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Director of Major Projects
Financial Accounting Standards Board
P. O. Box 5116
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Letter of Comment No: 6402
File Reference: 1102-100

FILE REFERENCE NO. 1102-100 (Share-based compensation)

Executive summary: I believe the liability for share-based compensation should be simply the greater of zero or

Service rendered to date * (Current Price - Exercise Price)
Service required for vesting

Issue 1 I agree with the Board's conclusion. Employee stock options are indisputably valuable to employees. Were that not the case, reform opponents wouldn't summon anything approaching their formidable vehemence on this issue. That value does not emanate from the ether; it comes from and at the expense of the corporation issuing those options. The cost to the corporation is both real and substantial. That cost should be reflected on the corporate financial statements. Let's end the fiction that options are free.

Issues 4(a) thru 4(d). Whatever their theoretical merits, the fair value methods are too complicated, too arcane, too hard to understand, explain and apply to be prescribed. **Accounting information should be provided by accountants, understood by accountants, and audited by accountants.** *Neither closed-form nor lattice models meet this vital test.*

Consider Appendix B of the Proposed Statement. In 75 pages and 23 illustrations of implementation guidance we do not once see an complete illustrative calculation using either Black-Scholes-Merton or a lattice model (just as we didn't in Statement 123). Instead the whole issue of how to calculate liabilities and costs is waved away in paragraph B9 by referring to models that "are based on well-established financial economic theory. Those models are used by valuation professionals, dealers of derivative instruments, and other experts to estimate the

fair values of options and similar instruments related to equity securities, currencies, interest rates, and commodities.” All well and good. But even the simplest case goes begging for a calculation. Consider paragraph B61: “Using as inputs the last 7 items from the table above, Enterprise T’s lattice-based valuation model produces a fair value estimate of \$14.69 per option.” How? How was the \$14.69 calculated from the 7 indicated inputs?

Now consider my recommendation that the liability for share-based compensation should be simply the greater of zero or

$$\frac{\text{Service rendered to date}}{\text{Service required for vesting}} * (\text{Current Price} - \text{Exercise Price})$$

Simple. easy to apply, explain, and defend. Since in an efficient market the current market price has a marvelous tendency to impound available information, there is no requirement to consider or factor in such inputs as volatility, dividends or the risk-free interest, no need to indulge an expanded set of assumptions such as the implicit one that past market volatility appropriately presages future volatility, and no necessity to engage experts from another discipline who don’t share accountants’ ethical responsibilities.

Can this recommendation be reconciled with the concept of accrual accounting. I think so. In defining assets and liabilities we refer to past transactions *and events*. In this case changes in market value would provide just such events. If we buy marketable securities and apply Statement 115’s mark-to-market accounting, the value of the asset reflects, not merely initial value, but also intervening events. A principle that the cost of stock-based compensation is recognized as the value of the stock increases has the effect of recognizing cost punctually at the time, and precisely to the extent, that the options gain value to their holders.

My recommendation offers the benefit that total cost over time will exactly equal the total value received by the option recipient. That statement cannot be made for the rather discredited intrinsic value method nor for the fair value method.

Finally, there is a practical consideration. By backloading somewhat (although not ignoring) recognition of appreciation-based cost, it would be possible, to some extent, to assuage the concerns of reform opponents.



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