

Letter of Comment No: 55/3
File Reference: 1102-100

Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7, PO BOX 5116
Norwalk, Connecticut 06856-5116

Via email to <u>director@fasb.org</u> June 29, 2004

File Reference No. 1102-100

FASB Invitation to Comment: Proposed Statement of Financial Accounting Standards, Share Based Payment, an amendment of FASB Statements No. 123 and 95

Dear Ms. Bielstein:

Thank you for the opportunity to comment on this Proposed Statement. We do not believe that it is possible to assign a meaningful value for financial statement reporting purposes to most stock option and related arrangements in a cost-effective manner. We believe that the only users of the financial statements who will benefit from this information are the institutional investor and investment analyst communities. Since these parties already have their own models that they use to determine the impact of option plans, we believe a better solution is to provide the additional information, such as vesting schedules, in footnote form so that they have all of the information they need to fill in their models.

However, if the decision is made to move forward with this Proposed Statement, we have the following comments on the wording and content:

General comment on the use of the term "Settled" and the application of the Proposed Statement to unvested awards at the implementation date:

We believe that the use of the term "settled" in paragraph 20, as defined in Appendix E, can be misinterpreted by a sophisticated reader. The first sentence states "This Statement shall be effective for awards that are granted, modified, or settled in fiscal years beginning after"

Appendix E defines the term "settled" as ".... Transactions and events that constitute settlements include (a) exercise of a share option or laps of an option at the end of its contractual term, (b) vesting of shares, (c) forfeiture of shares or share options..."

We believe that the intent of paragraph 20 is to require the adoption of this Statement for new awards issued after the effective date and to prior awards modified after the effective date of this Statement. Therefore, we recommend that the word "settled" be removed from the first sentence of paragraph 20.

2041 Mission College Boulevard, Suite 159 • Santa Clara, CA 95054

In addition, paragraph 21 states "Public entities and nonpublic entities that used the fair-value-based method of accounting under the original provisions of Statement 123 for recognition or pro forma disclosure purposes also shall apply provisions of this Statement in recognizing compensation cost of any portion of awards granted or modified after December 15, 1994, that is not yet vested at the date this Statement is adopted."

We believe that the Proposed Statement should only be applied to equity instruments granted or modified after the date of adoption. Application of the Proposed Statement to the unvested portion of awards outstanding at the date of adoption will create computational difficulties with little added benefit. In addition, comparability between periods would also be adversely affected.

Comment on application of the proposed Statement to Employee Options only:

While we are aware that the FASB has a separate agenda item to address ESOPs and transactions with non-employees, we believe that the existence of separate accounting literature for substantially similar instruments results in confusion for both preparers of financial information and the users of such information. Therefore, we recommend that the Proposed Statement be applicable to **both** share-based payment arrangements with employees (other than ESOPs) **and** share-based payment arrangements issued under substantially the same terms to non-employees.

It is common practice for non-public companies to issue stock options to both employees and consultants under exactly the same terms. The options are often granted from the same plan, have the same vesting terms, same exercise price, for a similar number of shares, and for the same term. Similarly, private companies often maintain both a Board of Directors and an Advisory Board. Appendix E includes non-employee directors in the definition of an employee for purposes of this Statement, but not Advisory Board members. Therefore, different costs will result from the recording of these substantially similar transactions.

EITF 96-18, "Accounting for Equity Instruments with Variable Terms That Are Issued for Consideration Other Than Employee Services Under FASB Statement No. 123," states that equity instruments issued to non-employees for services are remeasured until a performance commitment has been met or until the services have been provided. In practice, the date that the equity instruments vest is considered to be the date at which the services have been provided. Paragraph 6 of the Proposed Statement requires public entities (and nonpublic entities who elect the fair value measurement approach) to measure the cost of employee services received in exchange for awards of equity instruments based on the fair value of the instruments at the grant date. This compilation of literature results in different values for identical instruments based on the employee/consultant relationship. We do not believe that having multiple valuation methodologies within a single set of financial statements results in meaningful financial information for the users of the financial statements.

