

June 29, 2004

Director of Major Projects  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: File Reference No. 1102-100

Dear Sir or Madam:

This letter of comment is directed to your Exposure Document titled "Share-Based Payment – an amendment of Statements No. 123 and 95" (the "Draft").

I have several comments regarding this Exposure Document. I appreciate the opportunity to offer them. They are offered in the order the topics they address appear in the "Notice for Recipient."

### **Recognition of Compensation Cost**

My strong view is that employee stock options are not an expense. As I have read about this issue, thought about this issue, talked about this issue, and experienced the types of valuation techniques that would be used to calculate the expense the Draft proposes, I simply cannot see how options are an expense item. As I know others have said, options create no liability and they result in no out of pocket cost to the company other than limited administrative costs, which are undoubtedly accounted for separately.

On the other hand options do impact a company's capital structure and are dilutive to other shareholders' interests, although presumably not to the aggregate value of their holdings. Private company investors are constantly aware of this potential dilutive effect and generally consider value on a "fully diluted" basis. This consideration is completely separate from the financial statement performance of the underlying companies, as it should be.

Investors are also aware that the awarding of stock options offers them the potential to reap their share of the rewards of the productive efforts of employees who are working to build overall company value and they are willing to be "diluted" at the point of exercise when the increase in the value of their position outweighs the dilutive effects of exercise.

Therefore, it seems to me, that the Draft's suggestion to expense employee stock options misses the point and mixes clear reporting of operations and calculation of per share value in a way that is confusing and not helpful. In other words I see the proposal as using the "expense" approach

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as an indirect proxy for theoretical value diminution rather than dealing with the real issue in a more straightforward way that deals with earnings per share or ownership dilution. Such an approach would deal with the issue itself straight up instead of in a way that is unlikely to be understood or understandable.

### **Measurement**

The grant date is the only suitable measurement date in my view for either the approach to expensing in the Draft or my suggested alternative.

### **Fair Value Measurement**

I believe that for private companies the determination of the fair value of an option is very difficult if not impossible given the current state of the art. Unfortunately, in my experience, current models, Black-Scholes, binomial, or others, do not have the capability of reflecting all the theoretical characteristics of employee options. As such they are misleading by nature and should not be used.

Moreover, these models are not easy to consistently apply. Again, my experience is that two (or more) individuals who apply these models to the same options are unlikely to arrive at the same answer. The models, therefore, end up being arbitrary, inconsistent and hard to apply in a way that is helpful. As such they work against the very accounting principles we all want to see applied.

### **Attribution of Compensation Cost**

The vesting period is the right period to use if an expense is to be recognized at all.

The items in Issue 9 raise a number of concerns and would result in a very high administrative burden for many firms. Please remember that most private companies, even those with substantial backing, are relatively small enterprises with limited resources that need to devote their time, talent and energy to growth and development and not to excessive administration. We all want accurate meaningful financial statements and reporting but we also want them to be practical, timely and cost-effective to prepare.

One of the specific questions posed in Issue 9 is whether there is agreement on front-end loading of compensation cost. My answer would be no, based on the simple assumption that whatever cost there is (remember my position is that there is none) is more likely to be incurred the closer you get to vesting.

### **Transition**

The proposed transition rules will allow inconsistency and are not adequate. If you have the answer, apply it. If you do not, don't.

### **Non-Public Entities**

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I do not agree with the decision to allow use of the intrinsic value method. The primary reason is that I don't believe options create an expense in the first place. Equally important though is that even the intrinsic value method will place an undue burden on private companies who need to keep focused on company building and value creation. If these rules were to go into effect as much delay as possible would be helpful. One year is definitely not enough time. Two years would be better and three would be better yet.

Thank you for the opportunity to comment.

Sincerely,

A handwritten signature in black ink, appearing to read "Thomas A. Penn". The signature is fluid and cursive, with a long horizontal stroke at the end.

Thomas A. Penn

Partner