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Financial Accounting Standards Board
Director of Major Projects – Ref. 1102-100
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Please consider this response to the Financial Accounting Standards Board's ("FASB") Exposure Draft to amend FASB statements No. 123 and 95:

As an investor in the US stock markets, a primary user of financial information and a preparer of financial statements for over 14 years, I am concerned that the proposed changes put forth in this exposure draft are in direct conflict with some of the FASB's core stated objectives, "improve standards of financial reporting" and "provide information that is useful in making business decisions." I also believe this proposal is contrary to what many investors want from reporting in financial statements: a simplified measurement of a company's performance and a more accurate reporting of tangible events (as opposed to an increase in requirements for companies to incorporate speculation in the body of their financial statements – which confuses the reader). As an investor, I am bombarded by growing volumes of disclosure, complexity and redundancy in financial statements, driven by both increased regulatory requirements and the consorted efforts of forces at large, including (among others) the SEC, the major accounting firms and the FASB. The main intent of these groups appears, first and foremost, to reduce the risk of any potential for litigation exposure by reducing earnings. The cost results in over-complicating, lengthening and confusing financial reporting (this includes the creation of speculative liabilities that may not be probable or reasonably estimable which the FASB proposes in its draft). This trend may be genuine in intention but it will be detrimental in result.

I believe this proposal's objective is not meant to improve financial reporting, rather it is driven by a campaign to discourage the use of options as an indirect penalty (or tax) on compliant companies, which affects their employees and shareholders (not just their executives). The proposal is in direct response to the deeds of those few who caused some of the earlier fraud ridden scandals that were popularly reported in the media over the last several years. To date, there is no direct evidence of a correlation between fraud and the accounting treatment of stock options. This proposal would not have prevented, nor will it prevent, such fraud in the future. I believe the accounting profession and the SEC is attempting to install adequate measures. Its recent changes to requirements for corporate governance and review of internal controls, will have an impact in preventing future inappropriate behavior (however it will cost billions of dollars to install and maintain without a quantification of a measurable benefit).

In summary, if companies are required to adopt this proposal, or some form of this proposal, it will accomplish the following:

- Make financial information less useful by proposing for companies to distort operating results by incorporating unreliable compensation forecasts, through the use of inadequate valuation models, directly into its financial statements, undermining their credibility:

- Broadly force companies to potentially post a material artificial charge to earnings at the time the rule is adopted, significantly distorting earnings. This charge will negatively impact the economy and its industries and reduce the value of all stock investors' portfolios, including the portfolios of pension plans, IRAs and 401Ks;

- Allow for the institutionalization of a duplicate charge for the same potential event, understating earnings per share and reducing an investor's understanding of a company's finances;

- Discourage the use of options as a tool for companies to attract and retain key employees that add value to companies' earnings and share performance and discourage investment in smaller growth companies who don't have the resources to attract and retain employees thus deterring competition and stifling future economic growth.

To further expand on these points:

This Statement Proposes to Double Charge Earnings per Share

One of the most critical measures of a company's performance or a stock's "value" is diluted earnings per share (EPS). A shareholder or reader of financial information will typically, among other metrics, focus on EPS to measure performance and make business decisions. Operating events, transactions and other variables affect EPS. Under current rules, a company's stock options are normally granted to a broad base of employees (not just executives) as an incentive to retain employees. When exercise prices are above the average market value during the period being reported, they are required to be added to the weighted average basic shares outstanding – in effect diluting the shares. This dilution increases the base share amount within the calculation and reduces (charges) EPS for the common share equivalents of the outstanding options. This charge/dilution typically increases if the market price increases as more shares have a tendency to move "in the money" supporting a greater probability (and a greater charge) that options may be exercised thereby introducing new shares into the market. In my experience, the users of financial information currently recognize this dilution as a charge and consequence of issuing stock options. They place a greater emphasis on diluted EPS versus basic EPS. This emphasis is the primary benchmark of a company's performance. This is a recognized cost. Dilution negatively impacts EPS and may decrease a stock's value.

Your proposal to recognize a compensation cost when grants are issued within the Statement of Operations, while still requiring dilution of the shares, will require yet a second additional and duplicative estimated charge for the same potential event. This will cause likelihood of EPS, the key performance indicator of a company's value, to be understated and unreflective of a company's true performance.

