



Letter of Comment No: 5497
File Reference: 1102-100

June 29, 2004

By email: director@fasb.org

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

Re: **Share-Based Payment, an amendment of FASB Statements No. 123 and 95**

Dear Sirs & Madams:

The Biotechnology Industry Organization (BIO) submits its views on the Proposed Statement of Financial Accounting Standards, Share-Based Payment, an amendment of FASB Statements No. 123 and 95 (the Exposure Draft). We appreciate the opportunity to offer comments on this significant matter.

BIO represents more than 1,000 biotechnology companies, academic institutions, state biotechnology centers and related organizations in all 50 U.S. states. The biotechnology industry, like many other growth sectors of the economy, uses broad-based employee stock option plans as an integral part of our efforts to recruit and retain highly qualified physicians, scientists and other professionals. Such plans are especially important as the industry continues to develop and commercialize its products and needs to attract these highly qualified employees in increasing numbers. The comments in this letter primarily represent the views of the small-medium size companies that represent the vast majority of our membership and who will shoulder a disproportionate cost in implementing these new guidelines if they are required.

For the reasons outlined below, BIO has serious concerns with the mandatory expensing of employee stock options outlined in the Exposure Draft.

Part One: BIO's Opposition to the Expensing of Employee Stock Options

I. Mandatory expensing of employee stock options will decrease the reliability and comparability of financial statements

We believe that the mandatory expensing of stock options will decrease the reliability and comparability of financial statements for companies in our industry. Predicting the volatility of biotechnology stocks is especially difficult due to it being event driven rather than earnings driven.

Because our industry includes a large number of small entrepreneurial companies, the historical stock price volatility in the biotechnology industry is higher than that of more mature industries due in large part to uncertainty during the regulatory product approval process. For example, the average volatility assumption for a sample of 25 public biotechnology companies was 59%, as compared to the average volatility assumption of approximately 36% of 100 public companies surveyed by Ernst & Young LLP in 2003 across a variety of industries.

Because of the higher stock price volatility in our industry and the more extensive use of broad-based employee stock compensation programs, the impact of the adoption of the Exposure Draft will be significant. For example, the average percentage change of the Statement 123 pro forma net income (loss), as compared to the net income (loss), of a sample of 25 public biotechnology companies was a 21% decrease in net income or 30% increase in net loss, as compared to an average decrease in net income of 11% from a survey of 100 public companies surveyed by Ernst & Young LLP in 2003 across a variety of industries. Furthermore, the impact of the pro forma charges to an individual company can be even more significant. For example, the pro forma increase in the 2003 net loss for one of our industry's largest and most successful companies was 84%.

In addition, the high stock price volatility in our industry, when combined with other highly subjective assumptions, can yield an unacceptably wide range of results. While it may be useful to disclose a hypothetical charge in the footnotes to the financial statements, the inclusion of employee stock option expense in the statement of operations will result in less clarity, consistency and reliability of the financial statements. The sensitivity of the option pricing models to the significant estimates and judgments would permit two similar companies to have significant differences in the reported expenses. For example, of 25 public companies in the biotechnology industry the volatility assumption used in the calculation of the fair value of employee stock options ranged from 31% to 107%. When this wide range of volatility is applied in an option valuation

model, the values assigned to the stock options can vary more than 100%. Because of the magnitude of this charge to our industry, we believe that differences in judgment may adversely impact comparability and reliability.

II. Employee stock options do not represent an expense

We do not believe that an employee stock option meets the definition of an expense as defined in Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*. Specifically, we do not believe that stock options represent “outflows or other using up of assets or the incurrence of liabilities.” Conversely, the exercise of a stock option represents an increase to assets by the amount of cash paid by the employee to exercise the stock option.

III. The expensing of employee stock options will distort earnings per share

The potential dilution that may occur with respect to employee stock options is currently reflected in the diluted earnings per share calculation. The inclusion of a cost for employee stock options in the statement of operations will result in an inaccurate “double charge” in the financial statements.

IV. The cost required to implement a lattice model exceeds the benefit

We do not believe that the benefits of implementing a complex lattice option-pricing model exceed its costs. As outlined in Statement of Financial Accounting Standards No. 1, *Objectives of Financial Reporting by Business Enterprises*, information provided by financial reporting involves a cost to provide and use, and generally the benefits of information provided should be expected to at least equal the cost involved.

The biotechnology industry is a growth sector and includes a large number of small entrepreneurial companies. Due to extremely long product development cycles, usually 10-15 years, and extensive costs involved in conducting clinical trials and launching a drug, the vast majority of biotech companies (over 90%) do not yet have products on the market. The adoption of a complex and difficult to implement lattice model would impose a disproportionate administrative burden to many of these companies while they are trying to conserve cash for clinical programs. For example, a survey of thirteen public biotechnology companies in the San Francisco Bay Area with a market capitalization between \$145 million and \$375 million identified that the average size of the finance staff is 4.4 full time equivalent personnel. As such, it is unlikely that any company of this size would have sufficient expertise to accumulate and analyze the required historical data, such as employee exercise patterns, in order to appropriately

implement a lattice model. These companies thus would be required to hire external experts to assist in the adoption of the Exposure Draft. Based upon our inquiry of external valuation experts, we estimate that implementation of the Exposure Draft would cost small entrepreneurial companies \$100,000 to \$300,000 per year in external consultant costs to maintain compliance. In addition, we expect companies in our industry to incur additional internal compliance costs as well as increased external audit costs. Due the limited usefulness of this estimate to the shareholders of biotechnology companies, we strongly believe that the cost to prepare the disclosure far exceeds the benefit.

