

Karen Salmansohn

From: Director - FASB
Sent: Monday, February 11, 2003 10:57 AM
To: Karen Salmansohn
Subject: FW: Accounting for Stock-Based Compensation

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Accounting for Stock
Option Ex...



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-----Original Message-----
From: Randy Livingston [mailto:randyl@stanford.edu]
Sent: Friday, January 31, 2003 4:02 PM
To: Director - FASB
Subject: Accounting for Stock-Based Compensation

Enclosed are my comments on an appropriate approach to stock-based compensation.

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Accounting for Stock Option Expense

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January 31, 2003

Accounting for employee stock option expense is one of the hottest topics being debated in corporate boardrooms and amongst corporate regulators today. There is no question that stock options provide a form of employee compensation that is highly valued by employers, executives and rank-and-file employees. The question is how to accurately measure the value of employee options and when to account for that value in companies' financial statements.

The approach currently being advocated by the accounting profession and embedded in Financial Accounting Standard (FAS) 123 requires valuation of options at the date of grant, treating it similarly to the options that stock market investors can buy and sell in the open market. This approach is fundamentally flawed for two reasons. First, employee options are different in numerous ways from financial market options, and accountants have not developed methodologies to value these differences. Second, and more important, the employee is not compensated by the option itself, but only when he or she actually exercises the option and has the right to sell the associated shares.

The issues in applying financial market valuation techniques (principally the Black-Scholes option pricing model) to employee stock options have been well documented. Employee options are nontradeable, nontransferable and illiquid. They have a much longer duration, typically 10 years, compared to financial market options, which usually have duration of less than 12 months. Employees can directly impact the value of their options by successfully performing their jobs (in fact, this is the primary rationale for using options as a compensation tool). A large percentage of employee options are forfeited due to employee terminations before they become vested. Employees, and especially executives, have lock-ups and trading windows that restrict them from exercising options or selling shares much of the time. Employees have significant information advantages in understanding the prospects for their company and deciding when to sell shares. At the same time, conscientious executives will refrain from selling more than a small portion of their shares even when they believe the value has peaked, out of concern for sending a negative message to outside investors. Although accountants and academics are trying to develop methods to address some of these differences, such as option forfeiture, they are not close to establishing an approach that addresses all the variables.

Some companies, notably Coca-Cola, have proposed to establish employee option values by asking investment banks to establish a "market value" for the options. While this approach helps address the long duration of the option, it does not deal with all the other employment-related issues.

Employees only realize compensation when they exercise the options and are allowed to sell the exercised shares. The actual compensation realized varies enormously. We all hear about the handful of individuals who have made millions of dollars, but there are

many, many more who have earned nothing as the share value of their company dipped below the exercise price on their options. Why don't companies simply recognize stock option compensation expense when the compensation is actually realized?

There is an analogy in corporate bonus and sales commission plans, which are also forms of contingent compensation. Companies are not expected to record an expense based on the theoretical value to the employee of having the right to participate in a bonus or commission plan. Rather, companies expense the actual bonus or commission earned by the employee after the outcome is known. Why shouldn't companies do the same for employee stock options?

The Internal Revenue Service ("IRS") has long taken this approach to recognizing compensation from "non-qualified" employee stock options. Under the IRS approach for non-qualified options, compensation is recognized as the difference between fair market value and exercise price on the date the option is exercised. Employees are taxed on this compensation as ordinary income, and employers deduct the same amount as compensation expense. It is ironic that this approach long embraced for tax accounting purposes has not found its way into the debate for financial accounting.

One possible objection to this approach is that companies currently cannot control when employees exercise their options. The impact on quarterly earnings could vary considerably based on differences in when options are exercised and the spread between exercise prices and fair market value. Perhaps this type of earnings volatility is not bad, as it would help investors understand the actual compensation that employees are realizing from their stock options, as opposed to a mythical value that is quite different from what anybody realizes under the FAS 123 approach.

To address this potential volatility, companies could be allowed (or required) to impose restrictions on the percentage of options that an employee can exercise and sell during any quarter. For example, employees might be restricted from selling more than 5% of their total options and stock each quarter, or 20% per year. This would not only mitigate potential earnings volatility if options were accounted for upon exercise, but would have the added benefit of substantially preventing insiders from unloading their shares when they recognize their company's fortunes may be headed downward. Executives would have incentive to focus their efforts on sustained share value increases, rather than popping the stock temporarily.