

David W. Tice & Assoc., Inc.

8140 Walnut Hill Lane, Suite 300 Dallas, Texas 75231-4336

(214) 696-5474

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Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

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David Tice & Assoc. appreciates the opportunity to comment on the Financial Accounting Standards Board's Proposed Statement of Financial Accounting Standards "Share-Based Payment."

As an independent research firm with more than 15 years of experience focused on quality of earnings issues, we believe that we are in a unique position to comment on FASB's efforts to amend SFAS 123. We seek to warn our clients about companies taking advantage of current accounting standards and manipulating their financial statements.

It is not possible to eliminate all judgment from the preparation of financial statements, nor would we suggest FASB undertake such a project. The proposed amendments to FASB Statements No. 123 and 95, however, do not address a situation where current standards appropriately leave judgment to management. Instead, SFAS 123, in its current form, gives managements the option of whether or not to recognize an expense.

We believe that the quality of a company's earnings is of utmost importance. All too often, low quality earnings hide true economic problems with a company's business. In the long run, society is better off when accounting produces a measure of true economic profits in order to achieve a more efficient allocation of capital.

It is no surprise that managements that are narrowly focused on accounting profits are threatened by the Board's proposal as net income will decline as a result of the amendment. However, accounting cannot affect economics; it can merely mask actual economic problems for short periods when economic realities change faster than accounting standards.

In the following pages we explain why we support the inclusion of equity based compensation as an expense on the income statement. The amendment in its current form greatly improves the measure of profitability presented on the income statement. In

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addition, we suggest a few minor changes to the exposure draft in order to further improve the amendment.

Are Stock Options an Expense?

We believe that all compensation expenses should be reflected on the income statement. From our perspective, the question of stock options being an expense is more accurately a question of compensation. Are stock options granted as compensation? Few would disagree with our assertion that options are compensation.

If options are not compensation, then there is no reason for a company to grant thousands of options to employees at the expense of the shareholder. If options are not compensation, then the granting of options to employees is an indication of a board of directors giving away an equity interest in a company without receiving anything in return. If this were the case, we would expect Congress to intervene and outlaw the use of broad based option plans to protect investors.

We believe that all equity based compensation should be expensed on the income statement. The cost of compensating employees is a cost to a company that is no different from raw materials, rent, or interest. A decision not to expense options mandates an explanation of the difference between these expenses independent of the manner in which the expense is paid.

Paragraph C14 appropriately extends the use of equity instruments as a means to pay for expenses other than compensation. Perhaps instead of writing a check for raw materials, a company could issue stock options to the supplier. What is the cost of those raw materials? If a company only issues options instead of writing checks, does it have a 100% profit margin? More importantly, are the options received revenue for the supplier? We do not believe that the form of the payment in any way affects the true status of the expenditure.

The use of stock options in developing companies is perhaps a prime example of why options should be expensed. Cash is unavailable to adequately compensate employees. As a result, these companies pay their employees cash wages below market value for their services. In order to offset the below market cash salary, the companies grant employees stock options which under current standards are not expensed. In other words, the compensation expense on the income statement does not represent the total cost of compensating employees.

We are somewhat baffled by arguments made on economic grounds. We do not believe that expensing stock options in any way affects the economics of a company's business. Many technology companies have suggested that expensing options would affect their competitive position. Frequently, these comment letters argue that disclosure in the footnotes to the financial statements is adequate for users, and inclusion on the income statement creates an expense. Accounting cannot generate economic transactions. If current equity valuations consider disclosures in the footnotes, then the inclusion of an

expense on the income statement will not affect stock values. As a result, the argument that the financial markets are efficient and have already considered stock option plans must be accompanied by indifference between expensing the value and merely disclosing the fair value. A statement that disclosure of the fair value in the footnotes is sufficient for the capital markets is not a reason to exclude equity based compensation from the income statement.

