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Ms. Suzanne Q. Bielstein Director of Major Projects and Technical Activities Financial Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, Connecticut, 06856-5116

Re: File Reference No. 1102-100

Exposure Draft Regarding Stock Option Accounting

Dear Ms. Bielstein:

I appreciate the opportunity to provide comments to the FASB regarding the recent Exposure Draft on accounting for stock-based compensation. The possibility of reaching some closure on this accounting question is appealing because this debate has been allowed to fester much too long, as evidenced by my letter to the SEC's general counsel on this topic back in January 1994.

I must, however, begin by expressing my sincere disappointment that not enough effort has been spent to bring the two opposing positions together on this matter. Each side has resorted to political tactics to try to win this drawn-out debate by confusing an accounting question with their self-serving agendas to achieve social justice. One group wants to save stock options by arguing that the inability to accurately value stock options converts this into a "non-starter" situation. Meanwhile, the other side hopes to punish corporate misbehavior and abuses by trying to expense options into extinction.

As the CFO for public companies over the past 10 years, I suggest that it is now time for all practicing accountants to step back from this emotional situation, accept responsibility as visionary leaders for our financial reporting standards, and begin to develop the appropriate solution. The primary focus of this comment letter is to address this issue as an accounting question that can be solved using very simple practices that already exist. Unfortunately, the social justice implications of the proposed change, discussed later in this letter, seem to have taken on greater importance. The proposed solution to this simple accounting question is unnecessarily complex, almost impossible to understand for most practitioners and financial statement readers, and it will result in far great administrative burden than needed.

SUMMARY OF POSITIONS

In order to solve this accounting question, it makes sense to focus on the two most polarized positions in this debate. Those with positions between these two extremes would likely be satisfied if, at any time, the extremists reach agreement. The two extreme positions can be summarized, as follows:

1) Those Who Favor Expensing of Stock-Based Compensation – Arguments are:

- a) The economic benefit that employees receive when exercising stock options is directly traceable to the company that granted the options. The financial statements of the company should reflect these events.
- b) Salary and bonus administrative policies of companies are impacted whenever favorable stock option plans exist. That is to say, compensation levels are typically lower for individuals who are granted stock options than those in comparable jobs who are not.
- c) The IRS allows companies to deduct stock option gains as compensation, and there is no basis for treating financial statements any differently.
- d) Recording compensation expense improves transparency of financial reporting for readers of financial statements.
- e) No reliable or accurate method exists to calculate stock-based compensation expense.
- f) If option-related compensation is required to be expensed, then fewer stock options will be given to already over-paid senior executives.

2) Those Against Expensing of Stock-Based Compensation – Arguments are:

- a) The company is simply issuing stock at a bargain price when options are exercised, and it incurs no cash expense. In fact, these transactions are a source of funds as the company receives exercise proceeds and tax deductions.
- b) Stock options align the interest of management with those of the company's stockholders. As such, they are integral to the maintaining the U.S. entrepreneurial spirit and they are vital to the proper functioning of our world-leading capital formation system.
- c) The impact of options on the company should only manifest itself as dilution to existing stockholders. This impact is already reflected in diluted earnings per share amounts that are presented on the face of income statements and that are fundamental to determining the market value of stocks.
- d) Recording this compensation expense distorts the financial statements and makes it harder for readers to understand the company's financial results.
- e) No reliable or accurate method exists to calculate stock-based compensation expense [and no expense should be required until this is resolved].
- f) If option-related compensation is required to be expensed, then fewer stock options will be granted to rank-and-file workers under the broad-based plans that have become so popular in recent years.

There are significant philosophical differences between the two sides. The only meaningful agreement appears to be a fundamental belief that no accurate method exists to calculate stock option expense. Those against stock option expense have inappropriately leveraged this agreement by claiming that it represents a 'non-starter' to any changes in accounting. By casting murkiness into relatively straight-forward accounting issues, they hope to preserve the tradition of stock option plans.

This tactic worked well in the past; however, it will not, and should not, work any longer. As visionary and responsible leaders of financial reporting standards, practicing accountants must separate the accounting question from the political agendas. A simple accounting solution is readily available, as described later in this letter, if change is considered necessary.

