



SENT VIA EMAIL: DIRECTOR@FASB.ORG

June 30, 2004

Letter of Comment No: 5834
File Reference: 1102-100

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

Re: File Reference 1102-100

Dear Ms. Bielstein:

Thank you for the opportunity to comment on the Financial Accounting Standards Board ("FASB" or "Board") Exposure Draft proposing new rules regarding Share-Based Payment, issued on March 30, 2004 ("Exposure Draft" or "Proposed Statement"). We hope that you will thoroughly consider these recommendations on behalf of the Software & Information Industry Association (SIIA) prior to adoption of a final rule establishing new rules for share-based payments.

SIIA is the principal trade association for the software and digital content industry, representing approximately 600 companies that produce software and digital information products. Our membership, consisting of the largest and oldest technology enterprises in the world, as well as many smaller and newer companies, is an excellent cross-section of the high-tech, high-growth industry that helps drive the U.S. economy.

In summary, SIIA strongly opposes both the objectives and conclusions of the Exposure Draft for the following reasons, as highlighted below in greater detail and to retain the intrinsic value method currently contained in FAS 123. Should FASB decide to ignore this recommendation, SIIA also submits the following recommendations regarding the implementation of the Proposed Statement.

1. The "four principles reasons" for proposing new accounting treatment constitute flawed reasoning for requiring issuers to use the fair-value-based method,
2. Neither employee services received in exchange for equity instruments nor Employee Stock Purchase Programs, no matter what discount, are a compensation cost,

3. It is not possible to accurately estimate the “fair value” of share-based payments, particularly at the date of grant, trying to do so will decrease transparency and comparability, and
4. This rule would have a severe negative economic impact, disproportionately affecting the high-growth information technology industry.

1. The “four principles reasons” for proposing new accounting treatment are flawed, and should be reconsidered.

The Board’s first “principal reason for issuing this proposed Statement” listed is a very important one. It is critical that before beginning to debate the technical details put forth in the Exposure Draft, the Board consider whether such an action will be so harmful to the information technology growth sector of the U.S. economy, and thus to the U.S. economy as a whole.

While the Board has identified concern of users and “others” as a primary reason for moving forward with the formal project on Share-Based Payment in early 2003, and subsequently for the basis of this Exposure Draft, we have yet to see a strong show of support from any significant group of interested parties other than institutional investors. Yet this group of individuals possess the analytical tools they need to make calculations as to whether the investment is good or ill-advised, without adopting an expensing criteria. Indeed, the interest of the institutional investors is not on the alleged compensatory costs of stock options, but rather on the dilutive impacts of such offerings. Clearly one way to minimize dilution is to require expensing, which is at best an indirect way to reduce the numbers of options granted as a means of minimizing the expense that must be shown on the books. Ordinary investors will not understand the impacts of expensing, and, as noted herein, requiring such expensing will not, in turn, advance the transparency or comparability of financial statements over time.

We also note that the premise itself is flawed. The bedrock of FASB’s exposure draft is that stock options are compensation because they are granted for services that have already been received. Thus, asserts FASB, options represent an exchange of value for services rendered and have been given in place of additional cash or other quantifiable value. In fact, many companies, at least in the information technology sector, provide options not as a cash compensation event, but as an inducement for employees to maximize productivity, and in anticipation of future services. In this circumstance, the options granted are clearly not compensation for services rendered and should not be recognized as such on the company’s books.

Given our concerns with the fundamental underpinning of the Exposure Draft, we implore FASB to utilize an extended comment period to provide for a fair, realistic opportunity for input among the public. In that regard, we request that the Board provide a public analysis of the comments demonstrating a comparison of those in favor of the proposed new rule and those

opposed. SIIA is confident that such an analysis will demonstrate, if nothing else, that the support of investors and “others” for the Proposed Statement is not sufficiently stronger than the opposition by similar parties and issuers of share-based payment.

Second, and equally important, the Board has wrongly identified that eliminating the intrinsic value method in favor of the fair-value-based method will result in improved comparability of reported financial information. While there is no doubt that this action represents a streamlining from two methods to one, the reliance on faulty, inconsistent valuation methodology will create an environment where transparency and comparability among companies is significantly decreased, not increased.

