Subject: FW: Comment letters on the Stock Option Compensation Plan

Comment one.pdf (16 KB) Comment two.pdf (56 KB)

-----Original Message-----
From: andrei melnikov [mailto:andreimelnikov@hotmail.com]
Sent: Saturday, August 06, 2005 7:47 PM
To: Director - FASB
Subject: Comment letters on the Stock Option Compensation Plan

Dear Director of Major Projects and Technical Activities,

Here are the two comment letters on the Stock Option Compensation Plan.

Comment one contains the suggestion for an alternative presentation of the Stock Option Compensation plan, its substantiation and model.

Comment two is an expanded version containing the critiques of the expensing models. It also includes some suggestion that should mitigate some of the related to the Stock Option Plans abuses.

Please feel free to contact me regarding any additional information.

Thank you for your time and consideration,

Sincerely yours,

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STOCK OPTION COMPENSATION PLAN

Introduction

The initial treatment of the stock options certainly has deficiencies. However, it is still superior, in my opinion, compare to attempts to expense the transaction.

First line of evidences that suggest that the transaction is not a company expense comes from weaknesses of the arguments of the expense proponents.

The substantiation largely based on exceptions - use lost opportunity arguments, and assumptions - from assumptions that Board of Directors will probably buy share back that will create real cash outlay to assumption based expensing model(s).

Second group flows from absence of any outflow of resources. Results - the expense should be ignored in investment decisions, it will distort key financial ratios (EPS, Fully diluted EPS); it should be ignored during lending decision process (It will distort liquidity ratios).

Therefore it does not matter, how the option will be expensed, whether estimation model will be used or Fair Value model will be adopted; general misrepresentation will be unavoidable, because of the pervasiveness of the misclassification mistake. The only difference will be the amount of the misrepresentation and behaviour and mobility of the item (it will be smooth in one case and volatile in another).

The reason - hybrid nature of the compensative tool.

Hybrid nature resulted from the manner of the compensation - distribution of the shares.

The root reason of the misclassification is the breach of the legal and hence economic borders of the entity. The transaction with shares and options is the transaction between shareholders and/or potential shareholders and should be account accordingly. If shares, not cash is used for to compensate an employee - shares, not cash should be accounted for.

Inability to fit the transaction into the liability/expense definition (there cannot be liability without any obligation) is a direct result of the breaching an entity boarders.

An alternative concept

This view produces much more useful for analysis reporting. First of all, it is based on simple and mathematically perfect equation: there is no difference between reduction of the shareholder's control by mean of share dilution
caused by distribution of the stock option and direct transfer of certain number of shares from the conventional shareholder to the option holder.

Basically, instead of assuming that company would have more cash selling the shares on the open market, we should assume that company would have to sell fewer shares to obtain the same amount of cash. Cash, however, is an item that belong to the entity; therefore, it is more appropriate benchmark to determine the nature of transaction and its effects on the entity’s resources.

For example, if the option price of the share is $50 while on the market is $100, then assuming that 100 options are vested, employee would buy 50 shares at the market price and get another 50 free, or rather as a premium for making investors wealthier through market gains. This view reflects the substance of the event: there are not less assets (capital gain, dividends) that shareholder can claim upon, there are simply more claimers.

Company is just an agent that helps to avoid double postage (stock dividends/split’s shares are going from the company to the shareholders, than these extra shares are going to option holders from shareholders).

One important component, the income tax preferential treatments (capital gain discount in share transfer and dividend credit in cash transfer), is also transferred to the option holder. This is a result of the compensative nature of the tool.

This concept does not undermine any core assumptions and definitions, since the transaction between share and option holders, like any other market interactions is accounted for in Statement of Capital and related to it Notes Disclosure. It is exactly the place where the market related transactions should be reflected and hence this section of Financial Statement should disclose the related consequences.

Moreover, not an entire amount of the equity distribution that relates to the option plan is a shareholder’s expense. In many occasions, contribution to the equity effect is also present.

Stock options are exercised because of the growth of the share price; at the same time the stock option plans, in its turn, may be the reason for the (serious) share price growth. Moreover, presence and quantity of the stock option reduces (or at least should) share, and hence option value, since it directly suggests potential share dilution.

Income based plans are also often the reasons for the higher income. However, increase in income (or smaller loss) will be translated in either case in the higher equity.
Option plan in its turn, definitely, help companies to attract and retain talents and motivate the worker to achieve better result. Since the share price is partially driven by such important financial indicators as an income, effect of the stock option plan partially translated in changes in the equity the same way income based plan does.

However, market capitalization benchmark has still the different focus compared to income one and share price may move even in inverse direction to the income. For example, shares of an IPO company that often have been driven by the company’s growth, rather than income.

Therefore, extra efforts of employee motivated by option plan will be allocated to the entity’s equity differently than efforts stimulated by income based ones. The capture process of this contribution is a difficult task, because (often significant) part of the work of the option holders is going toward increase of internally generated goodwill, which is not recorded but revealed if/when company is sold and market and equity going through reconciliation process.

Otherwise, the increase in internally generated goodwill will still be (partially) reflected by the movement of the share price. The artificial expense should not significantly affect the share price; therefore, appropriation of equity to impose the expense will artificially increase difference between equity and market capitalizations (as if we do not have enough problems in this domain).

Situation is clearer in instances of the market downturns: options are likely to be forfeited and company would experience unrecorded, “volunteer” contributions.