Under the current rules, a company is already required to provide a disclosure of what the theoretical cost estimate may have been under current valuation methods prescribed in the rules. It should be noted that the majority of publicly held companies opt to make only the disclosure. This pro-forma disclosure is required in the notes to the financial statements, currently allowing the reader the ability, if so desired, to view this theoretical estimate. In my experience, I rarely question or field questions regarding this disclosure. It is a non-tangible event that investors prefer to be left in the footnotes to avoid "muddying the waters."

Since the current rules already demand a charge, and the information regarding the theoretical pro-forma compensation charge is already calculated and disclosed in the notes to the financial statements, the reader is currently supplied with adequate information under the existing requirements and it would be illogical and misleading to incorporate this pro-forma estimate into actual earnings.

Furthermore, if this recommendation is not considered or rejected, at a minimum, it would be unconscionable to duplicate the charge. I would like to impress that one charge to earnings is enough and the requirements to dilute outstanding shares for outstanding grants be retracted if this moves forward.

The Nature of the Option Exercise Eligibility Event is Dependent on Meeting Specific and Defined Criteria. A Liability Should be Considered only if Those Criteria will be Met and the Impact is Reasonably Estimable - Otherwise it is Merely Speculation

This proposal, in its recommendation to classify stock option grants as an event which gives rise to compensation costs, treats the event similar to a traditional employee/employer compensation arrangement versus its true nature, an incentive proposal. I would define a traditional compensation arrangement as one that provides the employee with consideration (in the form of wages) in exchange for their direct service. When this direct service is complete, consideration is exchanged immediately thereafter. The FASB proposal implies that an obligation exists by the mere granting of an incentive – this is false. There is no obligation on behalf of the company until the optionee meets specific criteria (whether it be tenure or defined performance goals) and accordingly no liability or cost should be associated. A transaction should not be reported until the event has taken place or there is reasonable certainty that an event will take place; and there is a means by which the event can be reasonably measured. Considering in your draft that you recommend to record an event that has not taken place and you have not put forth an accurate or consistent method to measure the event, you stray from this foundational groundwork.

It is Impossible to Predict the Future

Typically options will vest over a multi-year duration. Many plans that I have examined (for example) use a five-year incentive vesting period. Absent a market, I am not aware of any economist who has the ability to reasonably predict the value of this financial instrument. Since the nature of the instrument is so varied and potentially volatile, impacted by the countless potential market, economic and global events that influence the instrument, this task is impossible. Yet, the FASB believes it has somehow mastered this science. This proposal would require a company to incur a cost – even when the market value of its stock is below (or even materially below) the option purchase price.

I find it ironic that in the FASB's own words it poses when "it is not possible to measure the fair value of an equity instrument" – to require that the instrument would still need to be valued using an intrinsic value method.

The Proposed Transition, in Substance, is Retroactive and will Create Unfair and Unnecessary Artificial Charges at the time of its Potential Adoption

The proposed transition, contrary to FASB's statements, is calculated retroactively since it requires charges to companies for options already issued (prior to the exposure draft) that may not be vested. These charges will likely be material on average for companies being forced to adopt. This will distort a company's results and mislead the readers of financial statements, not to mention distort true operating results and potentially de-value a company's true net worth.

In closing:

I urge the FASB to retract this draft and I could not agree more with Nasdaq CEO Bob Griefield's view that "broad-based stock options plans foster innovation, a principle on which companies across all business sectors have been founded. Options have proven to be a valuable tool to increase jobs and grow the U.S. economy. For example, options enable small companies to attract talent and grow, and help companies of all sizes to better align the interests of their employees with the interests of their companies. FASB's plan has critical flaws, particularly in valuation models and is more likely to confuse investors than clarify company finances."

For such a controversial recommendation, the nature of which is artificial and may have a profoundly negative impact on a company's performance, I would suggest, if this debate can not be mutually reconciled, you make this concept voluntary and allow each unique company to decide, perhaps through their proxy, what is in the best interest of its shareholders. True, it may not allow for standardization across industries and the economy, but it will be no less standard than what you have recommended in this draft.

Sincerely,

Robert Ross, CPA