CORPORATE GOVERNANCE ADVISOR LLC

Thank you for the opportunity to comment on the proper accounting treatment for employee stock options. I believe that at the time of grant the expected cost of the employee stock options to the company as determined by an appropriate stock option valuation model should be recognized as an expense to the company and reflected in its income statement. The company also should establish an outstanding stock option account for annual re-evaluation. At the end of each fiscal year of the company, the value of all outstanding stock options in the outstanding stock option account should be re-determined through the stock option valuation model based on the then existing inputs to the model in terms of market price of the company's stock, time left prior to expiration of the option, risk free interest rate and volatility. Any net increase or decrease in the value of all outstanding stock options from this annual "marking to the market" should then be recognized in the company's year end financial statements.

DISCUSSION

First, let us determine the true cost of an employee stock option. I believe the true cost comes down to the lost opportunity cost to the company of selling equity at the time of the exercise of the option to an employee at a price below the prevailing market price which a third party would pay. Such an equity transaction by its nature results in dilution to all existing shareholders. A simple example will suffice. Assume Fair Company issued options with a term of five years to purchase 1,000 shares of common stock at a price of $30 per share to its President. The stock of the company, which operates fairs and circuses throughout the United States, sold at a price of $30 on the date of grant. Fast forwarding to year 5, the play "State Fair" has successfully been revived in theatres in all 50 states, thereby inspiring people throughout the country to visit fairs. Business is booming and the stock price is now $50. When the President exercises his options to purchase 1,000 shares at the option price of $30, the cost to the company is $20,000. This is because the company could have sold 1,000 shares in the market at a price of $50 and received $50,000. Instead, those 1,000 shares were sold to its President upon the exercise of his options at $30 per share for aggregate proceeds of only $30,000.

There was definitely a cost to the company and its shareholders at year 5 to the tune of $20,000. Even the most ardent advocate of not expensing options would have to concede that the company and its shareholders were shorted $20,000 at the time of exercise. But what about at the time the options were granted? That question is much more difficult. Reasonable minds can and have differed—and some have even changed their minds over time.

With that question a close one at best, given experiences of option tinged executive compensation scandals, I come down in favor of expensing, but with the caveat of annual updating of option valuations. At the time of option grant in our example, I would argue that there was a potential but admittedly uncertain cost that the company anticipated might come, and that the President certainly hoped would occur. Just because it is difficult to value what the exact cost of the options ultimately will be should not be a reason to omit an estimate of expense from the financial statements of the company at the time of grant. A company makes many good faith estimates that are reflected in its financial statements for expenses it expects to incur in the future. The company should make its best estimate through the use of a stock option valuation model and recognize the expense at the time of grant. But, realizing the uncertainty of such valuation, the company should update that expense as recognized on its books each year as time marches to the exercise or maturity date of the option when its true value will be known.

The difficulty of valuation—among other things--purportedly led in the mid 1990s to the relegation of information on the valuation of most options to just footnote disclosure. That approach is part of a regimen that was found to be terribly wanting. As we now know, in too many instances, company executives took advantage of the situation by demanding and/or accepting too many options. With just footnote disclosure, the true cost of option grants to the company fell below the radar screen.

Hopefully, in this post scandal, post Sarbanes-Oxley, post improved stock exchange rules world, compensation committees and boards will not be lulled into making more outlandish mega grants of stock options. Just in case some continue to sleep, knowing they will need to expense stock options in the company's financial statements—besides providing a more accurate financial picture—will serve as a reminder not to go overboard on option grants.

It is well known that the venerable Black Scholes pricing model was designed for exchange traded options. I understand that variants on Black Scholes are being designed for more accurate valuations of employee stock options. Improvements to Black Scholes for these purposes would be welcome, and it would be useful for the IASB and FASB to evaluate and standardize to the extent possible an employee stock option valuation model that all companies could use. However, given the uncertainties of the market it is of course impossible for any model to unerringly predict what the market price of a company's stock will be even one day in the future let alone 1, 5 or 10 years! Consequently, I propose that companies be required annually to reapply all the variables of the model (i.e., underlying share market price, time to maturity, volatility etc) to all outstanding stock options so the outstanding stock option account can be appropriately credited or debited for the year to reflect the most recent facts.

The mark to market of option values may also serve an additional useful purpose. Assume that the stock option valuation model returned a value of $10,000 for the options on the date of grant and that amount is duly reflected as an expense of the company. Let's suppose that "irrational exuberance" returns to the market and the underlying market price of the stock zooms from $30 at the date of grant to $60 at the end of the first fiscal year after the grant. As a result of the annual update, the original value of the options would be increased because of the increase in market price of the underlying stock. For the sake of argument, assume that instead of the original estimate of $10,000, the options are now valued at $35,000. The additional $25,000 of option value would hit the income statement as an added expense, which would cut into earnings and thereby perhaps lessen some of the aforementioned exuberance going forward.

Conversely, if the stock market price of the company's stock drops at a year end valuation, the effect would be to "undo" the expense, and generate income. Many believe that overly exuberant markets on the way up, also lead to irrationally pessimistic markets on the way down. A possible side effect of the proposed accounting treatment would be to "soften" the ride down as income is generated. Of course, the amount of income so generated could never exceed the amount of expense previously recognized in the income statement.

Finally, I believe it important that the accounting treatment for "performance based" stock options and "fixed cost" stock options be the same. From a corporate governance point of view, I believe that "performance based" options that require certain results for an option to vest such as stock market performance or the realization of certain corporate goals are superior to simple "fixed cost" options that are sometimes likened to "pay for pulse". The playing field should be leveled, and companies opting for "performance based" stock options should not be penalized by accounting treatment viewed as more onerous than that applied to "fixed cost" options

Thank you for your kind consideration. I look forward to the results of your deliberations.

Very truly yours,

Gary K. Duberstein
President, Corporate Governance
Advisor LLC