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**Responses To  
Notice for Recipients Of the Exposure Draft**

**FASB Statement No. 123  
Accounting for Stock-Based Compensation**

**Submitted By:  
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**June 21, 2004**

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**Introduction:**

The Delves Group is a Chicago-based executive compensation and corporate-governance consulting firm. The viewpoints in this response reflect our role as experts in these areas as well as our desire to improve integrity and performance in corporate America. We believe that an accurate, significant and meaningful expense for stock options is absolutely critical to the pursuit of better governance and more rational, logical and effective executive compensation.

**Recognition of Compensation Cost**

Issue 1 (Response): We agree that stock options are compensation and are used primarily to remunerate employees, particularly executives, for their services and for their performance. As equity instruments these stock options unquestionably have a cost that should be recognized. The FASB has proposed that this expense be determined as of the date the options are granted, and recognized over the period that options become exercisable or “vest.” This treatment follows traditional methods of recording compensation expense, and the treatment of compensation as payment for services delivered over time. This is rational, logical and simple.

While we support this methodology, we would like the FASB to consider two alternative concepts:

1. Executive services are not provided in a continuous, unbroken “straight line” stream. Rather, they are provided in discreet and sometimes sudden increments, based on opportunities and incidents, which are reflected in the up and down movement of the company’s performance or stock price.
2. Stock options may not be compensation at all, but rather represent an investment of human effort, innovation, and creativity, which have substantial capital value that is not recognized by our current accounting system. While we believe that this is a radical departure from the current accounting paradigm, we believe that it reflects the reality of what is

happening in today's modern, human capital-based organizations, and must, at some point, be seriously considered and developed into a viable methodology.

Issue 2 (Response): Yes, we agree absolutely with the FASB's conclusion on this issue. From a governance and executive compensation standpoint, we can say with definitive certainty, based on a multitude of examples, that the mere threat of moving the footnote-disclosed expense onto the income statement has caused and is causing boards of directors and management at hundreds of publicly traded companies to reassess their executive and employee compensation programs. For the first time, the cost of options is being seriously discussed in boardrooms and weighed against their potential benefits and compared with other alternative methods of providing compensation and incentives.

### **Measurement Attribute and Measurement Date**

Issue 3 (Response): We endorse a substantial and meaningful expense for options, and believe that such an expense is essential for good governance and effective and fair executive compensation. That said, we see several pros and cons to grant date/fair value.

#### *Pros:*

- The expense *is* significant and meaningful. Our analysis shows that over time and across companies, this fixed, upfront expense is likely to be approximately 50% of the ultimate, long-term wealth transfer from shareholders to employees via stock options.
- The expense is predictable and manageable. It does not fluctuate with the rise and fall of a company's stock price. This makes the cost of options relatively easy for boards and management to assess, understand and weigh against other forms of equity-based incentives.
- From an executive compensation design standpoint, a fixed, upfront expense and consistent treatment for all types of equity-based incentives opens the door to far greater variation and customization of options, restricted stock, and other equity incentive vehicles. For decades, we have been stymied in our efforts to develop truly customized and performance-based equity incentives by the narrow definition of APB25. Options granted at the current market price that vest purely based on time on the job have been used in almost every publicly traded company, and have been granted in vast quantities to the exclusion of all other forms of compensation. Because of this one-size-fits-all approach, equity incentives for executives and management have been far less effective than they could have been. With a fixed, upfront expense companies are already considering a number of performance-based variations that tailor pay more closely with performance.

#### *Cons:*

- From a governance standpoint, the job of the board of directors is to marshal the resources of shareholders. The true economic cost of options to shareholders is the spread between the exercise price and the market price when the option is exercised. This fact is well accepted and is the basis of the

tax treatment for options. That economic cost to shareholders is more complex and variable in its amount and timing than is reflected by fixed, grant date accounting. We believe that either the intrinsic value method or the liability method do a better job of reflecting the true cost of options to shareholders in both amount and timing.

### **Fair Value Measurement**

Issue 4(a) (Response): Based on our research on option pricing models and valuation methods, we are convinced that the technology exists to accurately estimate the value of virtually any form of employee stock option as of the date it is granted. Option pricing-models and measurement methods have evolved into a highly developed area of mathematics, which is capable of valuing far more complex derivative securities and transactions than employee stock options. That said, the methods for valuing and recording the cost of employee stock options will need to develop and evolve over time as the business community gains experience with these transactions. We believe that the actuarial profession is best suited to implement valuation methodology and to help develop standards for how valuations should be done. We do not believe that the FASB needs to provide any more specific guidance on valuation methodology than it has at this point. However, it should leave the door open for more precise valuations and standardized procedures in the future.

Issue 4(b) (Response): Based on our research, we believe that lattice models provide greater flexibility and ease of implementation than does the Black-Scholes-Merton model. We initially discussed this with Myron Scholes in Spring 2002, and again at the IASB-Delves Group conference (“Expensing Stock Options, Not Whether but How) in July 2002. While the boundary conditions of the Black-Scholes-Merton methodology can be adapted to adequately reflect the characteristics of employee stock options, it is easier and more straightforward to accomplish this with the lattice model techniques. The lattice models can also be more easily adapted to value new and evolving types of options and equity incentives. Again, we believe that the actuarial profession is best suited to implement these models and should work closely with the FASB to develop standard practices over the next several years.

