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Letter of Comment No: 3062
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From: Davis, Joe [JDavis@coremetrics.com]
Sent: Wednesday, June 02, 2004 4:25 PM
To: Director - FASB
Cc: jcdowling@nvca.org
Subject: Opposition to Stock Option Expensing

To: the Director of the FASB

Fr: Joseph P. Davis – Coremetrics, Inc.

Re: Opposition of Stock Option Expensing

Dear Sir:

As the CEO of a private venture funded small business I am very concerned with FASB's recommendation to force companies to expense all stock options. In my opinion this is a terrible mistake which is being proposed as a solution to an unrelated problem.

In the business world, the late 1990's were a time of many excesses: excess hype, excess valuations, and excess executive compensation. Many of these things occurred because seemingly rational investors lost sight of business fundamentals as they became caught up in the hysteria of an overheated market. Unfortunately a handful of individual executives took advantage of this temporary divorce from reality to enrich themselves as the expense of their shareholders. One way they did this was by securing large stock option grants from their companies that would not have been justified during a more rational time. With these option grants in place the executives did what they could to drive up their stock prices, employing means that were sometimes unethical or illegal. As long as stock prices remained high, investors were happy and turned a blind eye to the excessive compensation that some executives were getting.

However, when the market crash occurred and prices returned to reasonable levels investors lost significant money and then took a more critical look at the exorbitant profits that executives made during the boom. Investors cried "Foul" as they should have years earlier. Many investigations were conducted by the SEC and others into the situation and several executives were put on trial and forced to return some of their gains.

There were many villains in the history I have just recounted; unfortunately the stock option has been unfairly labeled as one of the villains. Stock options are an excellent management tool that is used to align the interests of employees with those of shareholders. It is intrinsically a positive if you believe that the interests of shareholders are the primary concern of management. Options only become an instrument of wrongdoing when they are applied improperly. The most common occurrence of this is when they are giving to executives in such large volume that the potential wealth they represent to the receiver entices them to sacrifice the best interests of the shareholders for a short term gain in the stock price. The problem that the FASB should be addressing is how to ensure that options are granted in a way that is not at odds with the interests of shareholders. Expensing them will not do this.

This problem is similar to an issue that every CEO faces most quarters: the definition of a compensation plan for your sales team. The general wisdom is that most salespeople are motivated by how much money they can make each quarter. The more they sell, the more they make. In the abstract this sounds good for the company. But reality is never that simple and each compensation plan needs to take into account more than just maximizing sales. Sometimes you want to give an extra incentive to drive up sales of a new product. Sometimes you need to drive a sales rep to partner with a distributor. Most executives have seen

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the results of a poorly designed compensation plan that pays a great deal of commission dollars to the sales team even though the company significantly misses its targets. But the answer to this is not to eliminate sales commissions. It is to fix the plan to align the behavior of the sales reps with the company's goals.

The FASB proposal to expense options in order to prevent the abuses we have seen in the last five years appears to me to be the equivalent of eliminating sales commissions because we can't find a compensation plan that works. Getting rid of commissions would get rid of most of your revenue just as expensing options would remove a tool that managers have to motivate their teams.

I firmly believe that there should be more oversight in the use of stock options. Transparent reporting of their use and estimated value should be a requirement of all public companies. But by forcing companies to expense all options you will only force most CEOs to minimize their use or provide financial reports which become more difficult to evaluate, not less.

In my company every single employee is given stock options when they join. Additional options are given for promotions or because of extraordinary efforts by groups or individuals. It is the most sought after part of the overall compensation package. Employees come to a private company like mine, sacrificing the higher salary they could get at a larger public company because they hope that the stock options they receive will be worth a substantial amount if our company is sold or goes public. If my ability to dispense options is reduced I would have to pay more to attract the talent to grow my business, and I would therefore make less money. If I were to continue to give out the options and expense them I would also appear to lose more money, even though there would be no cash associated with this extra loss. Either of these means my business will grow more slowly, making it less attractive to shareholders, potential investors and employees.

The other problem I have with expensing options is that the methods of evaluating them give me nothing more than an estimate of their worth. This means that my financial reports now have a higher level of uncertainty as to the financial health of my business. As a former student of Myron Scholes, one of the namesakes of the Black-Scholes option pricing model, I know that the value given by this formula is an estimate that comes from making a series of assumptions about future market conditions. At a time when CEOs are being asked to sign documents attesting to the accuracy of their financial statements as required by Sarbanes-Oxley, it is difficult to understand why we are being asked to add more uncertainty into our financial reports. The most important lesson we should have learned the last few years is the need to make financial reports more accurate and easier to read. Expensing options accomplishes neither.

To close, the current accounting treatment of stock options is clear, fair and well understood. It encourages economic growth and supports public policy. The FASB exposure draft is none of these. It adds more uncertainty to financial reports and will reduce economic growth, not stimulate it. I strongly advise you to withdraw the current FASB proposal.

Thank You,

Joseph P. Davis
Chief Executive Officer
Coremetrics, Inc.
2755 Campus Dr.
Suite 235
San Mateo, CA 94403

Joseph P. Davis
President & CEO

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