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Re: Expensing employee stock options in financial statements

Shame on you

I am a seasoned CPA and I am embarrassed by the FASB. In particular, I find the FASB's interest in expensing employee stock options a whitewash for the failures of the FASB. Expensing stock options is not sound accounting, so there is some hidden reason for advancing this requirement. These are difficult times for accountants and instead of the FASB being a leader, employing the experience and resources given to the FASB, it has, contrary to its promise to Congress, succumbed to simple politics.

Politics? Us? "We are independent..., our work is technical in nature..." (The FASB Report June 30), you're probably saying to yourself. Another letter opposing the expensing of stock options. Seen it before. What's new? Get to the predictable point, so I can shoot it down! This complacency is your error.

"The Board unanimously decided to add a project to its agenda... The opportunity to achieve convergence to a common ... international accounting standard. The high level of public concern expressed about the need to improve the reporting for stock-based compensation. The noncomparability created by the recent trend of companies to adopt the fair value provisions of our 1995 standard... The deliberations will benefit from the FASB's ongoing review of the vast amount of research and other literature in the area..." (The FASB Report June 30).

These and other FASB remarks and actions and inactions reflect politics, not a concern with sound accounting.

The Bias of the FASB

CPAs are trained to consider bias and are usually experienced in evaluating such bias.

Unanimous sounds better than any dissent. With a few hours of private and public deliberations and no dissent, there is no evidence that each of the Board members reached their conclusions independently.

Do you think no one noticed that Mr. Liesenring, the early nineties FASB Board chairperson of the SFAS 123 stock-based compensation project, (constantly chafing from the SFAS 123 “defeat” in his imaginary world), is now associated with the IASB? Did you think that the IASB, reorganized after being effectively rebuked by the SEC, would become the handmaiden to the FASB in an attempt at some acceptance? Did you think no one noticed how the IASB has folded like a “house of cards” on the nominal differences between the IASB stock options draft and the FASB tentative conclusions discussed to date? Achieving convergence with the IASB, who have limited staff and resources (and those key staff that exist mostly drawn from the FASB), is a related party transaction, and probably to such a degree as to make the IASB worthy of consolidation with the FASB.

The high level of public concern was reported as “expressed by individuals, and institutional investors, pension funds, mutual funds creditors, financial analysts and other users of financial instruments and the major accounting firms, about the need to improve the financial reporting for stock-based compensation” is a disquisition on the half-truth. What does this group want improved: the valuation (because it is incorrect) or requiring expensing? What are the consequences of a non-cash charge that can be easily manipulated? Are these the same institutional investors who had been indicted and/or convicted for selling their opinions in exchange for sales of their services to companies? Why would accounting firms, who unanimously opposed SFAS 123, now reverse themselves? What has happened between then and now? Let us think.

There are approximately 15,000 SEC registrants. I am uncertain how many have stock-option compensations plans. There are approximately 250 companies who have recently switched, with about 25 Fortune 100 companies having switched. Look at the credit ratings or controversies surrounding those companies.

For example, Coca Cola's heralded announcement was accompanied by the announcement that they now, post-Oxley Sarbanes, are consolidating their money-losing German affiliate. Freddie Mac also elected early adoption. Also, I suspect that the heavily regulated banks, a large element of the 25, were:

- Coerced by the Comptroller of the Currency (the delegate of the SEC), to report the expensing of stock options; or,
- Are attempting to respond to the deceitful scandals engulfing their industry; or,
- Are expanding their business to accommodate purchases and sales of employee options or to provide their valuations.

The "recent trend" is misleading

Most people know that the FASB wouldn't approach this issue unless it had the tacit approval of the SEC (whom they are "subject to") and the implicit view that one of their bosses, the Congress, wouldn't object. This is the ultimate in politics: Doing what your boss told you to do!

Admittedly, some of my problems with the FASB are really problems with the SEC who covers behind the FASB because they are afraid. It is a subversion of the Federal Administrative Procedures Act when the FASB and the SEC meet secretly to decide the fate of accounting rules, e.g., when the SEC's Walter Schuetze met with the full FASB Board a few weeks before they decided not to require expensing options under SFAS 123 in 1995. It is arrogance.

The Sham Options Valuation Group

The July 8, 2003 taped Options Value Group (OVG) meeting of deemed experts highlights the political agenda of the FASB.

You have constructed, for the most part, a sham group of experts on valuing employee stock options as part of your political process. You selected them in a closed process; met with them privately before displaying them in public; and tricked some into revealing their positions in position papers before attending the meeting. Oddly, they usually were not the published or cited academic or other “experts” in valuing employee stock options, which, frankly, is not a vast amount of people. In fact, I argue there are none.