Issue 4(c): We have no opinion on this issue

Issue 4(d) (Response): One of the critical variables in assessing the value of employee options is the expected term. This is an estimate that must be determined based on employee demographics and actual experience over time. We have noticed a tendency in FAS123 disclosures for companies to significantly underestimate their option terms. For example, some companies use option terms of three or four years, while for most companies five to eight years is the norm. Actual experience will vary depending upon factors such as the distribution of options among different levels of employees, the age of employees, the past and expected financial performance of the company, and the performance of the underlying stock. We reiterate here that these determinations are best made by the actuarial profession.

Issue 5 (Response): We agree that the intrinsic value method is an alternative in cases where the fair value cannot be estimated. However, periodic re-measurement can cause sudden and unexpected spikes in the expense. While we believe that these spikes

are an accurate reflection of the underlying economic cost, we suggest that the FASB consider some method of allowing companies to smooth period-to-period changes in the expense.

### **Employee Stock Purchase Plans**

Issue 6 (Response): We believe that the FASB's proposed treatment of employee stock purchase plans (ESPPs) presents a major problem. Calculating the cost of an ESPP upfront using the grant date/fair value methodology will cause many companies to discontinue their plans. This will be an unfortunate result. The intrinsic value method provides a much more accurate reflection of the amount and the timing of the expense to the company for these plans, and would allow the plans to remain attractive to companies.

### **Attribution of Compensation Cost**

Issues 7-9 (Response): The FASB's proposed allocation of expense over the service period is logical, rational and follows well-established accounting principles and practices. Dividing an award with a graded vesting schedule into several separate awards merely follows the procedure that has been used for amortizing the cost of restricted stock. Applying this treatment to options is nothing new

### **Modifications and Settlements**

Issue 10: We have no opinion on this issue.

### **Income Taxes**

Issue 11: We have no opinion on this issue.

### **Disclosures**

Issue 12: We have no opinion on this issue.

### **Transition**

Issue 13: We have no opinion on this issue.

### **Nonpublic Entities / Small Business Issuer**

Issues 14(a), 14(b) and 15 (Response): We believe that the intrinsic value method is more accurate than the grant date/fair value method. For this reason, we think that any firm that would like to adapt the intrinsic value method (with re-measurement to the settlement date) should be allowed to do so. Certainly, private companies should be allowed to use the intrinsic method. However, we do not believe that private companies need to be allowed any additional time to implement whatever method they choose. The grant date/fair value method does pose significant potential problems for small companies, startups, venture companies, new IPO companies, etc. Recognizing a significant upfront expense for something with an unknown economic cost can be detrimental to these companies. Stock options and equity compensation are very viable means for these companies to attract high quality talent while preserving scarce cash. Also, because of the high-risk nature of these companies, the grant date value of options is extremely difficult to estimate. However, the intrinsic value at the settlement date is simple and obvious. We do believe that these companies should have a significant and

meaningful *potential* expense if their options are ultimately in-the-money and are ultimately exercised. However, requiring that expense upfront is unnecessarily burdensome.

### **Cash Flows**

Issue 16: We have no opinion on this issue.

### **Differences between This Proposed Statement and IFRS 2**

Issue 17: We have no opinion on this issue.

### **Understandability of This Proposed Statement**

Issue 18: We have no opinion on this issue.

### **Addendum**

We have extensively studied a variety of different models and ideas for valuing and expensing stock options. While it has not been officially proposed by the FASB, we have been impressed by the liability method, particularly as described by Miller and Bahnson. The liability method offers the most thorough, complete and accurate reflection of the economic cost of options to the company and its shareholders over time. Implementation of this method would result in significantly better information to boards and management than the fair value method, and would result in more effective and informed decisions about the use of equity incentives by boards and management.

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Donald P. Delves, principal of The Delves Group, is an expert in helping companies to get what they pay for from their executives and employees by designing effective pay and incentive systems. He strives to create a high level of alignment, information flow and accountability between the Board, the CEO, management, and all critical points in the organization. He is also the author of **Stock Options and the New Rules of Corporate Accountability: Measuring, Managing and Rewarding Executive Performance**, published in October 2003 by McGraw-Hill. He has written numerous articles on corporate governance and executive compensation.

Mr. Delves has over 20 years of consulting experience. Prior to founding The Delves Group, Mr. Delves started and managed the Chicago office of iQuantic. Prior to that, he was a Senior Consultant at Sibson and Company and an executive compensation consultant with Towers Perrin. He has also served as a manager in personal financial planning and taxation with Arthur Andersen & Co., and as a financial consultant to middle market companies for Harris Bank.

A recognized expert on performance measurement and value creation, he writes and speaks regularly on these subjects. Mr. Delves holds an M.B.A. degree in finance from the University of Chicago, a B.A. summa cum laude, in economics from DePauw University, and is a Certified Public Accountant. He is also highly trained in organizational behavior and leadership development at the Wright Institute for Lifelong Learning of Chicago.