WHY CHANGE IS NOW REQUIRED

The primary user of consolidated financial statements is the investing public who are naturally represented by large institutional investors. Irrespective of whether public company management approves, and irrespective of whether the reporting is enhanced or impaired, once there is broad support for this type of reporting change, it is incumbent that corporate management accept the new reality and accept their leadership responsibilities.

Despite what many lobbyists would like us to believe, managers of public companies rarely rely solely on externally published reporting as the basis for running their businesses. Internally distributed financial reporting provides far greater detail than would ever be disclosed publicly. Occasionally, business unit-level reporting requires the use of pro-forma adjustments in order to better understand the economic essence of transactions. It could be argued the business managers have developed a keen ability to look past accounting methods when they cloud up the reporting of their business fundamentals. Assuming that management has, and will continue to, let economics dictate their business decisions, the process and outcomes should be the same whether stock options are required to be expensed or not. Management has the ability to adjust financial statements that they use by imputing or eliminating any stock option expense may have been recorded or not.

So, where does this leave us? The needs of the primary user of external financial statements should take precedence over the wishes of financial managers who simply prepare the information for dissemination. As discussed later in this letter, the purity of motives for those who have lobbied for this change should be examined carefully as accounting theory rarely makes for good public policy.

RECOMMENDED APPROACH

Once change is considered necessary to meet the needs of the investing public, mature leadership by corporate financial management must now take charge. In its simplest form, it is a straight-forward accounting question; and, the method by which stock-based compensation plans should be expensed can be viewed like any other accounting problem.

Our universe of accounting theory and practice regularly revolves around management judgment and educated estimations. Fundamentally speaking, the need to calculate stock-based compensation expense is very similar to the valuation of other long-term plans and programs. Pension plan accounting, for example, requires management to look well into the future to determine periodic charges, ideally with the benefit of actuarial studies and analysis. Self-insured general liability and workers compensation programs also require estimation of claims activity that stretches several years into the future, ideally with the benefit of well-established loss development factors. At times, actual results may differ from initial estimates. As variances become apparent with each passing year, management takes appropriate action to "true up" the financial reporting based on the most current assessment for the plan or program. With this framework in mind, solving the problem of valuing stock-based compensation plans is relatively easy, as follows:

Recommendation: On the date of grant, management estimates the amount of stock option gains that it expects will be earned by the optionee over the life of the option. Ideally, management would base its valuation on whatever sophisticated analytical tools that might be appropriate (e.g., Black-Scholes or lattice models), as well as historical trends by plan participants, awareness of potential changes in future behavior of optionees, financial prospects for the business and implications for stock price appreciation, nature of current and prospective investor trading behavior, and long-term strategic alternatives that might significantly impact the stock's market value (e.g., likelihood of filing bankruptcy, being acquired at a premium, transitioning from private ownership to public ownership through an IPO, etc.). In its most elementary form, projected stock price appreciation tables could be cross-referenced with anticipated exercise dates to develop equally-supportable estimates of valuation.

One thing is certain. At the end of each option's life, the exact amount of compensation earned by the optionee will be known. Just as with the accounting for other long-term programs, management would "true up" its accrued compensation liabilities whenever it become apparent that the ultimate payout will be significantly less or more than previously estimated. Under this approach, the exact amount of compensation from each stock option would always be expensed, it's simply a matter of timing. To the extent that management's initial estimates prove reliable, future "true up's" will be insignificant. On the other hand, should initial estimates significantly differ from actual results, current period charges would take such adjustments into account as the need for these adjustments becomes apparent.

In order to help financial statement readers understand how these charges are reflected in the financial statements, management would provide sufficient details in the financial statement footnotes. This would include a general description of the process used to calculate the estimated expense, extent of variances encountered each year, and statistical summarization of how stock option gains relate to the salaries and bonuses of plan participants (highly paid participants versus overall plan totals) and how these gains compare to the market capitalization of the company as a whole.

I suspect that it may take time for management to become proficient. However, after several years of options have lapsed, management would have more information to draw upon, and variances should become less significant.

POLITICAL AGENDAS - NEED FOR SOCIAL JUSTICE

It appears that each side of this lengthy debate is looking to solve something other than a simple accounting question. They seem to be using this accounting question to raise a growing social concern over the "fairness" of stock option compensation as it has developed over the past few decades. Neither side of this debate is without some degree of suspicion and doubt.