Given that the Exposure Draft permits the use of lattice models, such as the binomial model, Black-Scholes or other valuation models contingent on the coverage of the same variables, companies are currently striving to create new approaches to establish a fair market value for a restricted option, when no such value can accurately be estimated. Unfortunately, the choice of method, combined with the series of calculations that are company specific, provides for a significant lack of consistency and uniformity in valuation.

From the perspective of an investor comparing the cost of stock options across different companies with different stock option plans and different variations of the binomial or Black-Scholes models, the results are non-uniform and incomparable. The net result is that various companies are likely to arrive at different fair value calculations that are equally “legitimate” but are not meaningfully or uniformly comparable to the investor.

The current valuation methods force companies to predict stock prices, a task that is technically impossible and destined to produce inaccuracy and inconsistency. Certainly, unless the current inadequate stock option valuation models are vastly improved, SIIA strongly believes that the intrinsic value method—coupled with footnote disclosure—is the best method for providing valuable investor information, and that using such valuation models for accounting purposes would be ineffective and counterproductive.

The Board’s third objective, to simplify U.S. GAAP, is a noble objective that can hardly be contested on its merits. However, we do question the sincerity of this commitment given the extreme complexity of GAAP and FASB’s lack of appetite to make this an overarching objective that guides all of its rulemaking actions. Therefore, unless FASB is willing to sincerely make a genuine commitment simplifying the overly-complex GAAP, we do not concur that simplicity is a true objective in this case, but rather, a convenient outcome.

Finally, the Board’s fourth reason for the Exposure Draft is another that has reasonable merits but is also far from providing adequate incentive to change the accounting treatment of share-based payment at this time. FASB has been working in conjunction with the International Accounting Standards Board (IASB) for years to accomplish the objective of

international convergence, but it is FASB that is clearly out in front—potentially to the detriment of U.S. companies and the U.S. economy.

While the IASB did precede FASB with issuance of the International Financial Reporting Standard (IFRS) 2, *Share-based Payment*, that draft is far from finalization, presently undergoing consideration by the Accounting Regulatory Committee and others, as well as by the European Union (EU) member states. Therefore, we submit that the rush towards international convergence, while a worthy goal for accounting standards, is premature at best.

2. Employee services received in exchange for equity instruments are not a “compensation cost.”

Critical to the consideration of expensing options is the question of whether or not stock options truly constitute a “compensation cost.” On this matter, SIIA strongly disagrees with FASB’s assertion that share-based payment is indeed an expense. Rather, share-based payment represents a capital transaction that generates neither revenue nor an expense, particularly in those circumstances in which the option has been granted in exchange for the promise of future performance. Indeed, this unique quality is what makes employee stock options useful for the growth industries that have long taken advantage of broad-based employee stock options plans.

In contrast to the notion that options are an expense, the only “cost” of share-based payment is that of potential dilution to shareholders—causing the shareholder to incur a potential “loss” in the dilutive effect to shareholders, but certainly not a cost to an issuer. In fact, such a loss to the shareholder is at best speculative, as it is completely dependent on an increase in the share price and the options being exercised. As we have seen with many of the technology sector companies—although not exclusively a phenomenon of that sector—with the large number of options that were forfeited or expired under water, the degree of speculation only rises if the accounting treatment must be determined at grant date, with no opportunity to true up to reflect any sort of economic reality. Clearly, this is not a rational basis to require inclusion in an issuer’s financial statement, particularly given that the financial statements must now be certified as true and accurate.

3. It is not possible to accurately estimate the “fair value” of share-based payments, particularly at the date of grant, trying to do so will decrease transparency and comparability.

As SIIA has expressed in past comments to the Board, it is not possible to accurately measure the “fair value” of employee stock options at the time of grant, as proposed by the Exposure Draft. It is widely recognized that the binomial model, as well as the Black-Scholes model, is imperfect in many respects. The assumption that future stock evolution is lognormal with a known volatility ignores transaction costs and market impact, and it assumes that trading can

be carried out continuously. The fair value as estimated by pricing models does not accurately reflect the nature of the stock transaction, as this amount is not what is realized to the employee. That is, unlike publicly traded shares/options, an employee stock award does not include the ability to sell and receive the remaining time value—the employee will only realize the intrinsic value of the option on the date the award is exercised. And, as most commentators note, neither of these models was intended to value restricted awards—certainly not those with life spans that exceed six months. Most employee stock options, in contrast, are heavily restricted, with vesting periods that do not commence until the employee has been with a company in excess of that six-month period.

