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Mr. Ron Salole
Director, Accounting Standards
Accounting Standards Board
277 Wellington Street West
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25 March, 2003

Dear Mr. Salole,

Exposure Draft – Stock based compensation

The following are my own comments on the above noted exposure draft. Regarding the two questions specifically listed by you:

1. I agree with the amendment to section 3870, insofar as the amendment eliminates the option to expense stock based compensation.

2. I prefer neither the IASB nor the Canadian (or US) proposed methodologies for expensing options. The following explains that view.

Neither method truly and fairly reflects the cost of stock based compensation.

Quite unfairly, either proposed method penalizes companies that provide incentives through cash payments such as Stock Appreciation Rights ("SARs") when compared to companies that issue stock options. Equally unfairly, the proposed methods allow and therefore encourage companies to avoid recognizing the true cost of incentives by choosing to deliver incentives to employees as stock options rather than in cash. A company utilizing SARs recognizes the full, true cost of incentives, whereas a company utilizing stock options does not.

This incongruity arises because cash based incentives, including SARs, are expensed at the amount paid, and until paid are accrued at the market value of the liability. Whereas, under the methods proposed, the cost of stock based incentives does not reflect the value of the share at the time of payment. The market value of SARs is prescribed in paragraph 38 of section 3870 as the quoted current market value of the share. I propose that paragraph 38 appropriately requires a true and fair measurement of the cost of incentives.

I urge the CICA and the IASB to apply the same measurement parameters to stock based compensation as currently applies to SARs.

The cost to the company of an incentive is the same whether an employee is provided with a stock certificate or a check. In the former case, the cost to the company is the opportunity cost of not selling the share on the open market. In the latter case, the cost is the cash paid out, which is identical to the amount had the company bought the share on the open market.

I attach a document that more fully describes this method of accounting for stock options. The document was written last fall at the time of the debate over whether or not stock options should be expensed. Please refer in particular to paragraphs 3 and 4.

Yours truly,

Murray G. Johnston

Vice-President and Chief Financial Officer

cc: IASB, London, England

<u>Options? Stocks of problems.</u>

This article suggests that standing against the expensing of options is an ethical issue. Existing methods for calculating the expense are too complex. A simple method is proposed that recognizes all components of the expense, including market forces. If that is abhorrent to issuers, alternative incentive compensation plans are suggested.

1. A problem of ethics

One does not need to be a financial expert to become incensed by the positions taken on stock options by certain companies, individuals and institutions. Reconciling their stance with events in today's financial world becomes harder and harder. While these organizations publicly stand against expensing stock options, some will simultaneously promote ethical conduct.

There is no doubt that salaries and cash bonuses are compensation, or that they are an expense. The burning question is whether or not stock options are compensation. The renowned Warren Buffet often asserts that of course options represent compensation. In a recent television interview, the Chairman of Unilever added his opinion, "I have yet to hear an intelligent argument suggesting that stock options do not represent an expense".

Despite the belief held by many eminent individuals that options are clearly an expense, one institution, the FEI in the US and Canada, "the preeminent professional association for senior financial executives", remains strongly against expensing options. In the current environment of public distrust of the finance profession, this position is inconsistent with one of the FEI's premier Ethics, "*honesty and integrity*". Financial executives at Worldcom, amongst others, under-recorded certain expenses to the enormous cost of the integrity of the entire finance profession. To ignore an expense is arguably no better than reducing expenses by recording them as capital expenditure.

If, then, options are to be expensed, the skeptics counter: But there is no reliable way to measure the expense! Pleading that options cannot be measured is akin to a doctor refusing to amputate a gangrenous leg because he cannot measure the circumference of the leg. Certain organizations assure the public that all financial matters can be accurately measured, accounted for and even audited, but then claim an exception--we cannot measure stock options! This position detracts from the credibility of the organizations and flies in the face of ethics, for example, the FEI: *"Act in good faith, responsibly, with due care, competence and diligence…"*.

Under present recommendations, companies appear able to choose whether to expense options or not. Beneficiaries of stock options may have vested interests in not expensing options. Truly recognizing all components of the expense of options might drive down stock prices, which would reduce the wealth of those individuals. The choice appears ethically challenging. One of the FEI's Ethics includes the words: *"[avoid] actual or apparent conflicts of interest"*.

Many institutions value their integrity. It behooves an organization such as the FEI to look at itself as an outsider would, and correct a misguided position. Support the expensing of options as well as the search for a measure of the expense that accords with well-considered Ethics.

