

Karen Salmansohn

From: Director - FASB
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To: Karen Salmansohn
Subject: FW: Stock option acco

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

From: Troy, Dick [mailto:DTroy@cellpathways.com]
Sent: Friday, January 31, 2003 4:51 PM
To: Director - FASB
Subject: Stock option accounting

As a former CFO who commented in 1993 and testified on the first day of the hearings in 1994, I should like to make the following top-line observations as you revisit the subject of stock option accounting. It is imperative that the development of accounting principle remain independent of shifting social and political agendas and remain faithful to the fundamental purpose of reflecting the economic reality of an enterprise.

1. Statement 123 as initially proposed represented a deviation from fundamental accounting principle. It was based on the creation of fictitious accounting entries. A phantom asset would be created in the upper left of the balance sheet on the basis of a Black Scholes application; a phantom liability would be created in the lower right of the balance sheet to balance the phantom asset. The creation of these phantom assets and liabilities would permit charges to be run through the income statement on a periodic basis, irrespective of whether any option exercise had occurred. This proposal was recognized to represent fundamentally bad accounting principle and was withdrawn.
2. Experience with the then-completed six years of bull market (from the 1987 crash to the end of 1993) underscored the accounting distortion which Statement 123, as originally proposed, would have created. (Six years was deemed to be the average life of a ten year stock option.) As adduced at the 1994 hearings, during that six year period, the stocks of too many mainline, non-quirky companies went sideways or down; yet, application of proposed Statement 123 would have punished their income statements on the basis of the false hypothesis that their stocks had, instead, risen. Thus, at the hearings, the theoretical flaw of proposed Statement 123 was illustrated and graphically demonstrated by the reality of the then-recent bull market in which stocks had gone down, not up as hypothesized.
3. The theoretical and practical flaw of Statement 123, as initially proposed, was acknowledged by the FASB staff at the hearings. The staff acknowledged that the "volatility" factor in the original proposal always assumed that the price of the stock underlying the option would rise - and made no provision for the unfortunate reality of its decline. This utopian underlying assumption that all stocks rise and never decline further underscored the deviation between Statement 123, as initially proposed, and the realities which accounting principle seeks to reflect.
3. Aside from the then emergent pressures to bend accounting principle to social and political agendas, a source of impetus for the initially proposed Statement 123 was a desire to "perfect" the imperfections of APB 25 and its progeny. Yes, APB 25 was, and is, imperfect. So are many other matters of accounting principle. Accounting principle is difficult. However, the pursuit of perfection of any one principle may be at the expense of the larger picture which accounting principle seeks to project. Financial statements are intended to reflect the economic reality of the enterprise. A fabric of imperfect principles attempts to

achieve this. Elevation of the perfection of any one principle threatens to frustrate the achievement of the overall goal of reflecting the economic enterprise. Thus, "perfection" of APB 25 threatened, in the initial proposal of Statement 123, to introduce a fabric of phantom accounting entries which would bloat the balance sheet and distort the income statement, moving the financial statements as a whole away from the fundamental purpose of reflecting the economic reality of the enterprise. (For example, the asset-light balance sheets of emerging high-tech or bio-tech companies could have been bloated to many times their true size as the result of inserting newly created assets and liabilities to "reflect" the volatility of possible values associated with the grant of stock options.)

4. "But, aren't stock options worth something? Don't they constitute compensation?" Yes. And Yes. But that is a statement of a portion of the question, not a statement of the answer. And the real question, as noted below, is exceedingly difficult.

5. The difficulty of accounting for stock options lies in the dual nature of the stock option. At the moment of grant, the option has a heavy component (purpose and motivation) of compensation. Yet, over time, the stock option morphs into a capital transaction which may or may not occur. And, at all times, the option represents a contingency. Accounting principle is hard pressed to deal with a dual-nature phenomenon. Accounting principle wants to label every phenomenon as yes or no, red or blue, fish or fowl, capital or ordinary, etc. The dual nature of the stock option frustrates this urge of accounting principle to force all phenomena into simplistic alternative boxes. This urge is further frustrated by the contingent nature of the option - and the realization that huge numbers of options will never be exercised.

6. Prior to the initial proposal of Statement No. 123, the only truly applicable principle was that embodied in accounting for contingencies, Statement No. 5. The dialogues of the past ten years have served to emphasize that in many, if not most, situations, Statement No. 5 remains the most applicable principle: the contingent nature of the option relationship dominates all other features to the point that any treatment which deviates from treatment as a contingency opens the door to phantom entries and distortion of the financial statements.

7. One of the ugliest - and perhaps least sensational - lessons taught by Enron-like experiences is that our accounting, tax and legal systems have become complex to the point of obscuring reality. Accountants, auditors, lawyers and tax advisors can legitimately follow complex rules and bless transactions under the rubric of complying with these complex rules. Yet the financial statements emerging from the application of such complexities may fail to reflect the economic reality of the enterprise. This is not the stuff of which indictments or headlines are made. Congress is not likely to muster the political will to hold hearings into the shortcomings of the overly complex systems we have created. Apply this to stock option accounting: try to "perfect" APB 25 and its progeny; elevate achievement of "perfection" of APB 25 etc. above the basic principle that financial statements should reflect the economic realities of the enterprise. And you will exacerbate the trend toward complexity: generations of lawyers and accountants will master the new complexities and continue to churn out financial statements which correspondingly distort.

8. As a final reality check, consider the recent bull market and its implosion. If there had been mandatory expensing of stock options during 1998-2000, what would have been the effect on income statements and balance sheets during the rise of the bull market? And once the market had imploded and a tidal wave of stock options had become worthless, how would accounting rules have reflected the reality of what actually happened? (And, no, the answer is not that the expensing of stock options with phantom entries would have moderated the highs and lows of the stock market; we must not pollute the development and application of accounting principle with such speculation or burden it with such socio-economic agenda.)

9. The genius of Statement 123 as it finally emerged was that it recognized that financial reporting and disclosure need sufficient flexibility to deal with contingency. Footnote disclosure is not simply useful: it is powerful and, often, significantly more accurate.

I appreciate your time in reading these top-line comments. I submit them as a matter of guidance. I do not want to submerge you in a welter of detail. And, of course, I would be available to respond to your questions.

Respectfully submitted,

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