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Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Subject: Accounting for Stock Options

Dear Sirs:

I am enclosing a suggested accounting treatment for stock options. This treatment will accurately reflect the fair value of stock options during the option period, properly report monthly net income, and will correctly record capital accounts. It is far less complex than FAS 123 and I believe it to be more accurate.

The Current Problem

Historically, the accounting procedure for stock options had two major problems. The first being the proper recording of the difference between the fixed price for the option and the market value of those shares when they are exercised.

The second problem (actually the other side of the first problem) was that accountants did not report the expense the company had incurred in providing the option over the life of the option. More recently, this problem was recognized and discussed in FAS 123, but not resolved. FAS 123 recommended an estimation of fair value for the option at the date of grant with amortization over the life of the option. FAS 123 stated a complex method to determine the fair value of a stockoption (in fact on the date of the grant it has no value). In attempting to establish a current value for some future development, it became entangled in concern for a vesting period, ignored future price fluctuations, and lost touch with the real world. Assuming the optionee is a factor in the price of a stock (a fact assumed by the Board of Directors), the amount of deferred compensation earned by the optionee for the results produced is only determinable by reflecting the changes in the price of the stock. For different time frames, this may be either a plus or a negative, but will never be a net negative for the expired time from the granting of the option. The value of the option viewed by the grantee will increase or decrease over the option period as a result of the success or failure of the optionee. The change in market price is the measure of that value and needs to be the factor used to record the deferred compensation expense for the option. At issuance of the option there is no value to either the company or the optionee. Unfortunately, FAS 123 is estimating what can be accurately calculated as it is earned, and thus loses sight of the total consequences of the granting.

The IRS deferral of income from stock options until the optionee sells the stock has clouded both these problems. This deferral has caused concentration on the purchase side of the stock and not the operations of the company, Since the cost to the company for the option is not tax-deductible, its cost has been slow to be recognized. There is never a current or deferred tax consequence as the result of a stock option under present IRS rules.

I am reminded of a personal experience about 40 years ago. The CEO asked me to come up with a plan to solve a complex financial problem. There were a lot of nuances to deal with and I offered a solution to the CEO. He called in the news media to announce a breakthrough. His unfamiliarity with all the details led to a minor disaster and killed the plan. I learned the KISS principle that day and have tried to follow it ever since - KEEP IT SIMPLE STUPID.

Reasons for Granting Options

Boards of Directors see a direct relationship between the efforts of key personnel and the growth in value of the investment held by shareholders. They see a stock option (making available a set number of shares at a pre-established price per share for some period of time) as a way of sharing with that person the increase in the value of shareholder investments brought about by the optionee's efforts. By having a locked-in price, the optionee is able to share in any value increase when the market price of a share of stock increases. If the value of stock does not increase, the option has no value. The change in the value of the option can be determined and recorded each month by any change in the market price. This is exactly what the optionee does every day---look up the price of the stock and multiply his option shares times the increase or decrease in price!

Proposed Solution

NOTE - Stock-based compensation should be dealt with in two parts. The first I will call a pure stock option: the option price being equal to or above the market price on the date of the grant. The second would be all other. This discussion deals with only pure stock options. The value of the option at any point after granting is the current market value for the same number of shares covered by the option less the fixed price to make the purchase under the option..

First, make a monthly calculation of the change in value of the option by using the current market price for the option shares compared to the prior month's value for that number of shares.

Second, record the monthly increase by charging Deferred Compensation - Stock Options (an expense account) and crediting Deferred Compensation Payable (a liability account). For a decrease make a reverse entry.

Third, record a transfer from the Deferred Compensation Payable to the Paid-in Capital account when the option is exercised.

These actions will eliminate the two problems previously outlined.

The first problem was how to deal with the difference between the exercise price and the market price for the option shares. Under my proposal, on the date the option is exercised, the capital structure of the company will increase by the market value of the shares sold when the exercised payment is recorded. There will be a recording of the stated (par) value of the shares sold and a paid-in capital increase for the payment in excess of par value. The closing of the deferred compensation liability to the paid-in capital account has been previously referenced.

The shortfall of cash from the optionee to cover the market price for the stock being purchased is in effect the deferred compensation now being paid to the optionee and returned to the company in the way of paid-in capital: all of this a non-taxable transaction in the eyes of the IRS. This deferred compensation was earned by the optionee from the date of grant to the date of exercise.

Under this plan, both the capital structure and the cash received from the exercise of stock options are accurately recorded. This procedure accurately records the deferred compensation as measured by market price and it does it as it is earned. It avoids a too-common trap for accountants of recording a complex entry net of all its elements. This procedure also complies with the KISS principle.

The second problem as outlined above was that accountants have not recorded an accurate cost for the option over the life of the option. Under my proposal, the accurate cost is recorded each month, whether it is an increase or decrease. It should be noted that the Deferred Compensation Payable can never be reduced below zero---at that point the option has no value.

The company expenses are thus accurately measured each month and are properly reported in the monthly net income of the company. Per share data is already being reported on an actual and fully diluted basis; therefore, the shares under option would be included as outstanding for purpose of reporting fully diluted numbers.

My Background

- Retired as Executive Vice- President and Chief Financial Officer for American Water Works Company in 1991 after twenty-five years.
- Treasurer and Asst. Controller with Indianapolis Water Co., leaving after eight years
- Public accountant with PMM & Co in Indianapolis for nearly ten years
- Earned my certificate in Indiana in 1954
- Member of the Indiana CPA association for 48 years

I look forward to hearing from you. If there are any questions I have left unanswered, I may be contacted at my winter residence here in Scottsdale or by telephone at (480) 443-3969.

Very truly yours,

Loren Mellendorf

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