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Stacey Sutay

Subject: FW: Stock options: Accrue the bargain

-----Original Message-----

From: Calvin Johnson [mailto:chjohnson@mail.law.utexas.edu]

Sent: Wednesday, April 16, 2003 1:55 PM

To: Michael Tovey

Subject: Stock options: Accrue the bargain

Mr. Tovey:

FASB is considering revision of FASB Statement 123. Under FAS Statement 123, management may elect a reporting method under which the only cost of an option to the employer who issues it is the initial spread between the value of the employer stock when the option is granted, and the exercise price of the option. An option set up to have no initial spread between a fixed exercise price and the fair market value of the underlying stock will be reported as free in accounting statements given to shareholders and investors.

I join many others to urge FASB to correct the error of zero cost for no-initial-spread options (1 below). I also urge you to treat stock payout and cash payout plans the same, by accruing the bargain on an option as it arises (2. below). Accruing the bargain as it arises is administratively feasible in cases in which Black-Scholes valuation is not feasible, and is also more accurate, descriptive accounting.

1. The Cost-Free Fallacy

Zero value and zero cost for an option with no initial spread is not a good faith attempt to assess either value or cost of the option. If stock were like a bank account that never varied in value, an option to purchase the stock at its current price would have only the value of deferring payment. As volatility in the price of the underlying stock increases, however, the value of the option increases, even though there is no initial spread. The holder of an option with no initial spread can capture all of the subsequent gains from the appreciation of the underlying stock. Simultaneously, the holder has insurance-like protection on the loss side because if the stock value drops below exercise price, the option holder just does not exercise the option and evades the loss. Holding an option is much like getting to bet on the horse race, just after the race has been run. For very high-risk, long-shot stocks, a holder of a no-initial-spread option holds essentially all of the value of the stock. If there were a stock called Cold-Fusion Corporation, for example, which had a one in a million shot of becoming very very valuable, the holder of a no-initial-spread option would be able to grab the value in the rare case the high value comes to fruition. The value of the option would be short of the value of owning the Cold Fusion stock outright, by only one-millionth of the current value. Top management have been given options under the reporting theory they are worthless, free and too cheap to meter or account for, when they are in fact worth hundreds of millions of dollars.

If stock option really were free, then the employer would have a license to print money by granting options. The stewards of the corporation have no obligation to keep watch over options if they are free because they are responsible only for economic resources that have some cost or value. If option are free, then the top management of the issuing company with access to them might as well pick the options up off the ground by the bushel-full. Top management seems to be acting as if the accounting value assigned to no-initial-spread options were correct and shareholders seems to be letting them act that way.

Accounting has had a great deal of difficulty correcting itself on the zero-cost rule. In 1993, FASB published an Exposure Draft that would have ended the zero-cost rule and replaced it with a rule that would have required something closer to true value of the option to be treated as a corporate expenditure when the option was granted. The zero-cost rule, however, had by that time created a powerful constituency of managers who liked their compensation to be considered free. and the managers and their allies defeated the proposed reform with a firestorm of razzle dazzle, none of it with any merit. Investors and shareholders who would be benefited by more accurate descriptions could not get organized into an effective constituency and nobody important helped the Board. The Statement that finally came out in 1995 allowed a firm to continue to use the no-cost rule for no-initial-spread option, provided, however, that the firm disclosed in its footnotes the costs computed from value of the options at the time they were granted. The Canadian Accounting Standards Board has also caved in, saying that expensing of the true value of the option would be better accounting but, that in the deference to the principle of conformity of accounting with U.S. Standards, it would continue to allow the no-cost rule in reported earnings, with footnote disclosure instead of financial statement reforms. In March 2003, U.S. FASB announced that in the light of the "market meltdown and corporate reporting scandals," it would try again to end the no-cost rule with an exposure draft at the end of 2003 to be effective in 2004. Maybe this time, this time it will be different. Still the Standard Board's leaving the nocost rule in place so far is a very telling reminder to investors and shareholders that they have no friends in the accounting profession.