As a result, valuation using a modified option pricing model would often result in an overstatement of expense in the financial statements. Moreover, since the impact of outstanding options is already established in the diluted earnings per share (EPS) calculation, expensing the value through the binomial model or Black-Scholes would double-count the cost by lowering income through recognition of the expense while increasing the number of shares outstanding in the EPS calculations.

The inaccuracy of the existing option valuation models has recently been criticized by one of the creators of the fair value method. Mark Rubinstein, a finance professor at UC Berkeley's Haas School of Business and one of the inventors of the Board's recommended valuation models, stated at a recent event on June 24, 2004 that "I was one of the inventors of the model, and I say: Don't use it. It doesn't work." Further, Rubenstein also suggested that companies should only be required to expense the amount that an employee profits after he or she exercises the option to buy the stock.

Additionally, SIIA does not concur with the Board's conclusion that the grant-date is the appropriate date to measure the fair value of an option. Since options are granted in exchange for future services to be rendered, grant date does not make sense from a conceptual perspective. That is, until options actually vest, there is the opportunity for two key scenarios where there is not even any transaction. First, if the company terminates the employee and, second, if the options are not "in the money." Under both scenarios, even if an accurate valuation estimate were able to be reached, the cost to the issuing company will remain. In this regard, the Exposure Draft does not sufficiently allow valuation adjustments for early termination or forfeiture.

Finally, given the Board's objective to improve transparency and comparability of corporate financial reporting, there are likely to be significant problems arising from implementation of the Proposed Statement for many companies. Some companies utilize options that have complex vesting cycles, such as options that cliff vest. In these cases, rather than a single grant that would be far easier to track, the Exposure Draft would require options with a vesting cycle stretched-out over multiple years to effectively be treated as multiple grants. Under such a scenario, not only would there be an enormous administrative burden on the

issuing company, but more importantly, transparency for investors would most definitely be compromised considerably.

4. The proposed statement would have a severe negative economic impact, disproportionately affecting the high-growth information technology industry.

The Board, particularly Chairman Herz, has reiterated on numerous occasions that the mission of FASB is not to consider economic consequences. However, SIIA believes that the potential impact of this Proposed Statement is so economically harmful—particularly to small companies and companies in the information technology growth sector—that this cannot be separated from any rational consideration by a standards-setting body with the authority to serve the investing public. Although it is true that economic considerations are not specifically part of the Board’s “mission,” adoption of controversial policies that harm various companies and economic sectors would not be responsible on the part of FASB, given the Board’s stated commitment “[t]o promulgate standards only when the expected benefits exceed the perceived costs.” We strongly believe that this is not the case with the Proposed Statement.

Because there is no reliable method for valuing employee stock options, as noted above and agreed by many experts, including some on FASB’s Valuation Committee, companies in highly volatile industries will always be at a disadvantage as compared to companies that are in more stable industries. Higher stock price volatility will always result in higher option values. That is, assuming all other option model inputs are identical, simply because it is more volatile, current option pricing models will consistently compute a higher value at the date of grant for the option where the volatility is greater. The information technology industry, while clearly a key growth sector of the U.S. economy, would be adversely impacted by the implementation of this Exposure Draft, as it has historically been among the most volatile of industry sectors.

Additionally, companies that issue only a small number of stock options (usually only to top officers), would receive an advantage as a result of the Proposed Statement, as compared to companies that grant significant stock options to most or all employees, a practice commonly used by the information technology industry. Although the expense number will still be wrong, that wrong number is not likely to be material to the company’s financial statements. Such a scenario explains why the many companies that have been quick to voluntarily expense options in recent years have largely been companies that do not utilize broad-based options plans or have limited numbers of options outstanding, in part because they have made a decision to stop offering stock options on a broad basis. Essentially, requiring these companies to expense options will force companies to abandon broad-based options plans, an outcome that we cannot believe is desirable policy outcome, nor one that merits a change in the current rule.

SIIA Recommendations

As stated in above, SIIA firmly believes that share-based compensation is not an expense, and we strongly oppose the notion that options be treated as an expense. In accordance with these conclusions, SIIA supports continuation of the current method of accounting for share-based payments, as established by FAS 123, providing issuers a choice between the intrinsic value method or the fair-value based method. We recommend that FAS 123 not be amended other than for modifications to increase plain-English disclosure for investors and to increase transparency. However, if the Board does require expense recognition in a final standard, we offer the following recommendations and urge that FASB thoroughly consider these alternatives to the Exposure Draft.