Therefore, we recommend that this Proposed Statement be amended to include share-based payment arrangements issued to non-employees, including consultants and Advisory Board members, when such share-based payment arrangements are substantially the same as those offered to employees. Guidance can be provided to determine when an arrangement is substantially similar, such as:

- The arrangement is issued to an individual in exchange for services;
- The arrangement is issued with the same exercise price, vesting term and contractual term as employee arrangements;
- The arrangement is issued out of the same plan as employee or non-employee director shares; and
- The number of shares granted is consistent with the number offered to employees or nonemployee directors for similar services.

Response to Issue #1:

We do not agree that a company incurs a cost when it grants equity instruments to its employees. Equity instruments can be considered an "elegant currency." That is, while equity instruments have value to the employees, the company incurs no cost. The only "cost," for want of a better term, is to the existing shareholders of the company, who suffer dilution when equity instruments are granted to employees.

Response to Issue #2:

We believe that pro forma disclosures are an adequate substitute for recognition of compensation cost in the financial statements. We believe that the only users of the financial statements who will benefit from the inclusion of compensation cost related to share-based payments to employees in the financial statements are the institutional investor and investment analyst communities. Since these parties already have their own models that they use to determine the impact of option plans, we believe a better solution would be to provide disclosures, such as vesting schedules, in a footnote so that these investors and analysts have all of the information they need to build their models.

Response to Issue # 4(a):

We do not believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency.

Paragraph C22 states: ".... Uncertainties inherent in estimates of the fair value of share based payment arrangements are generally no more significant than the uncertainties inherent in measurements of, for example, loan loss reserves, valuation allowances for deferred tax assets, and pensions and other postretirement benefit obligations..."

It is our experience with over 200 companies in Silicon Valley that the significant majority of both public and nonpublic companies do not have the expertise to measure these estimated values. This is generally not an issue for them since they do not have loan loss reserves or pension benefits, and in many cases, due to ongoing losses, the valuation allowance for

deferred tax assets is simply 100%. In cases where valuations are required, these companies currently hire tax advisors to prepare their tax returns and accruals, and these professionals also assist with the reserve calculations for deferred tax assets. As for the valuation of intangibles and impairments, these companies must hire outside valuation firms. It is already hard to convince management that this is money well spent, and in fact, a number of nonpublic companies have decided to forego an annual audit rather than hire valuation experts. Therefore, the complexities of these rules are actual decreasing the reliability of financial reports for investors in nonpublic companies.

We believe that guidance and literature published by the accounting profession should be designed such that adequately trained accountants can reasonably implement that guidance. We are very concerned about the trend of establishing rules that require companies to engage outside experts in order to comply. Only the largest corporations are in a position to maintain staff with the requisite skills and qualifications. In addition, if we, as accountants, cannot implement the rules, it is highly unlikely that the average investor will understand and interpret the results in a meaningful way. These rules are also pushing nonpublic firms to forego annual audits, further increasing the risk to the investor community.

We would also like to point out that this is not a one-time valuation such as for acquired intangibles in a business combination. The Board is telling every public company, regardless of size, that qualified valuation experts must be utilized every quarter just to close the books. We do not believe there are enough qualified valuation experts available at reasonable prices to perform this work for every company who will need it. In addition, we do not believe that the results will provide enough benefit to the users of the financial statements to justify the cost each and every quarter.

Response to Issue #4(b):

We do not agree that the fair value of employee share options can be measured with sufficient reliability. Option valuation models, even the lattice models that the Board has deemed to be preferable to closed-form models, were designed to value options that can be freely traded on an open market. Except in rare cases, employee share options cannot be freely traded. In addition, traded options are almost never settled before their expiration date, while it is the norm for employee share options to be exercised prior to the end of their contractual term. While the lattice models that the Board has deemed to be preferable do compensate for these issues to some extent, they do so by layering estimates upon estimates. For example, when using a lattice model, companies must estimate volatility and employee sub-optimal exercise behavior and must do so for multiple vesting periods. The vesting periods may be monthly and range for up to four to five years in the future. Generally, the farther into the future an estimate must be made, the less reliable it will be. Accordingly, estimates for periods four to five years in the future will be inherently unreliable and generally will not provide a good estimate of the fair value of an employee share option.

