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FASB

Director of Major Projects and Technical Activities
Financial Accounting Standards Board
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Subject: Accounting for Employee Stock Options

Dear Sir:

I've seen options from both sides, as an employee with almost no equity wanting to get them to align my goals with the shareholders' and as a controlling shareholder and investor wanting to halt the excessive flow of capital away from shareholders and to employees and directors.

The unmistakable fact is that employee and director options ("options" hereinafter) take equity from the equity holders, and there are abuses - not just accounting issues - that bother investors.

The problems with options go beyond the flow of capital, because they include "trading" on inside information in the timing of options grants, and the disconnect between dollars and shares subject to grants. Shareholders and citizens see and understand the perceived unfairness of some companies taking deductions for tax purposes for options exercises eliminating all or most tax due.

The point of options should be to align management/employee/director interests with shareholders'. This means long-run interests. Not exercise-and-sell interests.

Options have the potential to skirt the insider-trading rules.

I've seen this happen for employee options and director options. All option grants should be effective, and have their exercise price determined, a minimum of 6 months and a day after public notice by an appropriate filing. Otherwise, the granting of options

can be done with knowledge of an R&D pipeline or other important development (not meeting the technical definition of material, non-public), to the disadvantage of equity holders. A requirement to exercise and hold for 6 months and a day would not solve the potential for abuse.

I've seen companies reprice options that *just happen* to have caught the exact bottom of a long-term decline. Repricing, when allowed, should be with immediate public disclosure.

Options are perceived as a give-away because there is a disconnect between dollars and shares.

If an employee or manager is deemed to need an equity-based incentive of some multiple of his base salary (or base plus minimum bonus), it would be reasonable to compute that amount and then divide by the exercise price to determine the number of options to be exercised. For example, if a base salary is \$250,000 and a board or compensation committee wants to give the upside of five times that, or \$1,250,000 of equity, and the exercise price (see next paragraph) is \$31.11, the number of options granted would be 4,018.

From my view any round number of options is likely evidence of an unthinking board. Perhaps this is beyond FASB's purview. I would require that any options grant be priced in dollars or as a multiple of some categories of compensation, and *compute the number of options granted after the exercise price is determined*. This would force boards and compensation committees to think of options as money, and probably lead to smaller grants.

Setting the exercise price 6 months and a day after notice might work, but there are other issues to consider (blackout periods, for instance). Thinking of options in terms of money and not round numbers changes the way they are granted and would change public perceptions of fairness. If tax law needs to be changed, let's make options fair and then address what legislation is needed.

Options reward mediocrity because they almost always have a fixed exercise price for 5 to 10 years. The 110% price recently used by IBM is progress, but very little. Why should options holders get a windfall for any stock improvement of less than 5% (or some other index) per year? The point is to give an incentive, to affect behavior and decisions, not to reward low thresholds of achievement.

When to Expense

Expensing at the time of grant or the time of determination of the exercise price, if later, works because the alternatives make no sense. We can't have financial reporting that results in lower earnings (a bigger financial hit) the higher a stock price rises. Continuing to allow companies to report earnings to shareholders before options deductions, while taking those deductions for tax purposes eliminating in some cases all or most tax due, also makes no sense.

Food for thought: If call options get expensed when granted, how would FASB treat issuing put options to management/employees/directors?

To see (the issue of) options clearly all you have to do is think like an owner.

Thank you.

/s/ Bernard E. Klein

Bernard E Klein

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