For Shik to man other

### RANDOLPH K. HARRISON

1035 South Forest Hill Road Lake Forest, IL 60045 Randolph.Harrison@attbi.com

home (847) 295-2468 mobile (847) 306-7122

March 20, 2003

Mr. Robert Herz, Chairman Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk. Connecticut 06856-5116

Letter of Comment No: 87-File Reference: 1101-SCU Date Received: 03/20/03

Dear Mr. Herz:

Allow me to reintroduce myself. My name is Randy Harrison. Like you, I am a retired partner from PricewaterhouseCoopers LLP. We worked together on the U.S. Senior Partner Nominating Committee. As you may recall, Bob, my career experience includes 15 years in HR and line management with British GE and Xerox and 14 years executive compensation consulting with Watson Wyatt and PwC.

The purpose of my writing to you, Bob, is threefold. First, a belated congratulations on your appointment as Chairman of the FASB. Second, you and the board are to be applauded for voting unanimously to put the issue of option expensing on your agenda. Third, as a retired PwC partner with no current ties to industry or consulting, I feel an obligation to briefly comment on the topic of expensing options.

## Introduction

There appear to be three core issues related to option expensing:

- · Are options an operating or shareholder expense?
- What impact does current tax policy have on the option expense issue?
- To what extent is the issue of option expense an opportunity for increasing investor understanding and clarifying performance expectations through new and appropriate disclosure?

#### Comments

OUESTION #1 - Are option costs an operating expense or a shareholder expense?

RESPONSE #1 – Options do not have an impact on earnings. They increase the number of claimants on those earnings. If I am the 100% owner of a firm, I have rights to 100% of the profits. If I give 50% ownership to a new partner, my rights to the earnings have been reduced to 50%. Unless earnings go up, my income will go down. However, the total earnings of the company have not changed.

## FINANCING COSTS FOR REMUNERATION SHARES/OPTIONS

There may be ancillary costs associated with options, such as how they are financed. Options can be "covered" by issuing new shares, using treasury shares or buying shares on the open market. Each of these financing choices is no different than any other financing choice the company makes. The specific choice that management makes will have an impact on dilution of other shareholders and use of cash. The decision on how to finance options is properly one for management to make. In turn, management should

disclose the potential impact of these financing alternatives; and possibly commit to a specific method of financing as part of the request to shareholders for shares to be used for remuneration purposes.

# VALUATION OF OPTIONS MAY BE THE WRONG QUESTION

The related issue of valuing options for the purpose of expensing has been problematic because it may the wrong question. If options are viewed as a change in the number of claimants rather than an expense, the valuation issue is moot. Irrespective of one's opinion of the applicability and accuracy of various option models to this issue, they are attempting to answer a different question than the question which investors are asking.

Option valuation models attempt to calculate the breakeven "opportunity cost" of owning an option versus owning the share. While this is an interesting question, it does not represent an estimate of shareholder costs. The disconnect between the shareholder question and the option valuation answer occurred because of the focus on options as compensation. If options are a shareholder cost and option gains are capital gains as discussed elsewhere in this letter, then option valuation for purposes of calculating compensation expense does not need to be addressed. The earnings-related "breakeven" analysis and financing costs, mentioned elsewhere in this letter, appear to address the real cost of options to shareholders.

QUESTION #2 - What impact or insight does current tax policy bring to the option expense issue?

RESPONSE #2 – The discrepancy between tax and accounting policy with respect to treatment of options is real. While not in the purview of the FASB, it may be that the current tax policy needs adjustment.

As a suggestion, if option gains were no longer compensation but capital gains, several things would happen.

- The gain would no longer be a compensation expense and no longer deductible, thus increasing
  corporate taxes. This approach might result in more judicious use of options and careful financing of
  same.
- The gains would be taxed to the individual at capital gain rates, thus decreasing individual taxes.

While there are many details to be worked out below these high-level descriptions, this approach is also consistent with treating options as a shareholder expense and not an operating expense.

From the IRS perspective, this approach actually increases tax revenues and is consistent with the current tax treatment of stock grants and 83(b) elections for restricted stock. Specifically, the basis is treated as ordinary income and all gains are treated as capital gains, given certain holding requirements. Since options have no basis and have value only if the stock price increases above the exercise price, such gains should be charges to capital; neither expensed nor tax deductible.

QUESTION #3 – To what extent is the issue of expensing options an opportunity for increasing investor understanding and clarifying performance expectations through new and appropriate disclosure?

RESPONSE #3 – The FASB has an opportunity to address procedural and technical issues related to option expense. In addition, it has the opportunity to link the "cost" of options to business performance, creating a value-added process for boards, managers and investors.

As a suggestion, disclosure could include a projection of the additional earnings-per-share required for shareholders to "breakeven" as a result of the dilutive impact of newly issued options. This disclosure would give shareholders and management the opportunity to establish earnings goals that relate to that breakeven point (higher or lower). Earnings goals could have an impact on the vesting or strike price

features of options. This approach solidifies the link between option benefits and real economic benefits as opposed to market speculation.

Furthermore, if the performance and related disclosures noted above were combined with disclosures related to financing costs (with 5% and 10% stock price appreciation assumptions OR at a pre-established range of earnings multiples), shareholders would have a useful understanding of the potential dilutive impact of both issuing and covering options.

Lastly, it may be appropriate that by treating all option related gains as capital gains and eliminating the connection to operating expense that the variable accounting required for performance related plans would be eliminated. The above recommended disclosure would provide substantial information for such plans and the impact on shareholders.

Bob, there are surely other considerations that the FASB must take into account. Many related issues are beyond my abilities to comment. I wish you and all the members of the FASB great wisdom in the coming deliberations.

Sincerely,

Randolph K. Harrison

847-295-2468

randolph.harrison@attbi.com