2. A problem of complexity

Certain companies have chosen to expense options and some use the Black-Scholes model to calculate the cost. Black-Scholes is based on a complex mathematical formula. The method is not easily understood, and may not reflect all elements of the cost. Indeed, the complexity itself is sometimes put forward as the reason options should not be expensed. Such reasoning merely avoids the issue: There is more to the cost of stock options than solely the payment of incentives to employees.

3. A simple alternative

An alternative accounting practice is proposed hereunder for stock options that would, as required by the FEI's Code of Ethics, "*Provide constituents with information that is accurate, complete, objective, relevant, timely and understandable*".

The grant of a stock option represents an opportunity cost. A company that transfers a share to an employee for a price that is less than the market price forfeits the opportunity to receive full value for the share. The full value can easily be measured according to the publicly quoted stock-market price. The cost of the option is the increase in value of the share, if any, from the strike price (when the option was originally granted) to the current market price of the share. This calculation is very simple, quite objective, and easily understood.

The cost of the option will be carried in the Balance Sheet as a liability until the option is granted under the terms of the option program. The cost fluctuates during that time according to the current market price of the share, and the changes will be recorded within expenses. When exercised by the employee, the option is already accrued at market value, and no further change in expense is required. At the same time, the outstanding share count increases by one, the liability is transferred to equity, and cash is received for the strike price and credited to equity.

This method also deals with another bane of the ordinary shareholder's life: re-pricing. If an option is struck at a certain price and then later re-priced, the opportunity cost and therefore expense of the re-pricing is easily ascertained and recorded. This is the difference between the value the company could have received for the share, represented by the original strike price, and the re-priced value. The new price will be used to calculate subsequent fluctuations in option costs as already described.

The practice of recording assets and liabilities at current values is embedded in many accounting principles and is reinforced time and time again in new policies. Why not for options?

Ironically, use of the method proposed may tend to moderate the escalation of a company's stock price in a bull market, and provide mild support to the price in a bear market. As market forces drive a stock price upwards, higher option costs would be recorded in the income statement, which reduces net income. Conversely, as stock prices fall, costs are reduced due to the option program and net income increases.

4. A problem of cost recognition

Clearly, the cost of options will fluctuate significantly over time when calculated according to the share price, and the income statement will bear the ensuing wins and losses. The counter-proponents of expensing stock options may point to this income statement phenomenon to justify their position. Like it or not, the phenomenon is the full, real identification of the cost of stock options. To understand the full cost of options, the expense must be recognized under two headings: management performance, and market forces.

Options are intended to reward management for successful performance as measured by, for example, EBIT, cash flow or return on capital. Certainly, these measures of management performance do affect stock prices. However, stock prices are also affected by other factors such as the performance of the economy, competitive activity, and consumer or business confidence. Let's lump these stock price drivers into the second category, described as market forces.

Option programs provide employees with opportunities not available to other individuals. The employee can freely decide to take advantage of market forces that lift the stock price, even though corporate performance may have been abysmal. When an employee chooses to exercise an option in these circumstances, the company and therefore the shareholders bear the cost of the employee's participation in the favorable market forces.

When a company grants stock options to employees as compensation, the company inherently and simultaneously issues options to participate in market forces. Both elements of the company's action should be expensed, thereby forcing an honest report to shareholders of the full cost of options. If a company abhors the exposure to the risk that market forces may move against the company (albeit in favor of the employee), then the obvious resolution of the dilemma is to stop issuing options as incentives.

5. Alternative incentive programs

An alternative incentive program must fittingly reward employees for superior performance. This proposal requires a company to: (a) specify the element of personal performance and the success criteria, and then, (b) write a check to the employee if he/she performs accordingly. The employee is rewarded for personal performance, not stock market performance.

The advantages of paying cash incentives are obvious: There is no disagreement that the payments are compensation and, therefore, an expense. The measure of the expense is the market price, which is clearly equal to the amount paid. The payment is tax deductible to the company, and taxable income to the employee. Finally, the exposure of the company and its shareholders to the cost of the incentive is finite.

6. The opportunity

There is opportunity for an authoritative institution to take a leadership position that is ethical and worthy of respect: Measure and expense all incentive programs at market prices. With equal accounting treatment assured, choose an incentive program with the appropriate risk profile.

The FEI's Code of Ethics includes a commendable recommendation for financial executives: "*Proactively promote ethical behavior as a responsible partner among peers, in the work environment and the community.*"

Murray G. Johnston
Member of the FEI
CFO, Winpak Ltd.
Winpak is listed on the TSX.
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