The opening remarks alluded to the fact that there were other experts being consulted. Do you really think anyone believes that Dr. Myron Scholes (whose Long Term Hedge Fund nearly brought down the U.S capital markets, but for a government bail out) is in substantive touch with the Board while he is under trial for tax evasion? That Dr. Scholes would reverse his earlier neutral position? At best, he should be shunned for the destruction he has wrought. This is Machiavellian politics where you align yourself with the unscrupulous if it serves your needs. If there are position papers to the FASB by eminent **traded** option scholars like Dr. Rubinstein and Dr. Ross, why are they not on the FASB web-- like comment letters to the FASB opposing the standard?

Dr. Schipper’s question to Mr. Crystal, a long-standing, known opponent of the FASB project and OVG member, was revealing of the political agenda. “Dr. Crystal...” she said, “It’s Mr. Crystal,” he interrupted. People’s credentials had already been displayed in writing, revealing that only two non-FASB and IASB members did not have doctoral degrees, and people were introduced. This was a crass, deliberate and petty putdown by one of the FASB “hosts” of the meeting.

The OVG Meeting Chairperson, Mr. Michael Crooch, formerly of Arthur Andersen, opened the meeting by admonishing the FASB and IASB Board members to not use the meeting to espouse their views. Yet, remarks like those of Dr. Schipper were not rebuked. Mr. Leisenring railed against Mr. Crystal’s proposal, (the only proposal made that day viva voce), and was not rebuked. Several times Board members testingly asked about the accounting and several OVG members remarked that they are not experts at the accounting. For example, Dr. Schipper pressed what if the accounting required were simply to fair value options and leave it to the preparers to value. “After all, no other accounting standard defines how to calculate fair value”, she went on. The response was underwhelming, as, I suspect that some of these bright minds began to realize they were being used. Mr. John Smith, IASB Board Member and formerly of Deloitte and Touche, remarked that “derivatives are traded” [and therefore had reliably determined fair values], was ignored by Dr. Schipper. The meeting Chairperson violated Robert’s Rules of Order that requires the Chairperson to promote a fair vetting of the issues.

Moreover, most of the experts do not appear to be independent. The majority of them are consultants who will profit from implementing a vague standard or have themselves or their firm cleansed by being associated with the “the right thing”. For example, Nobel laureate’s Dr. Merton’s et al’s recent analysis that advocated the expensing of employee stock option valuation in the April 2003 *Harvard Business Review* speaks more to his legal strategies in a tax evasion case than an academic solution.

It is noted that two of the OVG members (Dr. Finnerty and Dr. Cao’s firm) had advocated alternative valuation models, but oddly there was no discussion of these brave attempts.

The meeting was structured to elicit the members to comment on FASB selected aspects of a vague valuation idea. It was apparent that the members were not familiar with the SFAS 123. If this was a real vetting of the issue, the FASB should have taken the OVG through the current SFAS 123 model, harnessed the cynical side of the OVG academics, and asked for comments. But they didn’t. Indeed, when Mr. Leisenring miscalculated and asked of one OVG expert member (with a Ph.D in chemical engineering) if he agreed with the “Rubinstein” idea to use exercise date accounting, that member spontaneously took an informal poll of the OVG members and revealed the same thought by the key OVG members (self-touted, experienced capital markets options valuation experts). It was also surprising to see that no key expert accepted the Black-Scholes valuation, a FASB SFAS 123-advocated model, deferring to a binomial model—the same model developed by Dr. Ross et al at the OVG meeting. That rebuke of the SFAS 123 standard didn’t make it to the FASB press release on the OVG meeting. Indeed, the FASB is now in the process (FASB OVG Minutes) of covering up its previous error by positioning itself as never advocating the Black-Scholes model (SFAS 123 (19)). It was revealing that a short while later that Ed Trott, Board Member, said that he wanted “to revisit these issues in private”.

How dare you suggest that the FASB is unbiased!

Why?

When Enron went down, no one said it was stock options. It was the failure to objectively fair value long-dated transactions. When MCI went down, no one said it was stock options. It was a failure to not objectively capitalize certain expenditures. When GE went down dramatically in value, no one said it was stock options. It was a failure to not objectively disclose the effect of business combinations. The people pointing to stock options are pointing away from the truth; that what the U.S needs is objective accounting measurements.

Why are you doing this?

I too would like to make accounting seem more glamorous than it is. Arcane formulas seemingly invoking Nobel Prize winning-thoughts, might impress some. It is also true that the plethora of obtuse standards lead to the undemocratic result that no one can be a master of them. This leads to greater fees to large public accounting firms, a main source of your financial support or, fees for your publications, another main source of your support.

