Credit Acceptance's Practice Regarding Stock Options

In 1999, the Company began granting performance-based stock options to employees. Performance-based options are options that vest solely based on the achievement of performance targets, in the Company's case targets based on either earnings per share or economic profit. GAAP requires companies to expense performance-based options when it is likely that performance targets will be met and a measurement date can be established. The amount of the reported expense is the price of the Company's stock at the end of each reporting period less the exercise price of the options. The Company's non-performance options are not required to be expensed under GAAP.

Regardless of the accounting, options represent a significant cost to shareholders. The true cost is the business value transferred to the employee in stock, less the exercise proceeds, a number that is difficult to calculate since it depends on when options are exercised and the future performance of the business. GAAP provides several alternatives for accounting for this cost. In the Company's opinion, none of these alternatives provide a method that accurately captures the true cost of options in all circumstances.

Because the Company believes that accurately understanding and managing the cost of options is essential, over the last three years, the Company has developed the following practices regarding stock options:

- Options are issued only after shares have first been repurchased in the open market. In all cases, the option is priced at or above the average price of the repurchased shares. For shareholders, the impact of options therefore is the capital used to repurchase shares is no longer available to invest in income producing assets. This cost, the opportunity cost of the capital used to repurchase shares until the capital is returned upon option exercise, reduces the Company's reported earnings.
- Option grants are predominantly performance-based, with appropriately aggressive vesting targets. The Company believes that these options properly align the interests of management and shareholders by rewarding management only for exceptional business performance.
- Our reported economic profit (loss)includes three adjustments to the Company's results reported under GAAP to reflect the cost of options. First, to avoid double counting, the GAAP expense recorded for performance options is added back. Second, all options outstanding are included in the Company's fully diluted share base. Finally, economic profit (loss) includes a charge for the capital used to repurchase shares covering options grants. The Company's method of measuring options in the calculation of economic profit (loss) is conservative in two respects. First, the tax benefits of options have not been included in the Company's calculation. Because option expense is deducted for tax purposes upon exercise, more capital will be returned to the Company upon exercise than is invested in repurchased shares. Second, options may be cancelled due to turnover or the failure to meet performance targets. Cancellations will be factored in as they occur. One additional risk is assumed. Should options be issued and shares repurchased above intrinsic value, and the options subsequently expire unexercised, a loss equal to the amount paid above intrinsic value would be incurred.

The Company views options as a significant but necessary cost. In the Company's opinion, this cost is now accurately measured and charged to economic profit per share, the number on which the Company's management incentive compensation system is based. The Company believes the ability to measure the cost of options, combined with an incentive compensation system that includes this cost, enhances the probability that the Company's option program will produce favorable results for shareholders.