the IRS method of calculating stock options expense is not used in GAAP. He pointed out that while the IRS is willing to recognize a tax deduction for an expense only after it has actually been incurred, financial accounting attempts to recognize a liability for an expense as soon as it is clear that one is likely to occur. The GAAP approach is more useful to investors, hence, the desire to use an estimating model like Black-Scholes.

Mr. Ciesielski's point is well taken; however, the problem with the Black-Scholes approach is that the inexact nature of it is used as an excuse by those who wish to hide the cost of stock options expense. Their thesis is that it is better to report no expense than inexact expense.

Of course, this bizarre logic is followed absolutely nowhere else in financial accounting. Estimates and reserves are used more or less successfully in many areas of accounting. No reasonable person has suggested that their shortcomings be replaced by total lack of disclosure.

After consideration of this dilemma pitting accuracy against timeliness, my question to Mr. Ciesielski, FASB and any other party interested in this issue is this: Why not show both the exact amount of the current expense *and* the estimation of future liabilities. Specifically, why not disclose Black-Scholes estimates of the effect on future earnings per share as a prominent footnote, but incorporate the actual, exact cost of options exercised in the current year in the earnings statement. In that way, the current expense will be shown and the estimated future liability will be noted.

I know why many corporate executives will object to this method – Black-Scholes has consistently underestimated the true expense of stock options during bull markets – but I cannot see why those who seek accurate financial accounting would object to this method. It treats stock options expense the same way GAAP treats any other liability and expense.

This method, or some similar method of reserving and adjusting, would answer all serious objections about reporting stock options expense. Of course, it does nothing to satisfy those who are trying to obfuscate the issue for their own personal gain.

Jack Adamo, Editor, *Jack Adamo's Insiders Plus*