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Stacey Sutay

Subject: FW: Accounting for Stock Options

-----Original Message-----
From: Gyuri Orban [mailto:orbans@comcast.net]
Sent: Thursday, April 01, 2004 9:38 PM
To: Edward Trott; Leslie Seidman; Katherine Schipper; Gary Schieneman; Robert Herz; Mike Crooch; George Batavick
Cc: Michael Balmuth
Subject: Accounting for Stock Options

Dear FASB Board members,

As chairman of the Compenstion Committee of a NASD 100 company please allow me to be presumptuous at this late stage in your consideration of the above topic.
If public companies will be obliged to account for options the choice of method becomes of paramount importance.
In my view the "exercise method" is the least burdensome and most conforms to reality.
Attached is a published article I wrote on this topic some time ago.

Yours truly,

G. Orban
Chairman
Compensation Committee
Ross Stores, Inc.

Uniform method of accounting needed for options

Guest Opinion

GEORGE ORBAN

Since the implosions of Anderson, Enron, WorldCom, Global Crossing, Adelphia and others, much has been written about various aspects of the crisis of confidence spawned by the misbehavior of corporate executives, bankers, investment bankers, research analysts, lawyers and accountants.

Amidst the commentary, including most recently that of Karger and Wolfstone in the Sept. 20 edition of *The Business Journal*, the recurring theme is accounting for incentive stock options in corporate financial statements.

Setting aside whether one agrees or not that ISOs ought to be expensed for financial accounting statement purposes, the question one should ask is, "What simple, precise and realistic method could be used to calculate their value in the likely event accounting for them in published financial statements will become mandatory."

The principal method in use, Black-Scholes, as well as most of those being proposed, fall far from the mark.

Black-Scholes with its myriad and abstruse assumptions was devised to value freely traded market based instruments, not illiquid incentive stock options. Yet we continue to fill the pages of proxy statements that are meant to provide accurate information to investors with the inane results of these inappropriate calculations.

Recently we have been treated to the insights of The Coca-Cola Company. This esteemed corporation proposes to hold hypothetical auctions to determine how an independent third party would value the ISO grant. Try to imagine the question to the hypothetical bidder: "How much would you pay for an option to exercise 1,000 shares of Coca-Cola that vest over the next four years with cliff vesting of the first 25 percent after the first 12 months and forfeiture of the unvested balance upon termination if you were an employee of Coca Cola with the full knowledge and expertise of a Coca-Cola employee at the level which would merit the grant of a 1,000 share option, bearing in mind that the option is not transferable and even the vested portion will be forfeited within 90 days of your termination unless exercised, which act you would only perform if the stock were trading above the exercise price during that period? If you are a Section 16 employee, you may have a few limited, often unpredictable window periods during a year when you may be free to exercise options and sell shares."

The confusion does not start and end with the two methods cited above, for there are others. Yet there is one obvious, rational way to calculate ISO expense. It is the exercise method whereby option expense is calculated to be the difference between the exercise price of the option and the price of the stock at the moment of exercise. The company accounts for the event by adding the exercise price multiplied by the number of options exercised to its equity, charging the expense, increasing the number of issued shares and diminishing the number of options outstanding.

Including a value for the remaining pool of options in the balance sheet as some people are recommending would only distort the financial statements. Most of the options will not yet be vested and are therefore unexercisable so the liability value attributed to them on the date of the balance sheet is a hypothetical one. A footnote disclosure of the remaining number of options outstanding would be sufficient to apprise investors of future potential dilution without posting a hypothetical liability. Footnote charts could satisfy investor demand for any further details.

Underlying the exercise approach is the powerful yet never cited argument that an incentive stock option is essentially worthless to anyone but the grantee until the moment of exercise. It cannot be sold or transferred and literally has no tangible value until cashed in, so why assume otherwise. Anyone who doubts this need only take the tally of the hundreds of millions in money options that have expired, worthless, in the last few years.

The Financial Accounting Standards Board and other regulatory agencies may well compel companies to account for ISOs. If they do not create a uniform standard based on the exercise method we shall have passed from the abuse of options to the accounting abuse of options without getting to the proper accounting of option expense.

GEORGE ORBAN *is chairman of the compensation committee of Ross Stores, Inc. and director of Livebridge, Inc. and @Once.com.*