Dear Sir:

As a retired small investor, I have grave concern for the deluge of stock options being granted by some public corporations whose shares I own; often it seems they are issued without regard for ultimate costs. I appreciate the motivating effects of option grants, but they must be fair to the grant recipients (grantees), to the existing shareholders of the corporations that grant them (grantors), and to potential new investors who desire full transparency in corporate reports. I commend the FASB for its current effort to require the expensing of such options, with the expectation that this may inject a measure of restraint on their currently unrestricted freewheeling issuance. However, I believe a better approach is available than that currently being proposed; I offer the following “expense-and-fund-as-you-go” concept for your consideration.

Summary

- Expensing is done on a quarterly basis, beginning with the first financial report following the issuance of stock option grants, based on the incremental increase or decrease in the market value of stock that may occur above the strike price, i.e., as the “intrinsic value” increases from zero at the time of grant to an “in the money value” on the date of the next following quarterly report. If the market price remains at the strike price or falls below it, no expense is reported.
- An escrow-type Stock Option Value Appreciation Account (SOVA Account), similar to a 401K, is established immediately for each grant that is made to each grantee, and that account is funded with an equal amount being expensed for that grant with each successive quarter.
- A SOVA Account is accessible only to the grantor corporation, which adds funds being expensed incrementally if the option value increases, and withdraws funds that were previously expensed if the option value decreases incrementally from the prior quarterly report, but only in the amount of the incremental decrease and only to the extent that funds are available. Such withdrawal of funds is reported as income to the corporation.
- A “Potential Future Purchase of Stock Account” (PFP Stock Account) is established as a companion to each SOVA Account, this account being credited with the number of PFP Stock shares that could be purchased at the market price with the funds in the SOVA Account at the time of each quarterly report.
After the stock options become vested and the grantee elects to exercise them, the grantor corporation updates the SOYA and PFP Stock Accounts based on market price on the exercise date, withdraws all funds from the SOYA Account, and uses the entire proceeds to purchase stock for the grantee on the open market, thus converting the PFP Stock shares into real book entry shares. Any additional expenses (including brokerage fees for the share purchase) are shown on the next quarterly report. SOYA and PFP Stock Accounts are closed after the PFP Stock is converted into real shares, and the real shares have been credited to a book-entry account for the beneficiary.

Example

Quantity 1000 Incentive Stock Options are granted to John Doe at a price $7 by XYZ Corp. On the date of the subsequent quarterly report, the closing price of ordinary shares is $8. The income statement by XYZ Corp. shows expense of 1000X($8-$7) = $1000, and John Doe's SOYA Account is funded with $1000. The number of John Doe's PFP Stock shares is $1000/$8 = 125.

On the reporting date of the next two quarters, there is no change in market price of shares, so there is no additional expensing.

On the next reporting date, the market price is $9, indicating a $2000 increase in value for the original grant. Because $1000 had been previously expensed, this report will expense only an additional $1000. The number of PFP Stock shares is $2000/$9 = 222.22, and the SOYA Account is funded with an additional $1000, bringing it to $2000.

On the next reporting date, the market price is $6. The $2000 previously expensed is reported as income by XYZ Corp., withdrawing those funds from the SOYA Account. (There is no loss of $1000, there are zero PFP Stock shares, and John Doe's SOYA Account balance is also zero.) For the next ten months the market price remains below the $7 option grant strike price. In the interim, John Doe's options have become vested and exercisable, but are valueless (below the strike price and out of the money) due to market conditions, so John Doe takes no action.

Eventually, the market price rises suddenly from $6 to $7 to $8, so on the next reporting date, XYZ Corp. expenses $1000 and places $1000 into John Doe's SOYA Account; his PFP Stock Account is credited with 125 PFP Stock shares. John Doe waits, hoping for a better market price and greater number of shares to be purchased for him.

Subsequently, the corporation wins a big order, the market value of shares increases to $10, so John Doe exercises his incentive stock options, takes $1000 in cash and $2000 in book-entry stock, the real XYZ shares having been purchased for him by XYZ Corp. on the open market using funds from his SOYA Account, augmented as necessary from current revenue. For tax purposes, he must report the cash he receives as ordinary income, but if he holds his 200 shares of real stock for at least one year before selling it (and because at least two years will then have passed following his grant date), such a sale qualifies as a long-term capital gain with a zero cost basis. However, John Doe may have AMT tax liability for the year in which the grant was exercised. On the quarterly report immediately following the exercise of John Doe's grant, an additional $2000 is expensed by XYZ Corp., $1000 of the $3000 outlay having been taken from the now closed SOYA Account. His PFP Stock shares having been converted to real book-entry shares, his PFP Stock Account is also closed. If John Doe requests it, his book-entry shares can
be transferred to his existing brokerage account at no cost to him. (The tax treatment described above is similar to that currently in effect for incentive stock options, but may require IRS approval.)