Although, the principle of conservatism would, probably, not allow accountants to capture this contribution, at least in the most cases, awareness of such possibility should be disclosed.

An alternative model.

There are the ways to develop the presentation of information improving Capital section of Financial Statements or related to it Notes Disclosure. For example, some of the major information associated with stock options could be displayed directly on the Statement of a Capital and Note disclosure can be modified and/or expanded.

If there is need for more conservatism, stock option might be included in basic EPS earlier, when probability of the plan vesting is high.

Also, it would be beneficial to disclose the extent of reduction of the shareholder control (claim on resources) using an absolute, percentage or fraction terms.

It can be achieved using formula:
Percentage of the equity bonus = 100(%) + (1 - (TS + SCE)/(TS + SCE + SBD)) - X
Where:
TS - Total Shares (before option distribution)
SCE - Shares for Cash Equivalent. That represent the quantities of shares would be issued to raise the amount of cash that had been raise at the option price.
SBD - Share Bonus Distribution. That represents quantities of shares distributed as a (sum of the) bonus and contribution to the equity transaction.
X - Percentage of the shares distributed in exchange for services (unrecorded (or estimated) contribution to the equity).

For instance, assuming total amount of shares is 80 and 70 more shares were distributed to the option holders for the (market) price of 20 (so, 50 shares were distributed as an compensation (equity bonus & equity contribution), then common shareholder is given up: 1 - (80 + 20)/(80 + 20 + 50) = 1/3, 33.33% of control or 26.66... shares to the option holders (53 1/3 original shares left after the compensation payment).

Individual shareholder can calculate an effect using percentage point to calculate personal effect on his/her share of the claim on the entity's potentials (33% reduction of the personal share of equity, in our example).

It was mentioned above, that "X" will be very difficult task to isolate and it would be prone to misrepresentation, because both, management and BoD would be motivated to show more fundraising activities and less equity bonus. Plus, this amount represents contribution to the equity in absolute terms; it does not deal with distribution of control. Although, contribution to the equity with ones services happens mostly in the private sector and in partnerships, compensative option plan creates a unique among compensative tools situation when the attention to the contribution may be essential to achieve more complex company and management evaluation.

It might be possible to develop some models in instances when company's performance has identifiable benchmark (comparable competitors, for example).
Otherwise, "X" could be left without any estimation with disclosed possibility of such contribution, leaving the assessment up to the judgement of the user of Financial Statements.

Note that "gestimated" amount of X may be equal to the bonus distribution indicating that option holder paid market price for the shares (cash plus high quality of efforts) and received no equity bonus. Theoretically, in case of extraordinary performance that is not fully reflected by the market or in case of option forfeiture due to market condition - even exceed it. These situations represent good (extraordinary) bargain for the shareholder. It also can be zero, representing of fair bargain and theoretically even negative, indicating that use of the option plan may have a generally depressing for the equity
(share price) effect.

Shares' "inflation" over certain period of time can be shown in the Notes in the form of the schedule, for example, five years to demonstrate general compensative policies: their effects and risks involved. Showing dilution showing shares in similar to inflation terms will be clearly understandable to reader of Financial Statement. In our example, total inflation was 87.5% (70/80), including bonus related one of 62.5% (50/80) and fundraising related one of 25% (20/80). Information regarding share price history over the same period and (total) discounts earned by the option holder may also be disclosed.

II.

In the cases, when the entity repetitively buying significant amount of shares back in the relatively short period of time (5 years, for example) around the option distribution (vesting) point, than expensing option is becoming increasingly more appropriate.

It is important to consider that any company that uses option plan may have reasons to buy share back that are unrelated to the stock options. Therefore, to achieve better comparability and diminish punishing effect that may prevent the entity from the action because of reporting (not economic) reasons.

For example, if the company tends to buy back relatively insignificant amount (<30%). It would not worthy to bother with the schemes to avoid minor expense, especially since this amount still will be disclosed in Statement of Capital as an equity bonus. Therefore in case of insignificant shares buy back, full amount can be disclosed as an equity bonus.

When the entity buys back 30 to 70 percent of the shares during period of time, than the prorating is probably necessary to reflect situations of lesser clarity. It will reduce both, fundraising and bonus share distribution. Amount of cash that is used for the bonus part of the share buy back should be expensed (preferably retroactively restating Financial Statements, using average or moving average share costing models).

So, if the entity bought back 25 shares, in the year five after shares were vested, then using figures from abovementioned example, it would decrease fundraising part of the share inflation on 7.145 shares (25*28.58% (25/87.5 or 20/70)) or 8.93% (7.145/80); it would also decrease inflation of its equity bonus part on 17.855 (25*71.42% (62.5/87.5 or 50/70)) shares or 22.32% (17.855/80) with total decrease of inflation of 31.25% (25/80 or 8.93+22.32). Amount of expense that would be reallocated from equity section to Income Statement would be equal to the price that company actually paid to acquire these 17.145 shares.

If the amount of share that had been bought back is substantial (>70%), for
ex.) or if shares were bought back directly from the compensative option holder (under certain arrangement, for ex.), then equity bonus should be reduced first before starting to decrease fundraising part of the share dilutive activities.

Note, that sequence of the events, stock option initiation and share buy back, considering the amount of the expense over the period (five years in our example) is not important. This should prevent companies make the "preventative" accumulation of Treasury shares spending cash upfront.

