Letter of Comment No: 3079
File Reference: 1102-100

To: Director
Financial Accounting Standards Board

Fr: Donna Dubinsky

Re: Exposure Draft of a Proposed Statement for Share-Based Payment

Date: 5 June 2004

Personal Background

I have spent over twenty years in executive positions in Silicon Valley, and have managed, or been involved as a director with, thousands of employees who receive stock options.

I graduated from Harvard Business School in 1981 after having been a commercial lending officer for a large commercial bank, and, although I am not an accountant, I am very well grounded in accounting methodologies and financial issues for businesses.

I joined Apple Computer after HBS, and spent ten years helping build this company, and along with it, the personal computing industry. I then joined Palm Computing when it was less than six months old, and had fewer than a dozen employees. Again, we created a major new industry, handheld computing. In 1998, with my partner Jeff Hawkins, I created a new company, Handspring, which pioneered yet another new segment, smartphones. Handspring was merged with the Palm hardware business late last year to form a new company, PalmOne. PalmOne today is the world's leader in handheld computing, and one of the leaders in smartphones.

Over these more than twenty years, I've had the pleasure and the privilege to work with a huge number of very talented people who have created several new generations of computing: personal computing, handheld computing, and smartphones. Each of these businesses have generated great secondary and tertiary value for our economy, whether developers creating software and hardware add-ons, suppliers creating components, distributors creating channels to sell the products, partners creating solutions with these products as the foundation, or end customers who have experienced improved productivity. Consequently, I have been involved with the creation of billions of dollars of economic value through this long period.

Today I serve as a director of PalmOne, Inc., and Intuit, Inc., both NASDAQ listed companies, where in both cases I serve on the audit committee. I also am on the board of two non-profit organizations, the Computer History Museum, and the Redwood Neuroscience Institute.

Position Summary

My position on this issue is that the proposed draft is bad accounting, and creates confusing financial statements. I will elaborate on these key points:

1. The principle cost to companies in issuing stock options to employees is dilution.

2. The financial statements of a company ultimately must tie to cash in order to be true reflections of results of operations. Expensing stock options distorts these results.

3. Sophisticated investors will understand the false nature of stock option expenses, and will adjust for it. Unsophisticated investors will be harmed because they will be unable to understand this distinction. Consequently the proposed rule will have the exact opposite effect as intended, i.e. it will create confusing financial statements that will limit the ability of the average investor to understand the company's results of operations. Further, it will ensure that permanency of "pro-forma" results as companies strive to bring clarity to all investors.

Note that I am not commenting on the policy implications of this proposal, such as the harm done to innovation and value creation if stock options are dramatically reduced as a part of this rule. Those arguments have been well presented by others.

Detailed Arguments

1. The principle cost to companies in issuing stock options to employees is dilution.

Let's take an overly simplified model of a company. Company ABC has 100 shares outstanding, no employees, and earns $100. Consequently, it earns $1 per share and has no compensation expense. Let's modify it for several scenarios:

base case: 100 shares
no employees
profits are $100
EPS is $1.00/share

scenario 1: employ one person for a salary of $20
profits are $80 ($100 - $20)
EPS is $.80/share ($80/100 shares)

scenario 2: employ one person for 25 stock options and no cash
profits are $100, unchanged from base case (no cash has gone out)
EPS is $.80/share ($100/125 shares)

scenario 3: employ one person for $10 cash + 12.5 stock options
profits are $90 ($100 - $10)

EPS is $.80/share ($90/112.5)

I realize that this is an extremely simple argument, but the fundamental point is that the actual earnings of the company are unchanged by the act of issuing a stock option. However, these same earnings are now shared between the shareholders and the employee, so value has been transferred. The impact of whether the employee is paid in cash, in stock, or in a combination, is properly reflected in EPS. If we were to also count stock as an expense in the income statement, we would effectively be double counting it in the EPS calculation.

The impact to an employee of a stock option is to share in receiving the profits of the company, not changing the profits of the company.

It may be appropriate to elevate dilution in this debate. Let's examine whether we have the correct measures for dilution in our financial reporting. For example, perhaps there should be more detail provided in the Statement of Stockholders' Equity or in the footnotes to explain all the increases and decreases to share counts over the period. As another example, perhaps we should have an additional measure of potential dilution that would include stock options that are underwater, which currently are not counted.

2. The financial statements of a company ultimately must tie to cash in order to be true reflections of results of operations. Expensing stock options distorts these results.

Ultimately, the true reflection of the results of a company's operations is in its ability to generate cash, and as to how much more cash it generates than it uses. To the extent we create a host of non-cash items on the income statement, we are obscuring the purpose of these statements.

