Letter of Comment No: 44
File Reference: 1102-100

Stacey Sutay

Subject: FW: Expensing Options

-----Original Message-----
From: Scott Rand [mailto:srand@mmcgrand.com]
Sent: Thursday, April 08, 2004 12:05 PM
To: Director - FASB; ted.aronson@aimr.org
Subject: Expensing Options

Dear Gentlemen,

I am a current CFA and I am embarrassed by the recent 1/2 page article in the Wall Street Journal which urges members to support the FASB proposal to expense options. I also have earned my CPA, although I am not currently practicing in public accounting. It has been a long time since I have taken an accounting course, yet I clearly remember that stock options are already accounted for in the calculation of earnings per share under the treasury stock method. The treasury stock method takes into account the dilutive effect options have on earnings per share based on REALITY; your proposal wants to artificially adjust reported earnings of companies based on a non-objective method of determining a "cost" of options on the grant date. This "cost" is to be determined based on a mathematical formula which you require a company to use a single number as the volatility of a company's future share price as the key factor in determining the "value" of the option grant. This also assumes that the predicted price movements alone of a company would determine the "cost" to the company of that option, even though in reality, the actual cost will likely be nowhere near this estimate. The fundamental assumption behind the Black-Scholes pricing model is that markets are efficient. As you should both know, it is still called the Efficient Market Hypothesis because it has never been proven.

The value of these options, which has been recognized as an expense in the financial statements, changes over time given changes in the underlying stock price and changes in the all the assumptions that go into this theoretical pricing model such as the risk-free rate, dividend rate, time to exercise, and volatility. Yet, there is no subsequent adjustment for any of these factors, even though the actual (again, REALITY) cost to the company could ultimately be zero. You argue that equity instruments awarded to employees are not subsequently adjusted for increases or decreases in the share price. That is because there is an objective measure on the grant date, as opposed to options, whose cost is determined using a theoretical value using multiple assumptions which vary over time. The other major flaw, given my interpretation of this pronouncment, is that options will still be included in the calculation of fully-diluted shares outstanding. So in effect, instead of properly accounting for options in the denominator of earnings per share, which reflects reality, you now penalize both the numerator and the denominator in the calculation of earnings per share, providing a meaningless number to everyone.

The propoganda in the Wall Street Journal advertisement says investors want earnings to reflect reality. If your definition of reality is pulling a number out of thin air based on

assumptions about the value of the option iteself, employment termination patterns and employees' exercise patterns in order to recognize the "cost" of options, you have a seriously distorted view of what reality is. You also say that it is inadequate to have footnote disclosure of this fictitious expense number, because apparently "average" investors are too a) stupid, b) lazy, c) both, to find the "footnote buried in the back of the annual report". If that is the case, perhaps those "average" investors who "need to see a company's complete financial picture" should turn their investment decisions over to those "experienced professionals" who are able to "dig deep into footnote disclosures and dredge up this information".

In your propoganda, you cite "devastating losses that investors suffered when companies like Enron and Worldcom obscured their real expenses and liabilities" as a reason for creating fictitious expense amounts and flowing them through the income statement. Are you suggesting that had Enron and Worldcom expensed options, investors would have avoided devastating losees? You indicate that "Politics and financial-reporting standards don't mix". I agree with this statement, yet the options expensing proposal is precisely the knee-jerk direct result of political correctness in the aftermath of Enron and Worldcom.

You end with the statement "Because telling investors the truth - the whole truth - should never be optional". The truth is that options have always been accounted for in the calculation of earnings per share (which I'm sure your "average" investor isn't even aware of) based on the treasury method which is based on reality. Your proposed treatment of expensing options cost is based on numerous unestimable assumptions that will never reflect the truth. If this proposal is enacted, it will mean one more adjustment that this investment professional will have to make to the reported financial statements in order to determine the true value of a business. I should thank you in advance, since this will likely create more inefficiencies in the market that I will be able to take advantage of.

Sincerely,

Scott Rand