Methods and especially timing of allocation of equity bonus from equity to the income related operation should also be developed to reasonably comply with the matching (revenue and expense) principle. There are few ways to report the transaction when recording and in reclassifying (expensing, if there is need) the equity bonus, using different parts of the equity (Retain earnings vs. Contributed Surplus, for example). The details, however, cannot be formed before the finalization of the model.

Share inflation index figures over the period of time together with yearly control distribution (equity bonus payment) disclosure and quarterly assessments using EPS, P/E, fully diluted EPS and Equity/Share ratios should give Financial Statements user adequate information to assess the impact of capital transaction related to the compensative option plans on his/her investment strategies.

Other methods of capture or calculations movement of capital can be developed. The imperative is to avoid unnecessary misclassification on its basis level creating irreconcilable situations.

In conclusion, finance professionals already had a history when some section of the statement attracts more attentions than other. Certain events in relatively distant past force us to respect Statement of Cash Flow in addition to Balance Sheet and Income Statement. It is probably the time, considering recent abuses and market failure, to have more appreciation to Statement of Capital section as well, instead of placing separate transaction on the "light", i.e. in the Statements where it would be more visible and valued.
STOCK OPTION COMPENSATION PLAN
WHY AN EXPENSE IS NOT AN OPTION

PART I
Introduction

The decision regarding the treatment of Stock option seems to be in its final phase. The main focus, for now, is to find a way to expense it rather than substantiation of the classification of the event.

From the beginning, though, this fundamental part of the process was overshadowed by political style discussions. Many arguments represented specifics and interests of the two opposite lobbies and were only partially supported by accounting evidences and backed by the accounting theory.

The disclose-only group, led by tech companies, have insisted on the importance of stock option plans for the economy, warning that expensing it would have negative impact on economic growth. Their main relevant argument is that the entity does not experience a cash outflow, therefore reporting the expense will distort the reporting results.

Meanwhile, the pro-expense party pointed on numerous abuses involving stock option compensation mechanisms. Their main arguments, that had been broadly used to initiate changes in the related accounting section, can be grouped into two categories. First, the stock option plan increases investment and business risks causing an aggressive reporting and motivating management to choose a riskier business strategy.

Second, the company is losing the opportunity to raise more cash; selling the options or shares on the open market, instead of distributing them through the compensative mechanism. In addition, the distribution results in share dilution which encourage Board of Directors to buy shares back which creates a real cash outlay; plus, income and cash figures do not always correlate in time.

The major role of accounting system, however, is not to stimulate the economy or to punish abuses, but to translate economic events to numerical, analyzeable format. The closer our information/reporting system will reflect economic reality, the better service accounting will serve for the stakeholders’ interests. At the same time, a risk of abuses is a natural constraint of our ability to achieve the most accurate disclosures.

Consequently, principle of conservatism is broadly used in by accounting theory. In its turn, this principle may also be abused and/or misinterpreted. This risk is particularly high in situations when biased lobbies are overly involved in the accounting classification process.

II.

The accounting profession did experience serious problems. However, many of the problems in accounting profession resulted in scandals that are widely dabbed as an accounting ones, were (are) mostly legal and ethical (Arthur Andersen), not conceptual characters. Legal (self) administrative and (self) regulation systems, though, are still better tools to deal with legal and ethical failures. Taxation system is more useful to stimulate or funnel economic activities than an accounting one. There is also crisis learning mechanism that
is embedded in the market economy, that had already led to suggestions and developments of much more creative stock option compensation schemes. For example, there are the suggestions to include into the compensation scheme other than market benchmarks, such as profit or revenue.

GAAP did (and do) have deficiencies. For example, there were serious problems with revenue classification for Internet companies and the shortcomings in treatment of "special purpose" entities (in Enron’s case). There were no questions aroused when related rules had been tightened.

Use of an accounting system as a preventative or stimulating measure has a major setback; it distorts results and leads to less effective economic decisions.

**Why should we start all over again?**

Would expensing of the stock option prove to be wrong, negative consequences will be unavoidable. Though, outcomes will not be as gloomy as suggested by tech lobby (up to 2, 3 trillion losses in the economy as sited on www.savestockoption.org), the consequences still will be pervasive.

Misclassified item either will distort financial analysis on all levels, including macroeconomics (considering scale of the plans’ popularity) or will be ignored. Both scenarios are costly. First leads to lower quality investment and lending decisions, because both primary and secondary qualitative characteristics of accounting information will be undermined primarily affecting comparability of Financial Statements.

Second scenario, when transaction is ignored during the financial analysis, may create the stimulus for a new spin off of Pro-forma statements. Effect of these Pro-Formas will differ from the effect of Pro-formas of the 90th, when these statements had disregarded even some cash expenses (BCE Corp.).

If Pro-forma Statement would reflect economic reality better than conventional GAAP, GAAP (not Pro-Formas) will be undermined. Although, there will be more work for accountants, accounting work with regard of stock option expense will be viewed as an obligation to comply with the bureaucratic procedure, rather than or value added activity (incl. administrative necessities). Thus, the status of accounting profession will be, at some degree, negatively affected.

Since the compensative tool is still under development, we will see more and more different types of options, with different terms and timing. Subsequently, related section of accounting handbook will expand in volume and complexity to the point of contradictions and even confusions with regard of interpretations, considering the speed of the tool’s diversification and experience with some other sections of GAAP, such as pension one, where initial point of view have shaky foundations.