Given the broad reaching effect that the proposed rule changes would have, changes that may prove irreversible once enacted, it is imperative that we give some thought to possible motives behind each side of this debate, as follows:

- 1) Favor Expensing of Stock-Based Compensation Could it be that most of these proponents believe that stock option compensation is fundamentally unfair? Without question, the ability for stock options to properly reward two employees in comparable jobs (even at the same company) is severely impaired by such variables as the stock price on different grant dates, the nature of vesting schedules, the length of option lives, and the participants' decisions regarding timing of exercises. The incredible wealth that has been amassed by corporate leaders, both crooked and ethical, defies the imagination of most rank-and-file employees. Token grants and creation of employee stock purchase plans do little to appease those who do not fully share in what is perceived as windfall opportunities. If stock options were expensed, the injustice and executive greed would go away as it would become too expensive to issue stock options.
- 2) Against Expensing of Stock-Based Compensation Could it be that these proponents believe that stock options allow them to attract and retain the brightest employees by offering them the potential for greater wealth than could ever be justified with cash-based bonus programs? Newspapers occasionally depict stories of how middle-mangers, and even some administrative assistants, at emerging growth companies earned millions from stock options. Those employees, in many cases, were recruited to the company under the belief that today's worthless stock options might appreciate over time if they and the company performed well. Stockholders seemed to appreciate the way in which options brought managements' interest into alignment with their interests, even if it meant that they had to accept some limited dilution if everything worked out well. Expensing stock options would level the playing field with cash-based bonus programs, and there is no way that stockholders would authorize

management to distribute nearly as much compensation in cash expense that they are accustomed to giving out in unrecorded stock option gains. Because options would still be required to recruit and retain senior policy-making executives, look for broad-based plans to be eliminated in order to minimize program costs.

THOUGHTS ON PROPOSED ACCOUNTING CHANGES

Unfortunately, it is very difficult to separate the accounting question from the political agendas of the two sides of this debate. We are at a very important crossroad in Corporate America where passage of these rule changes will impact the way in which we compensate both management and rank-and-file employees. Because there is no "income" to offset the "expense" of stock-based compensation plans (i.e., the economic benefits are booked directly to equity on the balance sheet), the dilution that stockholders were comfortable sharing with management will now be directly imputed on the company's income statement without offset.

Perhaps this is appropriate punishment for corporate executives who so generously granted excessive stock option grants to themselves and others over the years. It would appear that they did not fully appreciate the economic impact of their decisions along the way. It appears that they never would have asked for stockholder approval to distribute cash bonuses that would compare to what employees were allowed to earn from stock options. Without question, the negative press associated with countless executive frauds and abuses has evolved into a political situation where Sarbanes-Oxley and other regulations make this form of "corporate therapeutics" an apparent necessity.

On the other hand, the real losers from this change will be the rank-and-file workers who, in many instances, were given the opportunity to participate in stock option plans. For those who worked at successful companies, there was probably no better way to prepare for retirement than through stock options. Companies benefited as well. Either out of loyalty earned through economic gain-sharing or retention gained with golden handcuffs, companies were able to achieve a measure of control in a world where company loyalties have declined significantly. Stories of millionaire secretaries are obviously rare, but one must wonder how many secretaries came to work every day because of the hope for a better life that stock options represented. To the extent that these accounting rules eliminate the hopes of so many rank-and-file workers, at least it could be argued that management will no longer be allowed to lure employees to accept less, or make them stay longer at their jobs, because of the slim possibility of what a limited number of stock options might do for the employee.

CONCLUSION

In conclusion, the solution of the accounting question is far easier to solve than is the issue of social inequality that has been so deeply associated with stock option compensation. The accounting question can be easily solved with methods that already exist. Control of stock option compensation is a much tougher challenge. Our economy often uses tax regulations

as a stimulus or deterrent for specific business or investment behavior. We have come to accept that this form of tax regulation serves the best interest of our economy and society as a whole. Before deciding whether to proceed with this accounting proposal, I suggest the FASB reconsider whether it desires to sacrifice generally accepted accounting principles in the same fashion.

Again, thank you for allowing me to submit my comments to your Exposure Draft on stock-based compensation plans. I recognize that some might say that "the horses have already left the barn"; however, I impress on FASB to take this letter into consideration, rather than proceeding to impose unnecessary and incoherent accounting methods to solve an accounting question that can be solved with simple and well-established accounting processes.

Very truly yours,

Daniel T. Carter