

Mr. Robert H. Herz, Chairman
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116

September 3, 2002

Letter of Comment No: 13
File Reference: 1101-SCU
Date Received: 09/03/02

Dear Mr. Herz:

I know the FASB is addressing the question of how to account for stock options.

I respectfully suggest that the Board give consideration to the points raised in the op-ed article in the Wall Street Journal on 8/3/02, entitled "Another Option on Options" which I have attached, and in particular to the suggestions in my responding Letter to the Editor, also attached.

I think the issue of properly accounting for options is of major concern to investors in equities such as myself. The run-up and collapse of the stock market, as well as the collapse of many CEO's ethics, was due in no small part to the non-accounting for options, the direct result of political meddling by Congress and big-dollar contributors. I recognize there continues to be much pressure on the FASB from these same sources, but lets not have this sad saga be repeated.

Very truly yours,



Wayne J Seltzer
105 Glen Drive
New Canaan, CT 06840

Attachments (2)

**By Reuven Brenner
And Donald Luskin**

More and more companies are stepping forward to voluntarily include the expense of stock options in their income statements. This trend is a welcome step on the road toward reality, away from the present world of illusions in which options expense is usually treated as though it were zero.

But even as this salutary trend gains momentum, there seems to be a pervasive sense that it doesn't do enough to provide wary investors with the information they need about the real impact of options.

Not Ideal

For example, in announcing that General Motors plans to expense options, its Chief Financial Officer John Devine said, "While we are enthusiastic about taking steps such as this to restore investor confidence in business, it is important to point out that current valuation methods available for expensing stock options are not ideal." And prominently heading *The Wall Street Journal's* online list of companies that have volunteered to show options expense is this warning: "Calculations come from the companies' data and use the Black-Scholes formula, which links the value of an option to such variables as the current share price, the exercise price, expected volatility in share prices and expected dividends. The formula doesn't give an accurate picture of the cost of options."

The problem is that today's accounting rules leave us with a Hobson's choice for calculating options expense: zero, or theoretical fair value. Zero is the frying pan—options are a form of compensation, and compensation doesn't cost zero to provide. But fair value is the fire. Fair value is subjective—and what's worse, it's just a snap shot made only once at the time the option is first issued. It's an estimate treated as fact, enshrined forever in earnings regardless of whether the option turns out in the future to be worth millions of dollars or to expire worthless.

The fundamental problem with both of the available methods is that they are looking for options expense in the wrong places. They mistakenly think of options expense as something that happens when an option is first issued. But it's not. At the time of issue, options expense really is zero—that's the one sense in which the status quo has always been correct. But options expense occurs when the option is exercised.

It's simple. An executive is issued options when his company's stock is at \$10. When he exercises the options, they'll entitle him to pay \$10 for the stock no matter how high its price in the market. Yes, the company has conveyed

something of real value to the executive—an option contract that the executive would have had to pay money for if he'd bought the same thing from a third party. But the company received something of value, too: the executive's commitment to work for the company, and probably at lower up-front wages than would otherwise be the case. It's an even trade—so when the option is first issued there is no net cost, not even an intangible one.

The costs show up when the executive exercises the option sometime in the future. The executive will make a profit of \$40 when he exercises his options if his company's stock is at \$50. That's a fact. It's so objective, he'll have to pay taxes on that \$40.

Since the executive makes \$40, it must be that

*The zero-expense frying pan
or the fair-value fire?
There's a better solution.*

\$40 is also the company's options expense—there's no such thing as a free lunch. It's a real cost: the company has to sell stock to the option-holder at \$10 when it could have been issued in a secondary offering at \$50. The stock transferred comes from the company's treasury stocks, which is always available for retirement or resale. Often, the company purchased the stock to be transferred to the executives at the \$50, and paid either by issuing debt or from retained earnings. Either way, it costs the company \$40 to sell \$50 stock for only \$10.

That's a fact, too. It's objective enough that current tax law allows the company to deduct that \$40 from taxable income.