In addition, companies will probably start design more comprehensive option plans specifically to avoid the expense, but to retain most of the option plan effect. This might not only escalate complexity of accounting process, it also will compromise the simplicity of this tool (stock option contract) at its base and the economic necessity in order to comply with better reporting requirements.
The unfortunate parallel is Iranian banks that had been forced to design complex ways to charge an interest on the loan since it contradicts to fundamentalist’s law. Banks found the way around the law, because interest is, probably, very useful tool for the bank. Still, clarity of the simple interest charge is certainly missed there.

The reasons that consequences are so significant are that the suggested problems with the treatment of the stock option plans are not technical but fundamental by nature: the question is not the amount or the method of expense, but whether it is an expense in the first place.

**Risks write off**

*Can we simply write off our moral failures?*

First of all, "risk writes off" arguments have too many significant weaknesses and too little support to be regarded for the reporting process. Risks pertaining to stock option plans are incalculable, arbitrary and differ from entity to entity based on factors of quality of BoDs involvement, sound Internal Control, relevant education level of an investor, appropriate degree of independence of the financial market service providers and, of course, on the managements’ integrity. Different designs of stock option plans will also create different types and scales of the risks. In addition, an intra-company allocation of the stock options between group of employees (management, technical, etc.) varies greatly from company to company which also affects level and type of the risks.

Moreover, expensing stock options will be a punishing transaction in comparison to other compensation schemes. Income or cash driven compensation plans also incorporate risks of abuses and can motivate management to adopt strategies that maximize their bonus even if the strategy is not in an entity’s best interest. Even company’s that have no bonus plan are not insured from abuses (in addition to greater risk of underperformance). The development of stock option plans as a compensative tool is actually aroused as a need to avert such risks.

Many of the financial risks, such as political or Industry ones cannot be put in numerical format. Nevertheless, they are taken in consideration when making an investment or lending decision whether they are required to be disclosed or not.

Expensing the stock option also cannot prevent abuses. This expense does not help to prevent from manipulation any of Financial Statement item. It cannot change the intention nor is the ability to do exactly what planned. Unfortunately, the accounting transaction cannot improve people’s moral. Expensing our personal potential failures as a way to prevent them can be achieved only in a boring accounting fairy tale story rather than in reality.

Would Enron (involved) management have expensed the options, the manipulations still would make the company look like a champion compare to competitors, especially that many of them would also had to expense the options. That still would be reflected in the share market price. If this would not be enough, this management could expense few more hundreds of millions to “compensate” the expense. Moreover, there would be even the plan “C”, issuance of very popular at that time Pro Forma.

In addition, would Enron management been rewarded using Income base compensation plan, they would not had to make any changes in a scheme to enrich themselves. Each
dollar of expense/liability that never reached Financial Statement would increase profit, that proportionally would increase the bonus.

Expensing option might have some discouraging effect with regard of the use of the tool. Nevertheless, it would not diminish attractiveness of the stock options for the tech and IPOs especially when profit is a secondary benchmark for them compare to revenue growth. It also cannot make an investment climate more conservative; consequently, it cannot decrease supply or demand for an aggressive accounting.

Expensing options looks like a conservative action, it does reduce the income. However the results of such conservatism do not achieve the goals of the principle. It just restricts positive and practically helpless toward negative effects of the option plans. In fact, the most reputable companies will experience the hardest hit, compare with ones that have questionable reputation or adopt the riskiest strategy. Under the suggested expensing model, more stable company will show higher option expense which would imply the higher risk.

Therefore, this expense neither prevent, nor properly disclose relevant to option plan risks. In this sense, the expense rather looks like an insurance expense, but without a positive effect of the actual insurance!

**Mission Impossible**

*Or chasing the “lost” opportunities*

Another set of arguments relates to lost opportunities to raise more money on an open market. The suggestion itself to write off lost opportunities is extremely exceptional. Moreover, this suggestion pleads to write off future lost opportunities because a company would lose the opportunity only at the time options are yested or exercised (if it ever happened!). The result is a rough approximation of not yet been lost opportunities, if any.

Estimation of future expenses and set up of relevant liability is not a new concept in accounting. However, such estimations (as mining site restoration or pension account) periodically reconciled and the company must use its own resources (normally; cash) to settle these liabilities.

**Conceptual weaknesses**

*Some of the “mute” assumptions*

The exposure draft issued by FASB, which is, in essence, a modification of the suggestion made by International (European) Accounting Standard Board, uses main features of the Black-Scholes model. The accounting section, of course, does not have the goal to justify the substance of the transaction.

Would the justification have taken place, than it would be noticeable, that the entire transaction is floating on assumptions and exceptions rather than based on typical accounting terms and definitions.
To justify the substance of the "expense", in the case when each separate event is normally recognized in capital section, numerous assumptions and exceptions must be developed in order to tie these events together. For example, to use arguments that the Board may spend cash to buy shares back has to be assumed that the Board has an initial intention to do so. Also, we should assume that there would be no events that may make change the intentions and the ability of the Board to buy shares back, (even if these events separated by five, or even ten years).

Moreover, we should assume that the Board will buy shares back at a price that equal (or at least close) to the share price at the time the options are vested. Otherwise, the amount of cash outlay regarding the share buy back and suggested lost opportunities would be considerably different. (None of its options could have been distributed when share price was $20, exercised when $100, and bought shares back when they were just $50).

Furthermore, it is essential to assume that the prime reason for the operation was the original issuance of the stock option and the quantity of the newly bought treasure share is approximately equal to the quantity of shares distributed through the stock option plans. It also preferably to assume that these shares are bought from the option holders, otherwise, option holder end up with shares and shareholder with cash.

