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Financial Accounting Standards Board 401 Merritt 7
Norwalk, Connecticut 06856-5116

## Dear Sirs:

For the past several years, I have read with interest and wonder as the FASB and others spend valuable resources focusing on when to expense stock options and how to value stock options once it is decided when they are "deemed" to be compensation. (The only justification for treating a stock option as corporate compensation expense is to "deem" it an expense since there is no rational explanation.) The profession continues to ignore the basic issue which is how does a stock option ever cause a corporation to incur an expense. In Opinion 25 and Statement 123, the FASB and its predecessor failed to properly address the issue of expense versus capital and chose instead to ignore accounting and economic realties as defined in its own accounting concepts. There is no corporate expense, no resource is expended or lost and no liability is incurred. Ignoring accounting and economic reality has contributed to a great deal of fuzzy accounting over the past 25 years and our profession is again caught in our own soup.

I learned many years ago that capital transactions generate neither revenue nor expense. How did the body responsible for establishing sound accounting principles lose sight of this sound principal? The question is "can a corporation ever incur an expense with a capital transaction". The answer is no and the Board should so state. Does the corporation ever incur an economic loss in a capital transaction? Where is the use of an asset or the creation of a liability?

First, the employee pays the option price which increases equity and takes the risk of market changes while holding the option (and subsequently). The option was granted in lieu of cash payment, i. e. salary/compensation but at no economic cost to the corporation (actually an economic benefit). The employee/recipient gains nothing unless the market increases and then all shareholders benefit. Where is the expense? The employee pays the corporation for the stock but only if the option is exercised. Where is the corporation's economic loss?

Second, there is the argument that there is an economic cost to the corporation at the date of grant (or at the date of exercise) described as "lost opportunity". This position is a red herring as the corporation can always issue more shares if there is a need for capital and the current shareholders may "suffer" dilution which is the only "cost" or "expense" incurred. Thus, one can argue that the shareholder may incur a loss but not the corporation. The loss to the shareholder is only perceived dilution and that may not be an economic loss since if the share price doesn't rise, then the option is never exercised. Furthermore, I have not seen any empirical evidence that prices drop when options are exercised. Generally, management exercising options is positively viewed by the Street so the market price would just as likely increase as decrease. Thus, no damage is done to the investor and certainly not if the option is never exercised. If the market price does not increase, then the option is never exercised. Where is the economic loss? How does one ever construct an expense at date of grant? Does failure to exercise result in revenue or income to the corporation.

Third, some have suggested that the deductibility for tax purposes of the difference between option price and market price upon exercise is "proof" that there is an expense. Using the US Tax Code and Regulations as the basis for good accounting borders on insanity. Permitting corporations to deduct the change in market value resulted from good lobbying, not good accounting. If an increase in market value results in corporate expense over a 3-10 year period (typical option period), then corporations should record an expense any increase in market price during the first 24-48 hours after initial and subsequent public offers of its stock. The stock was sold below market and thus an expense was incurred. If it works for options,

why not any new issue of stock? Then record revenue if the price declined after the stock sale. Sounds pretty silly doesn't it? In my view, no more so than the proposed stock option accounting.

Finally, the issue is politically driven because it is currently politically correct to say options generate an expense since they "replace" compensation. The public is upset over the excesses and fraud of selected executives of high-profile companies. To acquire labor, raw materials or services at below market (that is all that is being done with an option) is a plus for business and is usually an indication of sound management. I have never heard anyone suggest that these below market purchases are expenses. Options only benefit the recipient upon ultimate sale, even the exercise is only a paper profit. If the market declines before the acquired stock is sold, there is a reduced benefit—there may even be a loss if the market drops enough.

Having thought about this question for many years, I have never been able to see any well reasoned position that a corporation ever incurs an expense upon issuing stock—an option can never create a corporate expense. Sound accounting must reflect economic reality and there is no economic cost to the corporation from an option. No asset is expended and no liability is incurred

I regret to conclude that this is more fiction from my chosen profession and its "leaders".

Sincerely,

Fred B. Miller, CPA.