Options expense based on exercise is generally higher over the long run than options expense based on the fair value approach that companies are now signing up to adopt. For example, at General Electric, the exercise value method would have reduced net income by 8.3% on average for fiscal years 1995 to 2001. The fair value method would have reduced it by only 1.3%.

A more profound implication of the exercise approach, though, is that options expense can't be known until the options are exercised. That means that options are risky liabilities of unknown future cost—a short position in a derivative security, actually. As such, they should be reflected on the company's balance sheet and marked to market every quarter.

CEOs who wanted to keep options expense off the income statement aren't going to like putting options liabilities on the balance sheet, since the latter reveals sharply the higher risk—exposure of the company—a cost not reflected in income

statements. The accounting profession complied with the arrangement, superficially rationalizing the practice as being consistent with the principle of never putting equity instruments on the balance sheet.

But keeping options off the balance sheet conceals what is potentially a vast liability. The language of "equity" vs. "debt" is misleading in a world where financial instruments have characteristics of both, and where compensation and capital markets have been integrated in practice (though not in accounting). At Microsoft, for example, as of the most recent 10-k, the exercise value of all outstanding options was \$23.7 billion dollars. That's a single liability not shown on the balance sheet that was twice as big as all the liabilities that are shown.

But the Financial Accounting Standards Board's tradition-bound rules don't permit investors to see that liability—the FASB clings to the notion that executive stock options are "equity instruments," and therefore are not allowed on the balance sheet.

Putting options on the income statement reveals their expense. Putting them on the balance sheet reveals their risk. Together, they reveal exactly how and exactly how much a company is paying for its precious human capital.

Compensation Tools

In brief: Options are valuable—if imperfect—compensation tools. So CEO's should have nothing to fear by bringing all the costs and all the risks of options into the open. But the worst mistake they could make now would be to jump from the zero-expense frying pan to the fair-value fire, simply trading off one erroneous method for another, all in the name of corporate accountability. Putting options on the balance sheet, and counting their objective exercise value as their cost, is a solution beyond the frying pan and beyond the fire, too. It turns the cliché of "people being a company's most important asset" into sharp, numerical reality.

By bringing the true cost and nature of options into explicit public view, the debate will focus on the fundamental issues behind the accounting façade. One such issue is the role of boards and the functioning of markets for corporate control in awarding these compensations, and significantly altering the companies' risk profile. Another is whether or not linking compensations to stock prices, rather than companies' actual performance, is a good idea to start with.

Mr. Brenner holds the Repap chair at McGill University's School of Management. His most recent book is "The Force of Finance" (Texere, 2002). Mr. Luskin is chief investment officer of Trend Macrolitics LLC, and former vice chairman of Barclays Global Investors.

Letters To The Editor

September 3, 2002

“Another Option on Options”, by Messrs. Brenner and Luskin (WSJ 9/03/02) made some excellent points, especially those concerning the large liabilities not now accounted for on the balance sheet, and the observation that the options expense based on exercise is generally greater than that based on the fair value approach that is becoming popular. I would disagree on two points, however. While they agree that real value is conveyed to a worker when an option is granted, they go on to assert that there is no cost to be accounted for at that time simply because the company has received something of value in return, a commitment to work for the company, so it’s an even trade. Following this logic, regular wages would also not be an expense, because the company was getting work in return. An even trade does not mean the expense should not be recognized. Also, the suggestion that the option liabilities be explicitly recognized on the balance sheet is a good one – lately we’ve seen too much stuff kept off the balance sheet. But disconnecting the balance sheet from the earnings statement is a bad idea - charges to the balance sheet should be run through the income statement.

The answer to all this that suggests itself is to expense options based on fair value (presumably Black-Scholes) at the time of the grant (thus properly recognizing them as compensation) but also carry a reserve on the balance sheet that would be periodically adjusted based on the actual exercise outcomes, with any differences being charged or credited to income. That is, it would be somewhat akin to the accounting for employee pensions and retiree benefits. Only in this manner will the real cost of options show up in earnings statements, however unpopular this might be.

Wayne J Seltzer
New Canaan, CT
203-966-4761