Discussion

I have read a number of negative comments on the FASB web site regarding the referenced FASB Exposure Draft Statements - now topping 3,200, they seem to be arriving in an avalanche from individual option grantees naturally objecting to the concept of expensing stock options, and particularly when granted as "fair value" estimates based on purely hypothetical assumptions that may or may not be fair. Naturally, they prefer the status quo -- the currently permitted use by FASB of "intrinsic value" at the time of grant, i.e., typically zero -- a method of evaluation that is anything but fair.

Although there is occasional concession that option grants have a value greater than zero, there is enormous disagreement over methods of evaluation at the time the grants are made. I believe the "expense-and-fund-as-you-go" concept summarized above avoids the inappropriate application of esoteric expense-estimating concepts for the time of grant, e.g., binomial, Black-Scholes or other voodoo model variations, for which a doubtful ability to predict future costs is alleged.

At the time a grant is made, it is simply impossible to predict accurately the present value of an option that may or may not ever be exercised by the grantee at some distant future time and price. It is also unfair to burden a grantor corporation with a theoretical current expense for options granted that may never actually be exercised by the grantee. The "expense-and-fund-as-you-go" concept also corrects the fundamental unfairness of earnings dilution (a problem the current FASB proposal fails to address) by funding incrementally the eventual future purchase of stock on the open market. By using "true intrinsic value" measurements made, funded and expensed quarterly, this concept is both accurate and fair:

It may seem odd that a reduction in the market price of shares could create "income" to the corporation if prior market-price increases from the original option grant price had resulted in prior "expensing," but such income would logically be attributable to the extra-motivated work-effort produced by the grant beneficiary that was not fully compensated by his/her wages, yet was of benefit to the corporation; in such cases, the incentive was perhaps inadequate, or incapable of correcting other problems negatively affecting the market value of the stock. Naturally, after all prior "expensing" for a given option grant has been recovered as income by the corporation, there can be no additional income recognition of this type until additional expensing would occur following a subsequent recovery and rise in share price. Any income earned by funds deposited in a SOVA Account is reported quarterly as income to the corporation, and can be withdrawn as it is earned.

When the options are exercised, if they are converted to cash on the exercise date, the payout is withdrawn from the related SOVA Account, but any insufficiency is taken from current revenue and is expensed on the income statement of the next following quarterly report. If converted instead to real shares (i.e., no longer PFP Stock shares), the corporation uses the related SOVA Account funds to purchase real shares on the open market through a brokerage, and converts
them to real book-entry shares for the beneficiary, the number of such book-entry shares being based on the stock's closing price on the exercise date.

If the existing funds in the SOVA Account are insufficient to cover the purchase cost entailed when converting PFP Stock into real shares (including nominal brokerage fees), additional funds are taken from current revenue and expensed on the income statement of the next following quarterly report. In the case of an Incentive Stock Option Grant meeting statutory requirements, for tax purposes, such real book-entry shares should have zero cost-basis; if sold by the recipient beneficiary at least one year following the exercise date and two years after the grant date, they should be taxed to the seller as long-term capital gains (perhaps subject to IRS opinion). Naturally, there is no capital loss if options expire unexercised. If cash is taken, it is taxed as ordinary income to the recipient. Following the exercise and conversion of PFP Stock shares into real shares, the related PFP Stock account is closed.

Advantages of the “Expense-and-fund-as-you-go” Concept

- The incentive value of option grants is unaffected.
- The true market value of options and their cost to the corporation is reported on the corporation's income statements, with only a three-month delay (worst case).
- The corporation is not saddled with an initial estimated cost that would be entirely unrealistic if the options were to expire unexercised.
- Because book-entry shares are purchased for the grantee by the corporation on the open market, there is no change in the number of issued shares, nor "dilution" for other shareholders.
- The uncertainty regarding future financial effects of options that may or may not be exercised, and the ambiguity of reporting "diluted" earnings is eliminated.
- By recognizing fairly quickly the real cost to the bottom line, perhaps greater care will be taken in issuing "freebie" options.
- Taxes for both the grantor and grantee are simple and straightforward (although an IRS opinion may be required).
- Assuming the book-entry shares are taxed at the capital gains rate when sold at a future date at least one year after receipt, there may be greater incentive for key personnel and corporate officers to hold shares for future gains and the related tax advantages, likely resulting in an even firmer alignment of their interest with that of other shareholders.

This "expense-and-fund-as-you-go" concept does not attempt to predict the unpredictable, unknown distant future cost of stock options (that may or may not ever be exercised) through questionable estimating techniques. It accurately reports the current incremental increase or decrease of the true intrinsic value as incremental expense or income respectively, and funds the future non-diluting incentive stock-grant purchase in reasonable quarterly increments, usually over a considerable period of time.

Sincerely yours,

M. ROBERT PAGLEE, P.E.