Moreover, share buy back have not only negative but also positive consequences, it prevents share dilution (should we capitalize this effect?). Furthermore, many other operations, for example operations with conventional stock options or warrants, create the same effects, share dilution (should we expense them?). There are many other events lead to shares buy back (should we try to capture and expense these reasons?).

Without share's buy back the transaction, write off of the potential cash outlay often estimated in the relatively distant past, seemed to be hanging in the air. Otherwise, why not to write off many other lost opportunities?

In addition, the suggested pricing model itself is based on several assumptions. The Black-Scholes model, for example, does not deliver the end result when it determines an option price. Main principle behind the model, it is better to have some estimation than none. The option price is continuously adjusted with the flow of the new information.

Furthermore, in practice, the proposed model of expense will be the least relevant where it is needed the most. Tech companies and IPOs are loaded with the stock options plans. At the same time, Black-Scholes model or its spin-off is the least applicable to the companies with little history and vague future. It is the most appropriate to the well established cash cows that tend to use them less, because share dilution too directly affects amount of dividends. Therefore, since expensing will be concentrated in the certain sector of the economy, it would lead to the rough approximations of significant amounts of the economic effect that relates to stock option plan. This record will actually contradict the principle of conservatism (record what we know or able to estimate), otherwise predictive value of financial information will weaken. Hence, we will have to expect intolerable deviations or make an attempt to introduce a better model.

Many accounting treatments, that both, exceptional and "discriminative" by nature, which often resulted from application of the conservatism, actually do help to prevent abuses. Most of the time, an item is expensed instead of been capitalised (in-home developed patent vs. purchased one, AFDA). Another common important feature of these items is that they are or relate to the company's items (research, revenue) and
Therefore, can be directly manipulated.

To benefit from the stock option manipulation, market should be manipulated. Moreover, there are many other ways to influence market (and hence option) values "working" around Financial Statements using, for example, budget & forecast (Nortel), or technical information (such as, samples on gold concentration; Br-X).

In addition, exceptions that are used to justify option expense, such write off of the lost opportunity or of moral and market-related risks, as was noted, are also quite exceptional themselves.

The more exceptions accounting classification process will produce the lower comparability quality of Financial Statements will be achieved; the more assumptions will be used in attempt to estimate the amount the lower precision and hence reliability of the financial information will be achieved. Too many assumptions during the substantiation of the transaction may lead to its complete misclassification.

In summary, it is not unusual for accounting to develop assumptions and exceptions; however, when each stage of implementation need them, it might be a serious sign of conceptual weakness of the proposal.

The reason behind
"What liability?"

The true reason for assumption and embedded imprecision is a result of the fact, that an entity does not experience any type of outlay of any economic resources, not at the time of the plan initiation, or when it is exercised. Second, plan initiation does not imply any type of the formal obligation to buy shares back.

Absence of any legal obligations that would lead to decrease of economic abilities of an entity does not allow us to classify related to the suggested stock option expense liability as a liability in its accounting terms. There is nothing wrong with the term, though. The term, liability without any obligations, contradicts even to the meaning of the word "liability". Would we have a credit card that allow us not to pay the debt, many of the card holders would feel that their have less liabilities than it is recorded.

Breach of the well working definition did not come for free, resulting in the numerous exceptions. The breach of the liability definition, though, is not the root problem. This breach is a result of a distortion on even more fundamental level.

The root of the problem

Expensing option plans will violate a fundamental business assumption of a company, as a legal entity that determines a company's economic borders and separates entity's resources from our own pockets. Recording capital transaction on a balance sheet will breach these borders causing difficulties with classification of the item and trigger a need for numerous assumptions and exceptions to be able to record expense and liability.

Even worse picture will be shown if there will be an attempt to reconcile the "expense" to the market using fair value approach. Then, conceptual weaknesses of the proposed transaction will be even better revealed and suggested option expense model will reflect...
the same tendencies, though expensing estimated amounts will make the transaction smoother. Therefore, it is a useful test of the substance of the transaction.

Since stock option expense will reflect market related events it will assume their nature. For example, market capitalization of the company and related changes depends on perception of the stakeholders regarding the company’s value. Hence, option expense will be a partial write off of the perception from the performance. This item will be volatile and it would also move in inverse direction with the market.

For example, if share price will rise on improved perception of the management integrity (as it happened when Intel management promptly recognised technical faults with their chip, pointing that market value as quality higher than the real technical problems with the real cash outlay), than the amount of expense will hike, representing the write off of the management integrity(1). In case when the share price collapses, especially after some upward rides and option are forfeited, then write up of already written off amounts as the saving on compensation would be necessary. That, in our case, would improve (1) operational income.

In summary, relocation, shareholders' own, market related item from Capital section to the entity's Liability section will artificially reduce the entity's net worth. The product of the consequent liability reduction also does not fit to the conventional expense definition and therefore, its justification totally depend on accuracy of liability classification; but this, however, is already the closed circle.

PART II

An alternative view

First of all, the hybrid nature of the tool should be recognised and taken in consideration during the classification process. It has bonus features, but payment is in a form of the equity, and (ultimate) benchmark is a company’s share price; market risks are also shared between shareholders and intended beneficiaries of the plan.

Second, all negative consequences appeared at the time of option initiation and exercised time. Therefore, they should be disclosed at these times and operations with treasure shares are irrelevant for the purpose of Income statement, at least on this phase.