1. Field-testing, including an adequate evaluation and transition period, are critical given the dramatic impact on valuation.

SIIA has long believed that there is a significant need for field-testing to evaluate the valuation method(s) provided for expensing options prior to fully adopting mandatory expensing and to develop a better insight into the potential economic consequences that full expensing may have. Given the indisputable inadequacies and inaccuracy of the existing valuation methods, combined with the significant likelihood of the result be drastic over-valuation in many cases, we remain convinced that field tests are an essential next step, prior to ratification of this Proposed Statement. Such a process, at a minimum, should include a significant delay in the date of implementation for any new standard to allow for the performance and evaluation of such field tests.

With respect to opinions that field testing has already occurred, it is simply not credible to suggest that the companies that have expensed options in the past provide an accurate, reliable field test. On the contrary, the Exposure Draft suggests a shift towards lattice models such as the binomial model, rather than the Black-Scholes model most commonly used. Moreover, the companies that have implemented such analysis are not nearly broad enough to accurately represent the broad range of companies that this Proposed Statement will affect—such as companies that utilize more complex options packages that cliff vest, as discussed above.

We are encouraged by recent remarks that the Board would consider delaying the projected implementation from December 15, 2004. However, given that this consideration appears to be based, at least in part, on company needs to meet deadlines for new corporate governance rules, we urge the Board to fully consider a sufficient delay for sufficient testing and evaluation, and that any new implementation date be considerate of companies that have a mid-year fiscal year end is not disadvantaged—a mere six month delay would most certainly have

the effect of putting companies with a mid-year fiscal year end at a considerable disadvantage with respect to compliance with new corporate governance regulations.

2. The discount provided for Employee Stock Purchase Plans (ESPPs) should not be treated as an expense, and therefore should be excluded from the Proposed Statement.

ESPPs differ significantly from employee stock options, and in our opinion are neither “compensatory,” nor should they be expensed. First, the notion that ESPPs represent an employee benefit because they are only offered to employees on terms that are sometimes more favorable than those available to all shareholders is flawed because companies sometimes also sell stock at discounts to non-employees—issuance of discounted stock sold to investors are not required to be treated as expenses, and are certainly not regarded as compensatory. More importantly, the employee sets aside after-tax dollars to fund the purchase—certainly an indication that the right to purchase these shares is not a compensatory event (no matter what the discount may be).

On the contrary, rather than focusing on ESPPs from the perspective of the employee, FASB should concentrate on the employer. Given that the benefit that the employer—the issuing company—receives is no less than the company receives in an offering of traditional shares, treatment as an expense is simply inaccurate. There is no question that the incentive for companies to continue offering ESPPs if required to expense the discount would completely disappear, as would the broad use of ESPPs by U.S. companies. ESPPs were statutorily created by Congress to encourage savings and investment and, as such are radically different in structure, design and intent from stock options. If finding that stock options are compensation is a difficult argument to make, it becomes that much more attenuated with respect to ESPPs, which are paid for by employees using after-tax dollars. Moreover, as a construct created by Congress, we question the authority of any independent body, particularly one without enforcement or oversight authority, to overturn Congressional intent. SIIA strongly objects to any policy that analytically equates ESPPs with stock options, and with any policy that discourages the use of ESPPs. FASB’s Proposed Statement does both and for that reason, merits our continued criticism and objection.

3. The Board should consider setting anticipated volatility at zero, rather than requiring an inaccurate estimation.

While this approach is far from a logical solution to enable expensing of options, SIIA does not believe that any method(s) of estimating volatility could be met with success. Further, we are convinced that the process of allowing companies to estimate future volatility by using various measures will only lead to significant errors and manipulation, which is at serious odds with a public company’s obligations under Sarbanes-Oxley. On the contrary, setting volatility at zero for all companies eliminates the subjective judgment calls and the

possibility for manipulation, thus improving comparability among financial statements, one of the primary stated objectives of the Exposure Draft.

Again, thank you for the opportunity to comment, and we hope that you will thoroughly consider these comments before reaching any final conclusions.

Sincerely,

A handwritten signature in black ink that reads "Ken Wasch". The signature is written in a cursive, slightly slanted style.

Ken Wasch
President