Daiwa Asset Management (America) Ltd.

Financial Square 32 Old Slip, 11th Floor New York, NY 10005-3538

Tel: (212) 612-6250 Fax: (212) 612-7110

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Director of Major Projects—File Reference No. 1102-100 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

RE: Exposure Draft, Proposed Statement of Financial Accounting Standards

I am Chief Investment Officer of Daiwa Asset Management (America) Ltd., a Japan-based investment trust company. In that capacity I make recommendations concerning investments in American technology stocks. I am also a member of the Committee for Improved Corporate Reporting of the New York Society of Security Analysts. The following are my comments on the proposed statement of Financial Accounting Standards for Share-Based Payment.

I believe that there can be no serious argument against the contention that share-based payments are a form of compensation. As such, they should be shown as a cost of doing business on the income statement. The proposed statement is, therefore, an improvement over existing standards insofar as it mandates recognition of such compensation cost in the income statement.

That said, I believe that the proposed statement needs to go further by requiring that <u>net</u> cash outflows for the repurchase of shares issued pursuant to share-based payment programs be reclassified from cash flows from financing activities to cash flows from operating activities. If indeed share-based payments are a form of compensation, then the cost of repurchasing shares created pursuant to such programs is a compensation cost—and thus an operating rather than a financing cost.

If the cost of repurchasing such shares remains classified as a financing cost, corporate managements may choose to highlight cash flow from operations rather than the income statement and thus encourage investors to continue to underestimate the true cost of share-based compensation programs. It is true that even if the cost is required to appear as a reduction in cash flow from operations, the cost may still not be fully appreciated by near-term focused managements or investors because the cost would be postponed until the year in which share repurchases occur. Nevertheless, the knowledge that the cost of share repurchases must ultimately be recognized as a reduction of cash flow from operations should be a useful consideration in making decisions about share-based compensation. To be blunt, it may help to discourage the transfer of wealth from

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shareholders to management and other employees through the mechanism of stock options, to the detriment of non-employee shareholders.

Another reason for requiring that the cost be recognized as a cost of operations rather than a financing cost is that the current standards encourage not only excessive use of share-based compensation programs, but excessive share buybacks to mask their impact. This is illustrated by the following example. Assume that a company has seen its share count go from 100 million to 105 million as a result of the exercise of 5 million stock options at an exercise price of \$10 each. Also assume that the cost of repurchasing shares in the market would be \$20 per share and that the company has cash flow from operations of \$100 million. Current accounting rules would encourage the company to spend its entire cash flow from operations on repurchasing the 5 million shares to maintain its share count at 100 million and thus be able to show \$1.00 per share in operating cash flow, even if paying down debt or returning value to shareholders in the form of a cash dividend would be a better way of maximizing shareholder value. If the company in this example were required to account for net share repurchases of stock issued for options as a reduction to operating cash flow, the repurchase of 5 million shares would reduce operating cash flow from \$100 million to \$50 million and operating cash flow per share from \$1.00 to \$0.50. (Since the company had received \$50 million in proceeds from the issuance shares under the share-based compensation program, the net cost of repurchase would be \$50 million). The company would thus have no accounting-based reason to repurchase more than 2.5 million shares, the number at which there would be no net cash cost from the share-based compensation program.

I believe there are many companies that have passed from the high-growth to a more mature phase, but which try to maintain the fiction of being high-growth companies by buying back shares to reduce their share count and thus boost the growth rate of EPS and operating cash flow per share. They could put their cash to better use, but current accounting rules encourage excessive share buybacks.

My only other suggestion for improvement to the proposed standard would be a complete illustration of the calculation of compensation cost using both the Black-Scholes and the binomial methods for a typical share-based payment scenario. The illustration should show both the calculation of compensation cost and the financial statements using one of the acceptable fair value methods compared with the same financial statements using the intrinsic value method.

Sincerely,

Allan B. Campbell, C.F.A. Chief Investment Officer

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