It is our belief that the resistance to expensing stock options on theoretical grounds is artificial. Rather, individuals do not want to include an expense for stock based compensation simply because earnings would decline. Evidently, there is a belief that if a cost to a company is not included on the income statement, then it does not affect economic profitability. If the granting of an option results in an expense, then the inclusion of an expense on the income statement does not reduce earnings. Instead, we offer that income was overstated prior to the inclusion of an options expense.

Many of the recent comment letters have suggested that FASB is attempting to shape corporate governance through accounting standards. We do not believe that the question before the Board has anything to do with corporate governance. The proposed standard does not affect a company's ability to grant options. Original proposals to expense options 10 years ago demonstrate that the issue before the Board is not new, nor is it reactionary.

We also note the dramatic number of comment letters received by employees of some of the largest technology firms in the country. Implied in many of these e-mails is an expectation that employees will lose their options if the Board concludes that options should be expensed. If the employees' predictions are correct, it confirms that these companies' actions are dictated by accounting profits. These firms are inherently biased in discussing accounting principles as there is an apparent focus on accounting profits rather than generating real economic profits to be measured by accounting principles. If the granting of stock options generates an economic profit, then the use of options in compensation should continue. If a company ceases to grant options because of a change of accounting principles, then the company never should have used stock options to compensate employees.

Perhaps the most disconcerting statement that we have read is a statement that stock options are a cost borne by the stockholder, not the company. We would like to know what the stockholder receives in exchange for the options granted. Whatever the invented response, the discussion comes back to compensation. As investors, we would also like to know what expenses the company bears that are not born by the stockholder.

Few would disagree that the cost of compensating an employee should be included on a company's income statement. If stock options are used to compensate employees, then the value of the compensation should be included on the income statement. Regardless of the arguments against expensing options, the employee receives the option as compensation.

Valuation

Difficulty in valuing options has become a default reason not to expense equity based compensation. Many opponents to the amendment have conceded that options are compensation, but the lack of an easy valuation model is reason enough to keep stock options off of the income statement.

We recognize the difficulty in valuing an option, but an assertion that the difficulty in valuing options is so great to preclude an expense on the income statement generates a significantly more important question. If a company cannot value an option, how does the board of directors judge compensation levels? Perhaps boards are grossly over or under compensating employees. If options are so difficult to value, then perhaps the companies should refrain from granting options until the board of directors has a better understanding of the value being granted.

We do not believe that the difficulty in valuing an equity option granted to an employee should in any way affect FASB's decision to issue this amendment. Accounting standards are filled with estimates made to the best of management's abilities. Definitive models to value trademarks, brand names, and unproven technologies do not exist, but companies routinely make acquisitions and place dollar amounts on value of these assets in the form of intangibles or goodwill. Estimating the value of a stock option granted to an employee should be approached in the same manner. If options are an expense, then a good faith estimate of the value of the options should be expensed.

We do have a few concerns regarding the proposed valuation methods. Whatever model is used, we believe that the calculated value understates the true options expense due to the proposed limited upside of the binomial model, or using a period less than the full term of the option under Black-Scholes.

The relationship between the term of the option and the value of the option is recognized in paragraph B23. The relationship is non-linear, but all else equal, a longer term option is more valuable than an equivalent option of a shorter term. Limiting the extreme movements in the stock price limits the upside on the option and therefore lowers the value. The use of the binomial model with a limited upside based on a company's previous experience has the same effect. The calculated value excludes extreme movements in the stock price.

When an option is granted and no longer subject to a vesting period, then the employee owns the total value of the option, including the value of extreme movements in the stock price. We believe it is appropriate to expense the total value of what the employee receives. If an option is exercised prior to maturity, any premium over the intrinsic value is foregone by the employee; the proposed treatment suggests that the premium was never granted. At the very least, any foregone value is a gain for shareholders at the time the option is exercised and should not be recognized on the income statement.