Also, the administrative burden invites skimming the issues and the acceptance of the status quo. Focus on stock options and people will forget, for example, the:

- FASB failed to provide an adequate and timely consolidation standard (that Enron abused);
- that the FASB agent, the Emerging Issues Task Force (chaired by Tim Lucas, then Director of FASB Technical Research, who abruptly resigned May 2002), hurriedly reversed EITF 98-10 in the summer of 2002 on fair valuing long-dated energy contracts-- after it was revealed that Enron utilized this rule as part its nefarious schemes;
- the FASB reversed elements of EITF 96-13 that losses (or gains) required on certain contracts in a company's own stock to be excluded from net income by hurriedly issuing FASB 150 that requires losses and gains to be reported in net income after it was revealed that Enron applied this rule.

Moreover, beyond recent events, any objective review of the recently issued FASB standards, that are usually huge and have required amendments or addendums to explain what is going on, reveals that FASB is masking its ineptitude with specious volume, e.g., the FASB's 1000+ page travesty of SFAS 133/137/138/149 and related DIGS, SFAS 141 that now requires extensive implementation guidance for a rule that has been in existence since 1959, a revenue recognition project that discusses settling liabilities as revenue generating activities, without officially defining liabilities.

I think that the FASB is focusing on requiring expensing stock options for political reasons.

This error will be probably be compounded by the FASB failing to provide detailed guidance on determining fair value for employee stock options, just as in many of its other recent bogus standards. It is highly likely that the FASB will avoid responsibility for providing objective accounting standards, citing the meaningless buzz word "principles-based accounting". While it is true, as some FASB members say, a number of business events are complex, I believe that is why the FASB gets paid the "big bucks": To distill the complexity into cogent rules.

Part of the problem is there is no effective review mechanism of the FASB's actions. Lip service is paid to self-defined constituents. Comments on technical matters are ignored when they don't suit the Board's conclusions. The process is aided by FASB staff transfers to and from the FASB to the public or government sector. The SEC is invisible, content to exert power from behind a FASB screen or through undocumented policies (that invite and have created favoritism in favor of the large accounting firms and certain others), ignoring its due process to the detriment of the public. No wonder reasonable people invoke Congress in an accounting debate. CPAs are no longer self-regulated and, if you require expensing stock options for political reasons, the FASB should not have to authority to set the accounting rules.

Look at the 150 main ("Level A GAAP") SFASs you have produced. How many have been revoked or amended or represent standards that had there scope extended. Based on an analysis of the key standards, I suggest a rule of thumb is to wait a generation, then see how many standards are overturned by the next generation. You are the wrong group to produce principles based accounting that will stand the test of time.

What can you do?

Do the right thing and study the subject to realize that the measurement is not objective and does not fit in the cash-based (reality based) accounting world that the average reasonable person can trust.

The technical problems, your stated focus, with expensing stock options are obvious if you are truly looking. Expenses are cash outflows; employee stock options are not investments in the company. The issuance of stock options is not the in-substance issuance of stock immediately convertible to cash, which appears to be the knee-jerk error driving you down this road. You have had to subvert your own Conceptual Framework to work in such ideas about equity and fair value, without even going through the effort of amending the Framework before reaching such conclusions. Stop making a mockery of a technical process!

The measurement problem of using an options-pricing model, which ignores that the model depends on traded options and that it does not factor out the inability to transfer the options, is so obvious. Yet, SFAS 123 doesn't fairly acknowledge it in its basis for conclusions (SFAS 123 (169)). One can see that the FASB is starting to wake up to this fact by seemingly "testing" the view at public meetings that a SFAS 123 value is the best available value until a better valuation model comes along. If you were objective, you'd realize that this is a political approach by the FASB. It just gets something on the books to appease your misguided sense of what you think is a good accounting principle. It leaves the responsibility for measuring that impossible value to the preparers. It, once again, leave the unsuspecting public to interpret. It is not sound accounting.

Please produce a standard that can stand up to the light of day, as opposed to reflecting your "back room" machinations in masking your technical inadequacies.

Conclusion

In the mean time, I infer you will enjoy your FASB June 30 Report announced meetings at Caesar's and the Bellagio in Las Vegas and, the Hilton in Hawaii.

Hey, wait a minute!

The FASB believes that compensation is what is paid in cash and benefits.

- One of the benefits of being a FASB Board member is attending these conferences in nice locales.
- Neither the Board Members nor the FASB typically pay for the travel and lodging for attending these conferences-- they are paid by the sponsor, a third party.
- The FASB does **not** record a hypothetical value of such benefits on its corporate accounting (501-C- 3) books for the **third party's actual** cost of attending these conferences.

Yet, the FASB would require a **company** to record the **hypothetical** value of a stock option benefit that comes from the **possible** exercise of an option between a **third party** and the **employee!** How can the FASB produce fair financial statements without showing its full economic resources and uses (SFAS 116 Accounting for Contributions Received and Contributions Made (5))? Let us think.

Keeping it real, which is more than I can say for you.

Anonymous.

(I am anonymous because I am independent and concerned with technical matters.)

cc:

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