From: Ron Lazaro
To: Director - FASB

**Subject:** Please forward to the five members of the FASB and anyone else who this may be relevant to

**Date:** Friday, April 15, 2011 10:50:09 AM

Please forward to the members of the FASB and anyone else who this may be relevant to. Thank You.

Ron Lazaro

April 15th, 2011

RE: FASB Statement No. 128 and the treasury method

Hi,

I have given a lot of thought to employee stock options and their accounting treatment with respect to the number of fully diluted shares outstanding. I believe that there is a mistake in FASB Statement No. 128 because there is no discount rate used on the exercise proceeds from options and warrants to reflect the time value of money prior to the calculation of the treasury method.

Let me illustrate this with an example. Imagine that you own a business that retains the majority of its net income for reinvestment which is worth \$10 million dollars today. A buyer offers you \$10 million dollars but with a catch, they want an option on your business so that you will get paid in 10 years. You would immediately tell the buyer to take a hike because getting paid \$10 million in 10 years is worth substantially less than receiving the money today because of the time value of money or an opportunity cost of capital. Intuitively, a discount rate should be applied to the \$10 million to arrive at what the offer is worth in today's dollars.

When companies issue very long-term stock options (often 10 years) to employees, they are selling a fraction of the business at a long-term fixed price and the essence is a similar transaction to the example above. The money is not received from a stock option's exercise until a far off future period.

The current calculation of the treasury method utilizes "the amount, if any, the employee must pay upon exercise" (From paragraph 21 of FASB 128 amendment (Exposure Draft) dated September 30, 2005). The underlying assumption for the Treasury method is that the company receives the cash in its coffers <u>instantaneously</u> but in reality the cash is received often many years out.

To correct this mistake I would broadly propose that an appropriate discount rate be used to discount the expected proceeds from option exercise, which would incorporate the time value of money, before applying the treasury method.

In Financial Accounting Standards No. 128 dated February 1997 paragraph 102,. the issue of a discounted exercise price was considered, but I believe not implemented because, "the determination of (a) the time periods over which to discount the options or warrants and (b) the applicable discount rate is subjective." The reality is that there are many important areas of accounting that are subject to estimates and interpretation. The valuation of employee stock options, depreciation of very long

lived assets, pension accounting and loan loss provisions for banks all have complex estimates and assumptions. It is far better to have an estimated cost than to have no cost at all.

For practical implementation I would suggest discounting the exercise price by a cost of equity times the long term percentage of earnings retained (or 1 minus the dividend payout ratio). The reason for taking into consideration dividends is because option holders do not receive dividends while the shareholders still receive that benefit.

For simplicity, another option is to just use a corporate bond discount rate which would be a decent approximation. To be conservative, I think that the discount rate should apply over the entire time period the option has until expiration. The option holder may choose to exercise early, but until then, the cash does not come into the company's coffers.

As an aside, I view honest and accurate accounting as a key ingredient in a well functioning society for many reasons. Accounting is important to keep people honest and show investors what is really going on in their businesses including the consequences of certain managerial and board decisions on their company.

Thank you for your time and consideration.

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