If the stock price is expected to be greater in seven years than it is today, then the Board's proposals would be appropriate. However, option pricing models do not make this assumption. If we were to assume such a strong upward bias, then the probability of the option expiring in the money is significantly greater than the models assume, and option pricing models understate the true value of the option.

We suggest that the Board require companies to use the term appropriate to whatever option pricing model is used without limiting extreme price movements. If a pricing model is based on the total life of an option, then the standard should require consistency with the model. In the alternative, if the option pricing model assumes an upward bias in the stock price, then the expected life would be more appropriate.

We hope this recommendation is viewed in light of criticism received by the Board regarding the difficulty of calculating the value of stock options. Adopting the above policy creates a situation wherein an estimate of the expected life of the option is not necessary and therefore preferable to preparers of financial statements as fewer estimates need to be made. We are of course assuming that those against expensing due to difficulty in valuing stock options are making those arguments in good faith, and anything the Board can do to make the valuation less burdensome would be welcomed.

Modification

We also see a problem with the proposed statement specifically as it relates to use of the Black-Scholes model to value options at the time of modification. Consider the granting of a 10 year option to an executive. Historically, executives have exercised options seven years after receipt. Within six months of the option grant, the underlying stock declines significantly below the strike price. The exercise of the options is expected but not until the end of the original life. The board of directors decides to modify the original option by lowering the strike price in order to provide a greater incentive to management.

We agree with FASB's conclusion that the value of the original option grant at the time of the exchange should be used at the time of modification. Lowering the strike price on the option has a value, but the increase in value is not equal to the value of a new option with the same expiration date. Rather, the value of a new option with the same expiration date is offset by the value of the original option at the time the strike price is lowered. We do, however, see a problem when calculating the value of the original option at the time of modification as it relates to using the expected time period.

In this situation, the original award has a total remaining life of 9½ years, but the original expense assumed the option would be exercised in 7 years. The value of the original award at the time the strike price is lowered should be based on the remaining 9½ years. Comparing the original option expense on the grant date and the modification date will yield an apples to oranges comparison. Using the original 10 year term at the time the options are granted provides for adequate comparability of the change in value of the options between the grant date and the modification date. We believe that these two values should be comparable.

At the same time, requiring the use of the remaining life of the expected term would also be inappropriate. This treatment would require that the company calculate the value of the original option at the modification date using an expected life of 6½ years. Comparability would exist in this case, but the value of the option would be significantly understated as the option actually has an additional 3 years to move into the money.

We suggest that in order to maintain comparability and to accurately value an extremely out of the money option, the initial calculation of the option value should be calculated using entire life of the option rather than the expected life.

Cash Flow Reporting of Tax Effects

We support the Board's changes related to moving tax benefits from the exercise of a stock option to the financing portion of a company's statement of cash flows. We view the issuance of stock options as one decision with two separate steps: the amount of the compensation and the form the compensation takes.

The total compensation should be expensed and should be recorded as a reduction of cash flow from operations. This issuance of stock is fundamentally a financing decision regardless of the difference between the issue price and fair market value. Any tax implications related to the issuance of stock should be included in the financing section of the cash flow statement.

When tax benefits from stock issuance below fair market value is included in cash flow from operations, the ability of the firm to generate cash from current operations is overstated. In cases where the tax deduction is significant, sections of the cash flow statement can be seriously misleading.

Cash flow from operations should represent actual cash generated from operating the business. The level of tax deductions from issuance is related to the performance of the stock price and not the operation of the company. Valuations based on operating cash flow become somewhat circular. A higher stock price generates a greater tax deduction, and therefore greater cash flow. Higher cash flow justifies a higher stock price.

We appreciate the Board's dedication to a contentious issue. Original proposals to expense options 10 years ago were blocked by Congress without regard for the benefits of accounting standards being made by an independent entity. We are looking forward to the final standard this Fall and the increase in earnings quality that will follow.

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