

Karen Salmansohn

From: Director - FASB
Sent: Friday, January 31, 2003 1
To: Karen Salmansohn
Subject: FW: Expensing Stock Optio. .

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

From: Bruce Coleman [mailto:brucecoleman@percipient.net]
Sent: Friday, January 31, 2003 11:45 AM
To: Director - FASB
Subject: Expensing Stock Options

The following is a quote from a friend, Gary Sutton who wrote an article on the subject that stated the issue elegantly.

Expensing stock options is DUMB!

ARTICLE

Nobody predicted 9/11. If someone, somewhere forecast the stock market crash they were pretty quiet. In December you couldn't even get odds in Las Vegas for the next Super Bowl featuring two teams with pirates painted on their helmets, it was such a long shot.

Future results aren't predictable. That's why expensing stock options is dumb. It's also deceptive accounting.

But the SEC and Warren Buffett favor expensing options.

Remember our SEC is that same gaggle of geniuses who pushed companies to forecast earnings and display stock price history in annual reports. Nobody can forecast earnings. So when forced to predict, they start getting creative to make their results match the forecasts. Nobody likes to look dumb. So we got bad accounting. Putting stock price history in annual reports detracts from fundamentals, like net earnings and cash flow. Once again, SEC guidance fell two tacos short of a combination platter.

Buffett invests in mature companies where option expense is immaterial. If expensing options destroyed technology stocks, that investment money's got to flee somewhere. Do you suppose any of that cash might go into Berkshire Hathaway, inflating wily Warren's value?

All kinds of junk got reported in the nineties when everybody was a genius. EBIDTA replaced earnings, so interest expenses and debt were hidden. EBIDTA is the worst possible yardstick. Interest is a fixed cost; so hiding it buries reality under a mirage of fog.

Non-recurring expenses were discounted. The only problem is that nonrecurring expenses show one pesky trait. They recur. My favorite came when Waste Management

excluded a multi-million dollar expense as non-recurring. What was it? Painting their fleet of garbage trucks. Did they spray with enamel that lasts forever?

Pro-forma earnings is another gimmick Wall Street clings to, simply because the analysts have their software setup for this bogus calculation. Like a pricey hooker, it's done any way you want, so general criticism is tough beyond pointing out one isn't love and the other isn't earnings.

EBIDTA, non-recurring charges and pro-forma earnings have nothing to do with results. They shouldn't be used, but nobody's going to stop until investors stop falling for them.

Off balance sheet debt should be put back on. That wipes out General Motors and Ford. They've got pension obligations that would take more than every penny of their cash if they were forced to fund these binding obligations. They're broke, but unlike startups, these companies have lobbies and unions that help perpetuate this fraud.

Force companies to produce honest balance sheets. Eliminate EBIDTA, non-recurring items and pro-forma numbers. Jail anybody who capitalizes operating expenses or books phony revenues. That's what's needed. Anything else is distraction.

Stock options do not cost any company any cash. Period. They actually bring in a trickle when employees exercise. Most options are taxed as income, immediately upon exercise. Options do cost shareholders by diluting their shares. But if the company reports earnings per share on a diluted basis, this is factored in. And earnings per share are the single, most important performance measure. In fact, since 100% of the outstanding options are never exercised, diluted earnings per share is conservative reporting, already overstating the cost.

Since the purpose of accounting is to accurately reflect the health of a business, expensing options destroys accuracy by double costing. And take a peek at the method used. You hire an investment bank and pay a fat fee to have them estimate the future value of these options.

Investment bankers sometimes do better than dart-throwers when predicting stock prices six months out. Often they don't. This exercise asks that they predict the value for a stock option that may not vest for forty-eight or sixty months. Their fees will not be modest for this exotic service. Shareholders pay the bill since that fee comes out of company cash. The valuation is highly subjective from folks who've proven an inability to predict. That's progress?

Stock options should vest over four to five years, giving employees and management a longer view than their average shareholder. They should be priced at market, putting the grantees shoulder-to-shoulder with their investors. Insiders should only sell shares as preplanned, always keeping a majority while employed by the firm. It's best when employees earn as much or more on performance bonuses than they do from options, incenting them more towards narrower goals; ones they can achieve individually. This also

avoids the distraction of daily swings in the market, which reflect the outside world more than the business. Stock options should never be repriced. If the stock drops and some executives leave, great, maybe their replacements know how to boost the value.

We headed for this chaos the day the cable stations started running ticker prices across the bottom of TV screens and everybody became a day trader. The market never dropped, it only experienced a "correction" and nobody ever sold shares, investors merely "took profits." The Wall Street Journal ran an article from top to bottom of a page about VeriSign's stock price without once mentioning earnings or revenues. Peregrine sued Arthur Andersen which is like Charles Manson blaming the LAPD for allowing his crimes.

Through this confusion, remember that fifty years ago some guys at Bell Labs invented the transistor. Thirty years later a fellow at 3M invented Post-It Notes. Sometimes big companies get lucky. But try to name another invention from a big company.

Bell Labs never conceived the answering machine, for god's sake. And a Post-It Note isn't such a huge leap from Scotch tape, sorry.

Breakthroughs come from small outfits with stock options. Hobbling this could kill American innovation.

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