Due to the nature of the stock options, as a result of the initiation and vesting of the stock options, nothing really changes for the company and its economic abilities. There is the change of the probability of the increase in the quantity of the shares, which represented by change of digit in the equity section and company’s economic abilities do not depend on quantity of owners (at least in direct and/or quantifiable terms).
An alternative concept

I.
This view produces much more useful for analysis reporting. First of all, it is based on simple and mathematically perfect equation: there is no difference between reduction of the shareholder’s control by mean of share dilution caused by distribution of the stock option and direct transfer of certain number of shares from the conventional shareholder to the option holder.

Basically, instead of assuming that company would have more cash selling the shares on the open market, we should assume that company would have to sell fewer shares to obtain the same amount of cash. Cash, however, is an item that belong to the entity; therefore, it is more appropriate benchmark to determine the nature of transaction and its effects on the entity’s resources.

For example, if the option price of the share is $50 while on the market is $100, then assuming that 100 options are vested, employee would buy 50 shares at the market price and get another 50 for free, as a premium for making investors wealthier through market gains.

This view reflects the substance of the event: there are not less assets (capital gain, dividends) that shareholder can claim upon, there are simply more claimers.

Thus, the compensation from compensative stock option is coming not from company but the shareholders who promise, under certain conditions, the bonus directly to option holders in a form equity share transfer (which differentiates the plan from Phantom Option plans) to assign owners qualities and motivations to the plan’s participants.

Company is just an agent that helps to avoid double postage (stock dividends/split’s shares are going from the company to the shareholders, than these extra shares are going to option holders from shareholders).

Even if the amounts would be transferred in cash, nothing would change. Would these extra shares be sold on the open market, company would receive more cash which it can distribute as dividends to its shareholders with consequent payment to the (option) contract holders.

One important component, the income tax preferential treatments (capital gain discount in share transfer and dividend credit in cash transfer), is also transferred to the option holder. This is a result of the compensative nature of the tool.

This concept does not undermine any core assumptions and definitions, since the transaction between share and option holders, like any other market interactions is accounted for in Statement of Capital and related to it Notes Disclosure. It is exactly the place where the market related transactions should be reflected and hence this section of Financial Statement should disclose the related consequences.

Remarkably, but the party that demand the expense never really argued that current presentation regarding stock option compensation plan does not provide enough information to make an inform decision. They claimed that the information (“expense”) is buried in the Notes. There is a lot more crucial for shareholder’s wealth information is “buried” in the Notes that cannot be quantified, but still should be taken in consideration.
In fact, required disclosures with regards of stock option plans are already detailed
enough to integrate the effects of the plans to the financial decisions. To analyze the
investors' personal share of the gain or loss, we traditionally used key financial ratios
that link a company's performance with the market, such as EPS (Earnings per Share) or
P/E (Share Price/Earning): This incorporates effects, the company's performance and
capital movements. Negative consequences that arise at the time of the stock option
issuance are shown by another VIP ratio, diluted EPS.

There were many people who experienced a major financial setback during the market
correction. However, there were many people who did not lose or even gain money on
the latest rise and collapse of the market. Although "the stupid luck" played a big role on
the market that in some ways resembled the casino with its own set of rules and moral,
it is reasonable to speculate, that the pool of the less unfortunate investors used the old
fashion financial ratios more often than those who experienced the setback.

Some of the ratios had already indicated that the investor should expect to recover the
investments only in 1000 years (Research In Motion, for example), but shares still were
in demand. RIM was not an extreme example, the company actually make something
and it actually did have the earnings in contrast with Internet consulting companies, for
example, with their hideous level of market capitalization (10-11 digits) that was backed
with their flashy names and the wild imagination of the investors.

This demonstrates that the conservatism of the mind of financial market participant is
still imperative to the most conservative presentation, because the end result will still be
based on the perception and interpretation of the given information.

The suggested expense will accommodate speculative market of the past, because this
expense will provide presentational simplicity, that is so important for a speculator, who
must make quick decisions and need more superficial analysis than a long term
investors. The interests of latter will be forgone, because crucial qualities of financial
information will be sacrificed for the sake of the simplicity. Then, such expense will look
like an attempt to win the past war with all related consequences.

II.

If this transaction is already accounted for, does it mean that expensing it would create a
double count?

Expensing the option plans will trim a company's income, meanwhile quantity of shares
will be increased, first in Fully Diluted EPS, and subsequently (when options are
exercised), in Basic EPS. Thus, both nominator and denominator will be negatively
affected as a result of single transaction clearly pointing on the double count (that is also
reflected in equity per share ratio). Therefore, one or another, expense or option related
shares, should be ignored.

It would be absolutely unreasonable to ignore the increase of numbers of shares,
because, that exactly what happened. There is also no any outflow of economic resources
from the entity that expense implies. Therefore, the expense should be disregarded for
Investment decision.

The expense should not influence a bank in assessment of the company's liquidity or
Debt payment ability, for example. The trends, however, when applying the suggested
model, will be in inverse to the economic reality situation. Higher expectation with regard to the share price, will presume a lower ability of the company to pay the debt.

While in reality, quantity of issued shares, normally, is not an important factor for the consideration in the lending decision process. There are actually more concerns if options are forfeited, not to mention that restrictive ratios and covenants may actually preclude entity to use cash to buy shares back.

