

Sun Microsystems, Inc.
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Letter of Comment No: 2721
File Reference: 1102-100

May 25, 2004



Via Federal Express

Mr. Len Tatore
Planning, Development & Support Manager
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Subject: File Reference No. 1102-100

Dear Mr. Tatore:

Enclosed please find "Comments of Sun Microsystems, Inc. to FASB Exposure Draft on Share-Based Payments" signed by M. Kenneth Oshman, Presiding Director, on behalf of the Sun Microsystems, Inc. Board of Directors.

Thank you for your cooperation in including Sun's comments with others received on this matter.

Sincerely yours,

A handwritten signature in black ink that reads "Irma Villarreal". The signature is fluid and cursive, with a large loop at the end.

Irma Villarreal
Assistant General Counsel

Enclosure

COMMENTS OF SUN MICROSYSTEMS, INC. TO FASB EXPOSURE DRAFT ON SHARE-BASED PAYMENTS

We appreciate the opportunity to comment on the FASB Exposure Draft on Share-Based Payments.



Sun Microsystems believes in broad-based employee ownership and has issued over 87% of our stock option shares to our rank and file employees below the VP level. We believe that employee ownership motivates our employees to produce more innovations that create substantial additional shareholder value. In light of this we have significant concerns about FASB's Exposure Draft and the resulting impact of its implementation.

In a very real way stock options have aligned the interests of our employees with those of our shareholders by giving them an incentive to develop new technologies that have created real value in the marketplace. As "owners" our employees repeatedly state that they work both harder and smarter to help make the company more successful. This is consistent with the findings of researchers Joseph Blasi, Douglas Druse, and Aaron Bernstein in their book, "In the Company of Owners: The Truth About Stock Options (and why every employee should have them)", wherein they conclude "there is compelling evidence that broad-based employee ownership does in fact produce more value for shareholders", boosting productivity by about 4% and total shareholder returns by an average of about 2%.

However, we believe that our company and many others will not be able to continue this practice if there is a requirement that employee stock options are expensed using a valuation method that significantly distorts the impact of the award on the company. This would result in a negative impact on the high tech innovation which continues to help drive the U.S. economy, and which continues to help provide the U.S. military with an expanding technological superiority.

Our concerns with the Exposure Draft and its impact are in the following areas:

1. We don't believe that employee stock options constitute an expense to the company;
2. We believe that the proposed valuation methods will produce inaccurate, inconsistent, and unreliable results, that will distort - not improve - transparency and comparability of financial information. Further, Sun is concerned that FASB is not conducting market tests to assess whether the models proposed actually meet the fair-value definition. The potential impact of inaccurate valuation methodologies of such a large potential expense could have significant negative ramifications, and therefore, should be tested and adjusted to mitigate the risk of inaccurate reporting.
3. We believe that the proposed valuation methods will particularly penalize high tech companies that embrace employee ownership, because those companies award stock options to a very broad base of employees and have volatile stock prices.

We believe that the proposed expensing rules, if implemented, could have significant negative impact on employee ownership, on the economy, and even on national security, while not adding significantly to transparency or accuracy of information for investors.

1. Question of Expensing.

We agree that there is a cost associated with employee stock options. However, we disagree with respect to where and how the cost is recognized. The cost associated with employee stock options is already appropriately accounted for under the intrinsic value method in APB 25 and by the dilution experienced by shareholders. When employee stock options are granted those options are reflected in fully diluted earnings per share. This dilution in ownership for shareholders represents the cost of the employee stock option program. In effect, shareholders, as owners of the corporation, are paying for the options. And with recent NYSE and NASDAQ requirements, shareholders, by voting to approve stock option plans, can decide whether they want to make the investment (to incent and retain employees to drive up the stock price) and incur the cost. There is a cost/value relationship in this scenario that is not present in the proposed rules. To record a charge to earnings in addition is double counting the cost of the option.

2. Valuation Methodology.

It is well-known and understood that the market based models, such as the Binomial (or lattice) and the Black-Scholes models, are inaccurate tools for valuing employee stock options. Both models assume there is an open market to trade, that the options are transferable, that the options have short terms and no restrictions. In almost all cases, these assumptions are false for employee stock options. Further, the models (and proposed rules) require assumptions on the company's volatility in some cases as far as 10 years into the future. With so many factors outside of a company's control (political or other global events etc.), it is impossible to predict stock price volatility with any accuracy. Mandating the use of these or similar models will result in more complexity and cost for issuers, and less accuracy, consistency and comparability for investors.

The proposal would assign a value to an option at the time of grant and mandate a charge for that amount over the vesting period of the option. This violates the fundamental principle that, in order to associate a charge with an item, the item must have some realizable or attributable value. At the time of grant, these items do not have any such value because they are not transferable and are not exercisable for a significant period of time; they are subject to contingencies, and their future value is speculative. The proposal's failure to permit the reversal of the charge for an option that expires unexercised will significantly misrepresent attributed cost. The assignment of a value before any of the economic realities affecting the value (e.g., the market value at the time of exercise) is known, will cause further distortion – not clarity. And this is directly contrary to the IRS view that there is no attributable value in an option until it is exercised and has a known value.

We firmly believe that the current models do nothing to improve financial reporting, and, in fact, may denigrate the current level of accuracy.

3. Social Impacts.

Initial trends indicate that companies will grant fewer stock options to fewer employees due to the proposed expensing rules. These reductions will occur primarily in the awards to rank and file employees, who drive a significant portion of consumer spending. This can have a significant impact on the Federal tax base (a study conducted by Clark Consulting in 2004 concludes that for every 0.1% reduction in the number of options granted there is a corresponding decrease of \$1.6B in Federal tax revenue).



Ken Oshman

Presiding Director

**For the Sun Microsystems, Inc.
Board of Directors**