Certainly, there are many non-cash items today, but many of them are forced by the matching principle to ensure that expenses are better matched to revenues. Depreciation is an obvious large non-cash expense. However, depreciation was, indeed, cash at one time, when the original asset was purchased.

When a stock option is issued, no cash changes hands. When the employee exercises that stock option, he or she does pay cash to the company, which actually flows the opposite direction (i.e. an expense implies that the company reduces cash, but the company in this case actually gains cash).

One might argue that the cost of the option is less than the price a shareholder in the market might pay, so the company suffers from receiving less cash than it might otherwise have received if it had chosen to issue more shares to the public. This is essentially arguing that the company should record an opportunity cost, which is unprecedented in financial statements.

One of the current arguments currently being made in favor of expensing options is that when a company grants stock options it is giving something of value and that value must be estimated and recorded as an expense. However, the current accounting already captures correctly what the company has given up. As soon as the granted options are "in the money", the treasury stock method for calculating diluted shares begins to include a portion of those options for purposes of calculating EPS. In fact the treasury stock method even takes into account the cash that the company will receive upon exercise and assumes that cash could be used to repurchase a portion of the shares at current market price. Until the stock options are in the money, the company has transferred no value. When and if the employee exercises the stock options, the company will record a cash receipt and the full shares will dilute earnings. If the stock options ultimately expire worthless or are forfeited, there is no impact on EPS or on the balance sheet. In all cases, the transaction is completely reflected in the financial statements.

In brief, adding an expense on the income statement for stock options implies a cash outflow to the company at some point that simply does not exist. In fact, it ends up being a cash inflow.

3. Sophisticated investors will understand the false nature of stock option expenses, and will adjust for it. Unsophisticated investors will be harmed because they will be unable to understand this distinction. Consequently the proposed rule will have the exact opposite effect as intended, i.e. it will create confusing financial statements that will limit the ability of the average investor to understand the company's results of operations. Further, it will ensure that permanency of "pro-forma" results as companies strive to bring clarity to all investors.

When we took Handspring public in June, 2000, we were required to incur a "cheap stock" charge for options issued to employees that were viewed to be at a discount. This charge was $26M over nine months, on a revenue base of $50M. It was a non-cash charge that did not impact our operations or our cash at all.

Sophisticated investors totally ignored this charge. They knew that this was a fictitious expense, and all their models backed it out. We broke it out of our financial statements to help analysts create their models. If we had not done so, investors would have been misled in a substantial way as to the results of the business we were operating.

I believe that stock option expensing will be treated the same as the cheap stock charge. Analysts will adjust it out of their models because they understand that it is not really an expense, and it is double counted in EPS.

However, I do not believe that unsophisticated investors will understand this distinction. They will lose the ability to compare one company to another if one uses options heavily and another doesn't. They will likely think that there is an implication to the actual profitability of a company if it issues stock options. They will not understand that EPS is now measured incorrectly in that it includes the dilution both in the numerator as well as the denominator.

Moreover, sophisticated investors understand very well today the impact of options on dilution. At Intuit, where I have served on the board for five years, we have come under pressure from institutional investors to reduce our numbers of employee options, and we have done so over the years, in order to achieve a reasonable rate of dilution for a company at our stage of life. These investors have been quite comfortable with expressing their displeasure without option expensing because they have focused where they should, on the numbers of shares issued to employees.

If companies are required to expense stock options, they will be compelled to separate and highlight this expense in order to help these investors separate real expenses from non-cash expenses. They will do so in "pro-forma", or "non-GAAP" statements. Sophisticated investors will understand this; unsophisticated investors will continue to be puzzled as to why companies must issue multiple sets of financial statements.

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Conclusion

I could have focused my arguments on the positive social impact of stock options. I've helped create major new sectors of the economy with the support of thousands of employees, all of whom have participated as owners through stock options. I believe that the current expensing proposals are over-corrections to scandals such as at Enron, where outright fraud and abuse of the system was the core of the problem, not stock options.

However, I have not focused on these arguments because I feel there is a deeper, even more significant argument to be made. The purpose of accounting is to measure and present the financial results of the corporation. It is not to create policy or to manage behavior, which is the province of the tax code and of the legislative branch.

The expensing of stock options would obscure financial statements rather than elucidate them. The expensing of stock options would increase the divide between sophisticated and unsophisticated investors, with the former disregarding this fictitious expense and the latter struggling to understand it.

The appropriate measure for the impact of stock options is dilution not expensing. If more disclosure is needed, this is the direction to look.