In addition, the "expense" is also useless for internal decisions. Manager of the profit center might become directly motivated to decrease the option expense in order to get a bigger bonus. Long term positive market performance and particularly positive market perception of the company will become his/her noteworthy enemy, at least the short term ones.

In short, if there is any sacrifice, then, it is not at expense of the company’s resources, but by shareholders’ personal outlay of control (and related claim on present and future income and assets (capital gain and dividends)) and cannot be recorded as an operational result. The operations is operations between shareholders, hence, it is a capital transaction.

III.

Moreover, not an entire amount of the equity distribution that relates to the option plan is a shareholder's expense. In many occasions, contribution to the equity effect is also present.

Stock options are exercised because of the growth of the share price; at the same time the stock option plans, in its turn, may be the reason for the (serious) share price growth. Moreover, presence and quantity of the stock option reduces (or at least should) share, and hence option value, since it directly suggests potential share dilution.

Income based plans are also often the reasons for the higher income. However, increase in income (or smaller loss) will be translated in either case in the higher equity.

Option plan in its turn, definitely, help companies to attract and retain talents and motivate the worker to achieve better result. Since the share price is partially driven by such important financial indicators as an income, effect of the stock option plan partially translated in changes in the equity the same way income based plan does.

However, market capitalization benchmark has still the different focus compare to income one and share price may move even in inverse direction to the Income. For example, shares of an IPO company that often have been driven by the company’s growth, rather then Income.

Therefore, extra efforts of employee motivated by option plan will be allocated to the entity’s equity differently than efforts stimulated by income based ones. The capture process of this contribution is a difficult task, because (often significant) part of the work of the option holders is going toward increase of internally generated goodwill, which is not recorded but revealed if/when company is sold and market and equity going through reconciliation process.
Otherwise, the increase in internally generated goodwill will still be (partially) reflected by the movement of the share price. The artificial expense should not significantly affect the share price; therefore, appropriation of equity to impose the expense will artificially increase difference between equity and market capitalizations (as if we do not have enough problems in this domain).

Situation is clearer in instances of the market downturn: options are likely to be forfeited and company would experience unrecorded “volunteer” contributions.

Although, the principle of conservatism would probably not allow accountants to capture this contribution, at least in the most cases, awareness of such possibility should be disclosed.

### An alternative model

There are the ways to develop the presentation of information improving Capital section of Financial Statements or related to it Notes Disclosure. For example, some of the major Information associated with stock options could be displayed directly on the Statement of a Capital and Note disclosure can be modified and/or expanded.

If there is need for more conservatism, stock option might be included in basic EPS earlier, when probability of the plan wasting is high.

Also, it would be beneficial to disclose the extent of reduction of the shareholder control (claim on resources) using an absolute, percentage or fraction terms.

It can be achieved using formula:

\[
\text{Percentage of the equity bonus} = 100\% \times (1 - \frac{\text{TS} + \text{SCE}}{\text{TS} + \text{SCE} + \text{SBD}}) \times X
\]

Where:

- **TS**: Total Shares (before option distribution)
- **SCE**: Shares for Cash Equivalent: That represent the quantities of shares would be issued to raise the amount of cash that had been raise at the option price.
- **SBD**: Share Bonus Distribution: That represents quantities of shares distributed as a (sum of the) bonus and contribution to the equity transaction.
- **X**: Percentage of the shares distributed in exchange for services (Unrecorded or estimated) contribution to the equity.

For instance, assuming total amount of shares is 80 and 70 more shares were distributed to the option holders for the (market) price of 20 (so, 60 shares were distributed as an compensation(equity bonus & equity contribution), then common shareholder is given up: \(1 - \frac{(80 + 20)}{(80 + 20 + 50)} = \frac{1}{3}, 33\% \) of control or \(26.66\% \) shares to the option holders (53\% original shares left after the compensation payment).

Individual shareholder can calculate an effect using percentage point to calculate personal effect on his/her share of the claim of the entity’s potentials (33\% reduction of the personal share of equity, in our example).

It was mentioned above, that \( X \) will be very difficult to assess, and it would be prone to misrepresentation, because both, management and BoD would be motivated to show more fundraising activities and less equity bonus. Plus, this amount represents contribution to the equity in absolute terms; it does not deal with distribution of control. Although, contribution to the equity with one service happens mostly in the private sector and in partnerships, compensative option plan creates a unique among
compensative tools situation when the attention to the contribution may be essential to achieve more complex company and management evaluation.

It might be possible to develop some models in instances when company’s performance has identifiable benchmark (comparable competitors, for example). Otherwise, “X” could be left without any estimation with disclosed possibility of such contribution, leaving the assessment up to the judgement of the user of financial Statements.

Note that “gestimated” amount of X may be equal to the bonds distribution indicating that option holder paid market price for the shares (cash plus high quality of efforts) and received no equity bonus. Theoretically, in case of extraordinary performance that is not fully reflected by the market or in case of option forfeiture due to market condition even exceed it. These situations represent good (extraordinary) bargain for the shareholder. It also can be zero, representing a fair bargain and theoretically even negative, indicating that use of the option plan may have a generally depressing for the equity (share price) effect.

Shares’ “inflation” over certain period of time can be shown in the Notes in the form of the schedule, for example, five years to demonstrate general compensative policies’ effects and risks involved. Showing dilution showing shares issued similar to inflation terms will be clearly understandable to reader of Financial Statement. In our example, total inflation was 87.5% (70/80), including bonus related one of 62.5% (50/80) and fundraising related one of 25% (20/80). Information regarding share price history over the same period and (total) discounts earned by the option holder may also be disclosed.

