John Endean *President*

American
Business
Conference *A Coalition of Growth Companies*

January 31, 2003

Letter of Comment No: 191
File Reference: 1102-001
Date Received: 1-31-03

VIA E-MAIL AND OVERNIGH'

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

Re: Invitation to Comment on Accounting for Stock Options

Dear Sir or Madam:

The American Business Conference (ABC), a Washington-based coalition of midsize American companies chaired by Alfred West, CEO of SEI Investments, offers its comments on the November 18, 2002 *Invitation to Comment* of the Financial Accounting Standards Board (hereafter 'FASB" or "the Board") on accounting for stock options. We are also signatories to a separate comment letter from the International Employee Stock Options Coalition (hereafter "the coalition letter"). We make reference to the coalition letter in these comments.

The *Invitation to Comment* encourages respondents to point out any "significant" differences between FASB's Statement No. 123 and the recent International Accounting Standards Board (IASB) proposal on options accounting, whether or not those differences are cited in the *Invitation to Comment* itself. However, the Board advises respondents *not* to comment on certain issues including, crucially, "whether stock options granted to employees result in compensation expense for the issuing entity" and "whether the fair value of stock options can be reliably measured." The Board argues that since the FASB and the IASB both agree that options are a compensation expense and that their fair value can be reliably measured, comments on these matters are irrelevant to an exercise focusing on the *differences* between Statement No. 123 and the IASB proposal.

1828 L Street, NW Suite 908 Washington, DC 20036 (202) 822-9300 Fax (202) 467-4070
Website: www.americanbusinessconference.org

We sympathize with the Board's desire to discourage comments extraneous to the task at hand. However, we find it impossible to discuss what we, and, very likely most observers in the business community, take to be the most important difference between Statement 123 and the IASB proposal – namely the IASB's desire to impose mandatory expensing of stock options – without taking up, later in this letter, the issue of compensation expense and measurement reliability.

Indeed, we do so with some urgency, given the IASB's apparent intransigence on these matters. We note, as just one example, a recent public statement by a high-ranking IASB official who, when asked if stock options could be valued, fired back: "They sure as hell can be – certainly a lot better than they currently are, which is zero."[1] His attitude, which may or may not be shared by others at IASB, seems to us neither correct on the merits nor reflective of a calm, open-minded, deliberative style one associates with accountants. As a consequence, we think it important to use every opportunity to express our views fully on relevant areas of concern even if those views entail references to matters beyond the preferred scope of the Board's *Invitation to Comment.*

<u>We begin by noting what should be obvious to all: there is no consensus among the FASB's various constituencies in regard to how to account for stock options.</u>

We think Statement 123 reflects an earnest and constructive attempt to grapple with that lack of consensus. In this regard, ABC apparently has a higher opinion of Statement 123 than does the Board itself.

From the beginning, the Board has expressed unease with its Statement 123 because the Statement "recommended but did not require companies to recognize compensation cost for all stock-based employee compensation at fair value." The Board even went so far as to insert in the Statement itself its view that the failure to mandate expensing was simply an effort "to bring closure to the divisive debate on this issue" and "not because [FASB] believes that solution is the best way to improve financial accounting and reporting." Rarely has a standard been issued with less enthusiasm by the standard-setter.

[1] "Option Conniption: An Accounting Battle Heats Up," *Business Week,* February 3, 2003. The IASB official is Tom Jones, the Vice-Chairman.

We do not think the Board's diffidence about Statement 123 is at all warranted. Since its issuance in October 1995, the Statement has required disclosure in the notes to financial statements a *pro forma* disclosure of the effect on net income and earnings per share of the fair value of employee stock options. For those who believe that stock options are a compensation cost that should be expensed, these disclosures have provided abundant information to permit comparison of the size of stock option grants and their imputed cost across companies. Moreover, Statement 123 permits companies, if they so choose, to move beyond footnote disclosure and expense the fair value cost of the options they grant. Many companies in recent months have opted to do just that.

At the same time, by not making expensing mandatory, Statement 123 recognizes the existence of the large body of opinion that rejects the relevance of expensing and believes instead that the cost of stock options is best expressed in terms of dilution. This viewpoint sees the potential cost of stock options as being borne by existing shareholders, not by the company itself. ABC is solidly in that camp. The coalition letter, which we cosigned, records the views of many accounting specialists who take this position as well. Their views will not be repeated here.

We would like to point out to the Board, however, that some of the leading voices *in favor* of expensing ironically fall back on dilution as the best way to talk about the cost of stock options. For example, Arthur Levitt, Jr. ABC's founder and the distinguished former chairman of the Securities and Exchange Commission (SEC), has announced his support for mandatory expensing. However, in his recent book about his years at the SEC, he construes the cost of stock options for his readers as follows:

> Money may not follow out of company coffers when options are granted, but real costs are incurred. One is the cost to existing shareholders when their equity stake is diluted, or watered down, as options are exercised. Dilution is not a minor issue. If a company has one thousand shares outstanding, and you own one hundred of them, your stake is 10 percent. But if the company grants its CEO two hundred options, it must issue two hundred new shares when the CEO exercises his options. When that happens, your stake suddenly shrinks to 8 percent.[2]

[2] Levitt, Arthur, TAKE ON THE STREET, (Pantheon, 2003), pp. 107-108.

