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Dec. 11, 2002

International Accounting Standards Board
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Share—Based Payment

Above all, the Board is to be commended for requiring stock options to be charged to earnings.

Problems in Option Models

However, I suggest that the method chosen and the period over which the expense is charged are wrong. I think marking the value of the option to market every period up to exercise and charging the gains and losses to expense is superior.

Use of Black—Scholes or other option pricing models brings up problems. It produces a figure which is unchanged over the option life. As a result the value ultimately received by the option holder and the cost incurred by the employer may be completely unrelated to the accounting answer. We now see options expiring worthless with a substantial annual charge to earnings. Conversely, in a rising market we have options with the holder receiving pay, cash equivalent, far in excess of the recorded compensation. This makes little sense; it is an accounting result determined by its own rules, not by observation. Annual reports and proxies say, again and again, “... the ultimate value of stock options granted will be determined by the actual lives of options granted and the actual future price levels of the company’s common stock”. For once the corporations are right.

Compensation is what one ultimately receives from the company. No option holder thinks of his or her options as worth so many dollars under Black—Scholes. The value is measured by the difference between market price and strike price. I do not deny the existence of time value but market value is a readily determined, objective figure.

Moreover, that spread, the difference between market price of the stock and strike price, is what it costs the company. By selling stock at the strike price, say 10 when the market is 30, it has chosen to give up 20. How nice to have a convergence between what the employee gets and the corporation expenses.

Maribeth Coller and Julia L. Higgs, Financial Analysts Journal, January/February 1997, Firm Valuation and Accounting for Employee Stock Options, showed that significant differences in valuation may result when different yet equally acceptable calculation methods are used. They calculated volatility and dividend yield under different acceptable assumptions with material differences in the result.

Jane B. Adams, senior analyst, Maverick Capital, in a speech at the Midwest Financial Reporting Conference, Sept. 27, 2002, referred to biases observed in measurements in Fortune 500 companies using significantly shorter expected lives and lower volatilities.

The Board should use a method for valuing options, market price, that is objective and readily determinable. The last thing needed is judgment of the accountant. We have enough illustrations of the result of that in the daily papers.

Results that are not in accordance with common sense have no place.

Expensing Periodically Based on Market Price to Exercise

Expensing over the vesting period also is objectionable. It is an incomplete time period. The option holder still has to put up cash to exercise the option. Only then will his holding be the same as that of the stockholders. The value of a vested option may be increasingly dependent on the value of the underlying stock and that should be taken into account in measurement.

Moreover, work is not the only exchange for an option. Those who retire with unvested options may still be able to exercise their options in retirement. On the other hand, payment is required in every case to exercise an option. Only then is the option holder like other stockholders; only then does the vested option become a share like the other shares outstanding. How often does a vested option carry a vote? How often does a vested option carry a right to dividends?

Intrinsic value is rejected because it does not fully reflect an option’s value. So too should vesting date be rejected; it doesn’t reflect the full value. If we had perfect foresight we could know the value of an option on exercise date. Failing that we may creep up on it by marking to market every period till exercise.

If the deferred tax on exercise or expiration of the option is finally settled at such time then the market value of compensation can also be settled then.

Indeed, there are fewer problems with marking to market to exercise than with the Board's draft.

Conceptual Framework

Again and again the Board states that options do not meet the definition of a liability under the Conceptual Framework or that exercise date requires options to be liabilities, something inconsistent with the Framework. That is no answer. In the case of stock options the Framework is wrong. To those in the market it makes no sense. There is no reason to be tied to a Framework that is inconsistent with what is obvious, what is observed. Nor is there any reason to wait for years for the Conceptual Framework to be changed.

A vested option simply is not the same as the stock that an investor has bought and paid for. Further accounting is needed. If the Board did not state, "...forbidden by the Framework" what argument is there to deny the obvious? None. Resort to authority, the Conceptual Framework, in the face of observation perpetuates error. The essence of an employee option is to float something forth that may be of considerable value ultimately while being sold at a bargain price. The Board has failed to capture that. The valuation objective should be the measurement of extra compensation received from exercising an option.

Marking to market every period to exercise date makes financial statements more reliable and relevant for users in the long run and presents fewer problems than the Board's draft.

Sincerely,

cc: FASB