In sum, we do not support the use of limited cash resources to calculate a hypothetical non-cash charge. Rather, we believe that cash resources would better serve shareholders of companies in our industry when applied to the development of life-improving biotechnology products.

Part Two: Specific Concerns with FASB's Proposed Amendment of Statements No. 123 and 95 (the Exposure Draft)

In the event FASB moves forward with all or some of the expensing requirements outlined in the exposure draft, which BIO strongly opposes, we also want to raise additional concerns about how these rules might be implemented.

I. The Exposure Draft does not provide adequate "safe harbor" on valuation and could lead to a significant increase in litigation.

The Exposure Draft does not provide sufficient guidance to enable the finance departments of many of the companies in our industry to assign a valuation to employee stock options without undue cost. Because the potential impact of employee stock compensation expense will be material to many of the companies in our industry, it does not appear that the Financial Accounting Standards Board would endorse the use of other simplified models. According to a survey of 100 companies conducted by Ernst & Young, of the 97 companies that provided the pro forma net income and earnings per share (EPS) disclosures required by the Statements, 91 companies used the Black-Scholes formula for estimating the fair value of the options granted during 2002. Of the remaining six companies, two companies used a Binomial model. Therefore, if some form of expensing is required, at a minimum we recommend that the Exposure Draft be revised to permit the use of simplified assumptions and methodologies in a wider, and more

objectively defined, set of circumstances. We also recommend that the Exposure Draft be revised to include simplified examples of how the Black-Scholes option-pricing model can be adjusted to take account of the characteristics of employee stock options that are not consistent with the assumptions of the model.

Absent clear direction from FASB on which valuation methodology companies should use, how they should be employed, and a “safe harbor” provision that protects the decisions on inputs that will undoubtedly vary from company to company, we are concerned that the current approach could result in a significant increase in litigation by groups claiming earnings were misrepresented. This concern is examined in detail in an article by Kevin Hassett and Peter Wallison, entitled “A Troubling Requirement” that appeared in the Spring 2004 edition of the journal *Regulation*.

II. Neither of the existing valuation models proposed by FASB adequately discounts for the unique attributes of employee stock options.

The option pricing models contained in the Exposure Draft fail to incorporate factors unique to employee stock options, especially two critical factors that should be significantly discounted for: lack of transferability and blackout periods.

Lack of transferability affects the valuation of employee options. There is no market for employee stock options until they vest. More importantly, out-of-the-money options vested or not would have value in the eyes of a third party willing buyer if they were transferable. Therefore compared to a traded option with otherwise identical terms, the lack of transferability restriction associated with an employee stock option significantly reduces the value of the option. In fact, Dr. Jonathan Mun, author of the Crystal Ball valuation method that the binomial method is based upon, has in a recent submission to FASB (*FASB comment letter on FAS 123 Exposure Draft No. 2402*) stated, “the author’s suggestion is to allow the incorporation of marketability discounts be taken by firms issuing ESOs.”

Similar to the lack of transferability, blackout periods are common for employee stock options and should also be discounted. In many companies there are large numbers of employees that are blacked out from exercising stock options for “calendar” reasons. For example, executives and most finance departments are blacked-out at least two weeks prior and two weeks following quarter-ends and until after quarterly earnings releases are made.

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In addition, in the biotechnology industry stock prices of individual companies are usually event driven and often fluctuate because of events like drug approvals, release of scientific data, or study delays and reporting of adverse events. During and prior to these events, companies are forced to black out teams of employees. These blackout periods restrict the number of days employees can trade their options. To accurately value employee stock options there must be significant discounts for these blackout periods.

III. Investors in Biotechnology companies are predominately focused on “cash burn”, not non-cash charges

We do not believe that the expensing of the hypothetical non-cash cost of employee stock options will be meaningful to investors. Rather, the primary focus of investors in our companies is on the rate of “cash burn.” Accordingly, by including the non-cash charge for employee stock options in earnings, it creates incentive for management to develop additional non-GAAP accounting disclosures. For example, the inclusion of non-cash stock based compensation expense in research and development on the statement of operations will obfuscate the true rate of cash research and development expenditures. We question whether this result would be consistent with the Financial Accounting Standards Board project on Financial Performance Reporting by Business Enterprises. In our opinion, this Exposure Draft will contribute to the proliferation of alternative and inconsistent financial performance measures and will undermining high-quality financial reporting, which is essential to well-informed investment decisions and efficient capital markets.

We urge you to consider whether the objectives of the Exposure Draft outweigh the significant costs that will be placed on the small entrepreneurial companies in our industry. This additional burden is overwhelming when combined with other recent sweeping regulatory requirements, such as the Sarbanes-Oxley Act of 2002. We appreciate the opportunity to offer these comments. If you have any questions regarding this letter, feel free to contact Steve Lawton at (202) 962-9200.

Sincerely,



Carl B. Feldbaum
President
Biotechnology Industry Organization