A recent commission convened by the Conference Board similarly relies on dilution to describe the cost of stock options. This commission, in a report released on September 17, 2002, embraced with much fanfare the mandatory expensing of fixed price stock options. But in doing so, it added this footnote:

> Median dilution from equity compensation rose from 8.3 percent in 1990 to 16.3 percent in 2000. Companies often offset this dilution by using cash to buy back stock in the open market. The "costs" of these options is not widely understood by the public.[3]

Even financial journals betray some confusion about this matter. Typical of this is an article in the June 10, 2002 edition of *Fortune*, which on the one hand supports mandatory expensing and then repeats without comment this view from a value fund manager:

> "What we're concerned about is shares being given away at a price at or below the intrinsic value of the company," says Chris Bloomstran, a St. Louis money manager....As a result, he largely ignores the options-adjusted earnings number, *instead making his own estimates of the future earnings dilution options could cause.* [emphasis added][4]

The dilutive effects of stock options are already accounted for in financial statements, a fact that renders absurd the IASB official's annoyed assertion, quoted above, that no value is attributed to options in financial statements. It also calls into question the repeated use of the tired phrase "stealth compensation" to describe options. This moniker, so beloved of Congressional leaders trying to influence the FASB process in favor of mandatory expensing, conveniently ignores dilution of ownership. Shareholders know, or ought to know, better.

As Chairman Levitt notes, dilution is not a "minor issue." It is in fact the *readily comparable* metric by which informed investors, such as Mr. Bloomstran, evaluate stock options plans. It is the metric, too, that responsible corporate managers employ when they think about the size and timing of options plans. It is the metric, in sum, that really matters. And it entails real costs, not "costs" as the conflicted Conference Board commission grudgingly puts it.

---

[3] The Conference Board, *Commission on Public Trust and Private Enterprise: Findings and Recommendations, Part 1: Executive Compensation,* September 17, 2002, p. 6, n. 7.

[4] "How Big is the Options Bite?" *Fortune*, June 17, 2002, p. 191

If dilution is not well understood by the public, it seems to us urgent for the FASB to make the display of that measure clearer in financial statements, along the lines, perhaps, of what some technology companies are already voluntarily doing.[5] What the FASB should not do is follow the IASB in demanding that all companies double-count the cost of options by adding mandatory expensing to dilution. Differing as it now does with the IASB proposal in regard to mandatory expensing, Statement 123 remains the better alternative.

Of course we understand that, having more or less disowned Statement 123 at birth, the Board is not likely to play proud parent now by arguing for Statement 123's superiority over the IASB's mandatory expensing proposal.

What is disappointing, however, is that the Board, in its desire to turn on the landing lights for the IASB alternative, seems uninterested in exploring the two major difficulties with mandatory expensing: namely, how to measure the value of options at issuance and whether or not options truly represent compensation. The *Invitation to Comment* tells readers that the Board made up its collective mind on both issues in 1995 and that its collective mind has been closed on those matters ever since.

Others, fortunately, have been willing to take a second look at the difficulties inherent in valuing stock options and whether options indeed are compensation. The coalition letter describes recent commentary from accounting firms in regard to the inability of option-pricing models to estimate the fair value of stock options as well as the tendency of those models to penalize growth companies in particular. The coalition letter also highlights the important findings of Blasi, Kruse, and Bernstein to the effect that, "[f]ar from being compensation for labor performed, options are instead a form of capital income."

Again, we will not repeat what is already contained in the coalition letter. We would only add that, particularly in the matter of measuring the value of stock options, the Board has before it the opportunity to test its assumption, reached eight years ago and never revisited, that options can be reliably valued.

---

[5] We note in passing that the FASB has ratcheted up its investor education activities via the production of a videotape entitled "Financially Correct" and starring such commentators as Warren Buffett, a Nebraska investor, and Floyd Norris, a New York writer. This would seem to be just the kind of vehicle for explaining to investors how the cost of stock options is captured through dilution, although it might require some re-editing so as to include someone willing to point that fact out.

The laboratory is that group of almost two hundred public companies that have in the past year decided to expense their employee stock options. ABC has seen no indication that the FASB has studied in any detail the valuation methods these companies have chosen to employ or management and investor satisfaction with those methods. Perhaps insufficient time has passed to permit a definitive study.

In any case, anecdotal evidence suggests that voluntary adoption of expensing under Statement 123 has slowed because companies *that are eager to expense options* lack confidence that a reliable way exists to measure the fair value of options.[6] Surely this possibility ought to be explored by the Board through intelligent field tests.

Otherwise, the Board's confident 1995 assertion that options can be valued will look like, to use an old phrase about second marriages, the triumph of hope over experience. This is a stance that perhaps works with serial matrimony but ought not to govern a decision about stock options accounting.

Conclusion In summary, the American Business Conference believes, in regard to the Board's *Invitation to Comment,* that the most important difference between Statement 123 and the IASB proposal is that the IASB proposal demands the mandatory expensing of stock options.

We believe Statement 123 is the better alternative. We do so first because we believe that the value of stock options is best understood in terms of potential dilution – put another way, this means the cost of options are borne by existing shareholders, not by the issuing company itself. Moreover, despite the claims of the Board and the IASB, we also believe that the assumption that the fair value of stock options can be reliably valued is, at best, untested. If the FASB insists upon following the IASB in what we regard as the wrong course toward mandatory expensing, at the very least that assumption should be tested.

Sincerely,

John Endean

John Endean
President

[6] "Voluntary Expensing of Stock Options Dwindles – Study," *Dow Jones News Service,* January 27, 2003.