June 8, 2004

Director of Major Projects
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Dear Director of Major Projects:

I support the mandatory expensing of stock options, and am writing you to strongly encourage the FASB to adopt this accounting rule change.

My quarrel with current option accounting is not about the morality of stock options, but instead how the accounting rule, as written today, provides incentives for behavior unwanted by investors.

I have no problem with companies issuing a few options to a small group of senior executives whose work performance has a direct impact on the overall success and long-term value of a corporation. If used very selectively, options can be a useful compensation tool for a publicly traded company. Furthermore, if companies issue just a few options, how they are accounted for is really not that big of a deal.

However, for those willing, current option accounting allows the floodgates to open for the issuance of large amounts of stock options which creates distortions and unintended results. When companies issue a material amount of options that are not expensed, they now are essentially paying employees partially through the capital account instead of just through the income statement. Investors are hurt at least two ways: (1) a portion of employee compensation is not reflected in a company’s costs so reported profits are artificially inflated, and (2) since corporations don’t have to count the cost of options, they have tended to go hog wild on issuing them which inflicts significant dilution on shareowners. You know the numbers better than I do, but I regularly look at financials of companies whose issued options are 10%, 20% or 30% or more of outstanding shares.
Handing out “free options” not only distorts the profit picture for investors, but also for management as well. Although they don’t seem to realize it yet, the technology and other companies clamoring to let options go on being issued without being expensed should actually be thanking the FASB for the mandatory expensing of options. By reporting results which include options as a compensation expense, they would have a truer picture of the economics of their businesses and realize that they are neither earning the profits nor return on capital that they thought and could make adjustments to improve their returns (raise prices, cut costs, etc.). It’s like grade inflation in school – getting straight A’s for mediocre work may feel nice at the time (and impress parents to whom the results are “reported”), yet learning under a harder grader can make someone a better student and eventually a more able person.

From what I read, I am preaching to the choir. The FASB apparently wanted to do the right thing regarding options in 1994. My hope is that Congress will refrain from interfering again in 2004 on an issue which clearly falls within your area of expertise, not theirs.

Lastly, if Washington, D.C. or the FASB still has any hesitation about the rule change to make expensing of options mandatory, then each person involved should think for a moment about the investor calamities over the past 10 years (Enron, WorldCom, overinvestment in telecom, 2001-2003 recession, and Internet bubble to name of few), as well as the individuals and families which were harmed as a consequence of them, and whether those financial tragedies could have been lessened or avoided if a FASB rule expensing options had been put in place in 1994. History and common sense show that a society is better off with good accounting. The International Accounting Standards Board has already determined that good accounting includes the expensing of stock options.

I appreciate all of your hard work and thank you for your efforts on this matter.

Sincerely,

James R. Membrino  
Chief Executive Officer