In the cases, when the entity repetitively buying significant amount of shares back in the relatively short period of time (5 years, for example) around the option’s distribution (vesting) point, than expensing option is becoming increasingly more appropriate.

It is important to consider that any company that uses option plan may have reasons to buy share back that are unrelated to the stock options. Therefore, to achieve better comparability and diminish punishing effect that may prevent the entity from the action because of reporting (not economic) reasons.

For example, if the company tends to buy back relatively insignificant amount (<30%). It would not worthy to bother with the schemes to avoid minor expense, especially since this amount still will be disclosed in Statement of Capital as an equity bonus. Therefore in case of insignificant shares buy back, full amount can be disclosed as an equity bonus.

When the entity buys back 30 to 70 percent of the shares during period of time, than the prorating is probably necessary to reflect situations of lesser clarity. It will reduce both, fundraising and bonus share distribution. Amount of cash that is used for the bonus part of the share buy back should be expensed (preferably retroactively restating Financial Statements, using average or moving average share costing models).

So, if the entity bought back 25 shares; in the year five after shares were vested, then using figures from above mentioned example, it would decrease fundraising part of the share inflation on 7,145 shares (25*28.58% (25/87.5 or 20/70)) or 8.93% (7,145/80); it would also decrease inflation of its equity bonus part on 17,855 (25*71.42% (62.5/87.5)
or 50/70)) shares or 22.32% (17.855/80) with total decrease of inflation of 31.25% (25/80 or 8.93+22.32). Amount of expense that would be reallocated from equity section to Income Statement would be equal to the price that company actually paid to acquire these 17.145 shares.

If the amount of share that had been bought back is substantial (>70%, for ex.) or if shares were bought back directly from the compensative option holder (under certain arrangement, for ex.), than equity bonus should be reduced first before starting to decrease fundraising part of the share dilutive activities.

Note, that sequence of the events, stock option initiation and share buy back, considering the amount of the expense over the period (five years in our example) is not important. This should prevent companies make the “preventative” accumulation of Treasure shares spending cash upfront.

Methods and especially timing of allocation of equity bonus to from equity to the income related operation should also be developed to reasonably comply with the matching (revenue and expense) principle. There are few ways to report the transaction when recording and in reclassifying (expensing, if there is need) the equity bonus, using different parts of the equity (Retain earnings vs. Contributed Surplus, for example). The details, however, cannot be formed before the finalization of the model.

Share inflation index figures over the period of time together with yearly control distribution (equity bonus payment) disclosure and quarterly assessments using EPS, P/E, fully diluted EPS and Equity/Share ratios should give Financial Statements user adequate information to assess the impact of capital transaction related to the compensative option plans on his/her investment strategies.

Other methods of capture or calculations movement of capital can be developed. The Imperative is to avoid unnecessary misclassification on its basis level creating irreconcilable situations.

III.

Suggested disclosure also does not contain any counter abuse measures except for the effect of improved informativeness. However, treating options as a capital (market related) item make the manipulations the clear cut market fraud which is a serious offence and threat of retaliation is a preventative measure itself. Meanwhile, expensing option implies that it is an intra-company transaction and these abuses often results with the slap on the hand.

Enron management that participated in in the scam used fraudulent schemes and weaknesses in the company’s legal and hence financial borders to leave enormous amount of liabilities and expenses outside of them. These borders just got tighter, surprisingly, but expensing the options will weaken them again.

Hybrid nature of the tool can be exploited to design preventative measures using the Taxation System. Option and stock holders in compensative situation, share the market risk. Option holder does not have a risk of losing money (but bear risk of getting nothing, or risk of over contribution to the equity), while shareholder bear risk of inadequate (compare to option holder efforts) share dilution.

So, tax system may set its own clear cut term in recognition of the compensative option income. For example, share retention requirement could be used to distinguish between
types of income. For example, income from selling the company's shares minimum in five years from the moment of the option plan vesting could be deemed to be a capital gain (i.e. the additional market risk would deem to be accumulated). Otherwise it could be considered as a bonus and tax preferential treatment will be lost.

This action will not prevent legal abuses, but will reduce incentive to use company's strategy for the personal use, because it will help to refocus management toward more long term objectives, building company's fundamentals. It also reduces shareholders' risks, because it adds the time test of the option holders' efforts. Early share sell off, by the option holder(s) may also play as a warning indicator for the stakeholders.

In conclusion, finance professionals already had a history when some section of the statement attracts more attentions than other: Certain events in relatively distant past force us to respect Statement of Cash Flow in addition to Balance Sheet and Income Statement. It is probably the time, considering recent abuses and market failure, to have more appreciation to Statement of Capital section as well, instead of placing separate transaction on the "light", i.e. in the Statements where it would be more visible and valued.

May be

ADD:
In the section ...Income based compensation risk..
Add: risk that management motivated to halt research and stop equipment maintenance and cash based plan may lead to management decision to sell an MV(P) asset of the company.

Add to effect of stock option expense:
Demonstrate effect of reporting on effect of operational functioning comparing to affect of the performance measurement ratios of Wall street of the cell phone provider on quality of the reception (in Europe, more general - customer satisfaction (that include quality factors) compare almost quantity of subscriptions.

Add: superficial expense analysis (definition problem) in the section: expense depend on liability

Add: