Karen Salmansohn

From: Director - FASB
Sent: Friday, January 31,
To: Karen Salmansohn
Subject: FW: File Reference:

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-----Original Message-----
From: Jeremy McCarthy [mailto:jeremy@hireloop.com]
Sent: Friday, January 31, 2003 1:26 PM
To: Director - FASB
Subject: File Reference: 1102-001

I have attached the copy of an article I wrote several months ago against the prospect of expensing stock options. I am a former Big 4 CPA and currently own a recruiting software and search business in Silicon Valley. Thanks for your time.

Regards,
Jeremy

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Expensing Stock Options: Political Accounting

There's an old saying about not cutting off your nose to spite your face. It reminds me of what is currently happening with the stock options expensing argument in the wake of recent accounting scandals. The theory goes that massive stock option grants are to blame for corporate malfeasance, and expensing options will put an end to this.

Virtually every article and news report I have seen the past few weeks has been heavily biased in favor of expensing options. Business journalists, Senators, accounting professors and some corporate leaders at Coca-Cola and General Electric all seem to be drinking the kool-aid. But a ray of hope arrived recently, as Intel stepped forward in opposition to this practice.

As I see it, the only relevant question is this: Will expensing stock options be an accurate reflection of financial position that will help investors judge the overall performance of a company? The answer is No. The calculation is essentially a meaningless number with no operational or cash impact on a company. That's why it belongs in the footnotes and not on the income statement.

Let's first get the non-accounting issue out of the way, because it's the easiest myth to debunk. Expensing stock options will have no impact on corporate scandals or corruption. In fact, this treatment will only scare companies into cutting back their option pool to the rank-and-file employees while still offering generous options packages to executives. Stock options are only a symptom of corrupt executives, not the cause. Consider this analogy: Hondas are the most commonly stolen cars in my city. Should we reduce the number of Hondas sold in order to reduce car theft? Car theft is caused by criminals, not by cars. And corporate scandals are caused by corrupt executives, not by stock options.

So now we have the accounting issues. It's hard to argue that stock options don't have some kind of potential value to employees. They can be an important part of the total compensation package. But there are significant problems with the accounting treatment associated with expensing options:

- Expense? - The real cost these options have to a company is theoretical. Equating stock options with employee salary or some other cash expense is an oversimplification. Expensing stock options is simply a way to show the possible dilution effect to shareholders. But that's already disclosed in the footnotes to the financial statements and in the fully diluted earnings-per-share calculation. The "expense" isn't related to the company's operations, it's really an expense to the individual shareholder. Shareholder dilution is an equity issue, not an income statement issue.

- Show me the money - Stock options are essentially a cash-free transaction for a company. If significant non-cash expenses get buried in the income statement, it is actually more misleading to investors than not expensing them. Pro-expense lobbyists insist that most investors are not "savvy" enough to understand the dilution effect of stock options without showing them as an expense. If investors aren't savvy enough to read a financial statement and understand the possible dilution affect of stock options, they certainly aren't savvy enough to read a financial statement to understand that a stock option expense has no cash impact on a company.

- Privacy, please - And what about privately held companies? There is significant debate on how to determine a fair value for expensing stock options for companies with a public market for their stock. Valuing this transaction for private companies is essentially impossible.

- Double trouble - Then there's the issue of taking a double hit for the options in a company's earnings-per-share calculation (EPS). In the fully diluted EPS calculation, the dilution effect of options is already taken into account. Deducting stock options from the calculation of net income essentially double counts the dilution effect of these options.

- A taxing situation - And no one has even begun discussing the potential tax abuse implications for expensing stock options. It's hard for option expense advocates to argue that options are a true expense, unless you consider them for tax purposes. And if these options become tax-deductible, the opportunity to abuse a non-cash expense to manipulate a company's tax liability is frightening.

At the end of the day, options are a dilution of individual shareholder equity and not an expense. To treat them otherwise will favor politics over accounting. Intel finally had the courage to stand up against expensing stock options. Hopefully other business leaders will do the same before it's too late.

Jeremy McCarthy is a former Big-5 CPA and is currently the CEO of HireLoop, Inc.

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