There are some who think that zero cost valuation of options is merely attempted fraud, rather than completed fraud because the smart market is able to see through bad accounting. Even if smart investors were able to see through the subterfuge, however, that does not justify accounting so bad is it amounts to fraudulent intent. Accountants should not be trying to fool the market or trying to raise the barriers that a smart market might or might not overcome. Indeed the difficulty

of correcting the silliness is pretty good evidence that someone thinks the that fraud is succeeding.

2. How to fix it: Accruing the Bargain

The accounting profession gets it right if the payout to the executive under the compensation plan is in eash rather than by issuance of employer stock. Stock appreciation rights (SARs) or phantom stock plans are like stock options in giving the executive the increase in value of the stock (but not loss) over some period, but SARs and phantom stock plans pay the executive in eash. For eash payout plans like SARs and phantom stock, the accrued obligation is treated as an accrued expenditure as it arises even though it is not yet paid. An increase in the stock price increases the employer's obligation and so increase its reported expense. If the stock subsequently drops in value, the decrease will reduce the employer's cost under the plan and some of the previously accrued expense will be reversed into income. Payment in eash is like paying a payable and it creates no new expense to the extent that the payout has been accrued previously.

The distinction the accountants make between payout in stock and payout in cash is unprincipled. The corporation has the same economic burden whether the compensation is to be satisfied in stock or in cash. Indeed we could imagine a single plan could be satisfied either in cash or in stock, perhaps at the option of either the employer or of the employee without that making any difference in the economics of the plan. Stock and its cash equivalent are equivalents, we can say tautologically. Fair market value of the stock means the cash equivalent of the stock.

Accrual of the bargain as it arises, which is required for cash payout plans, seems to be better accounting than the valuation of the option at grant, which is required under the current accounting standards for the purpose of footnote disclosures. Black-Scholes option pricing requires a track record and broad market to generate volatility measures. New companies, closely held companies and thin markets do not generate the information needed to make up-front valuations work. For a broad range of new and smaller corporations, there is enough data to calculate the accrued bargain at year end from the stock price, within an acceptable range of error, but not enough data to calculate initial option value, within an acceptable range of error. A 10-year stock option given as the company is formed would be impossible to value, but by the time the option is exercised there will fine data to calculate value of the stock. The market for the stock may be volatile, but within that volatility will be the market's correcting itself so that too larger bargain will be corrected in subsequent years. Black-Scholes, moreover, is designed for arm's length investors and that can understate the company's cost. For a CEO and top management team that really can change the value of stock more than the market ever expected, the arm's length assumption understates the value of the compensaton package the management has received. The stock option is platform that superior management can turn into gold in ways in which the Black-Scholes option pricing formula can not pick up. What is gold for the recipient is a cost to the payor, so that the cost of superior management will in fact be higher for a company than arm's length option pricing can pick up. Conversely, management that performs under market expectations or damages the company will be cheaper for the employer because the stock options will not be all that valuable. The cost differences between the high cost surprisingly superior management and the low cost surprisingly inferior management will not be picked up by Black Scholes or any other a arm's length valuation method done before the management performs The accrued bargain approach also matches the accounting cost to the cause of the cost automatically. Under a stock option, management makes money by causing the stock to rise during a year. If management causes a big rise in the stock price, that will mean a big cost. If stock price drops, that reduces cost. The initial valuation approach, by contrast, requires some kind of arbitrary allocation of the big up front cost across a number of years of the option. Thus for example a 10 year option is treated as costing 1/10th of the total value each year, whether the management causes a big rise in price or loss in stock price. The accrued bargain approach tells outsider investors more about the costs inside the company than the does the valuation of options at grant, whether under Black-Scholes or some other method.

Please call on me if I can provide any further help or information to you on this matter.