In addition, as we have stated in our response to issue #4(a) above, we believe that lattice models are so inherently complex that most small-to-medium-sized companies will be forced to hire outside experts to assist them in determining the input variable for these models. We fail

to see how this additional, and probably significant, cost will benefit either the companies involved or their investors.

Response to Issue #4(d):

We agree that compensation cost should be recognized only for those equity instruments that vest; however, we do not agree that estimating future terminations is the best method for recognizing this particular unique characteristic of employee share options. As we have more fully explained below in our comments to Issue #9, we do not believe that the accelerated expensing methodology is the appropriate accounting treatment for options with multiple vesting dates. If the option is treated as it is intended by both the employer and the employee as a single instrument that vests straight-line over time, the expense should also be recorded straight-line over time. If this is the case, there is no need to anticipate forfeitures – rather, expensing stops at the forfeiture date.

Paragraph C20 states that ".... After an employee share option (or other equity instrument) vests, the employer has benefited from the services received. Both the benefit and the risk of subsequent price changes are the employee's. No additional compensation cost is recognized subsequent to vesting because the exchange transaction has been consummated." We agree with this statement, and believe that it should apply during the vesting period such that the expense recorded is the greater of straight-line over the service period or the amount of expense associated with the vested portion. If the expense recognition is not accelerated, there is no need to estimate future forfeitures, thereby eliminating one of the numerous estimates in the calculation and increasing the reliability of the calculation.

Response to Issue #5:

We agree that there may be rare circumstances in which it is not possible to estimate the fair value of an equity instrument on the grant date. We also agree that the intrinsic value method is an appropriate alternative accounting treatment in these rare circumstances. However, we do not believe that the remeasurement period should extend through the settlement date. Instead, we believe that the remeasurement period should end when the equity instrument is vested. This position is consistent with the position the Board stated in paragraph C20, which states in part:

"After an employee share option (or other equity instrument) vests, the employer has benefited from the services received. Both the benefit and the risk of subsequent price changes are the employee's. No additional compensation cost is recognized subsequent to vesting because the exchange transaction has been consummated; the requisite service has been rendered by the employee and equity instruments have been issued by the entity—the exchange transaction is complete."

Our position is also consistent with the requirements of EITF 96-18, which states that equity instruments issued to non-employees for services are remeasured until a performance commitment has been met or until the services have been provided. In practice, the date that the equity instruments vest is considered to be the date at which the services have been

provided. While we understand this Proposed Statement is not intended to apply to transactions with non-employees, it seems that the accounting for similar equity instruments issued to both employees and non-employees should be the same, as we have stated in our comment on the application of the Proposed Statement to only employee options, above.

Response to Issue #9:

We do not agree, for the reasons stated below, with the proposed accounting treatment that considers an award with a graded vesting schedule to be in substance separate awards, each with a different requisite service period. This treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions.

We believe that the accelerated expense methodology is not a preferable expense recognition method because:

- It does not match the compensation expense to the services being provided.
 Employees do not provide more service in the first year than in later months. If anything, they are more productive in later years.
- 2. Employers use ratable vesting as an incentive to retain employees with the intent that the employee receives equal value in each year of employment. We have heard the argument from the FASB that there is evidence against this in the fact that many employers grant "refresh" options to employees. We do not believe this is a valid argument because:
 - a. This argument assumes that the refresh grants are guaranteed. This is never the case. Companies are not obligated, either by contract or verbal agreement, to issue such awards. We believe that to take into account a potential future event in valuing a transaction today is to set a very dangerous precedent in the accounting profession.
 - b. This argument also assumes that the refresh grant will be for a similar number of shares. This is rarely the case. In most cases, refresh grants are for significantly fewer shares than the original grant unless they are granted in connection with a promotion or other service related event. Therefore, they are similar to annual salary increases, which would never be accrued for prior to issuance.
- 3. If this were a cash compensation arrangement, the resulting credit to the balance sheet would not meet the definition of a liability under FASB Concept Statement No. 6 which states: "Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." The simplest verification of this fact is that if the employee terminates after completing 2 years of service, 50% of the option will not vest and will be cancelled. Therefore, the credit to the balance sheet should never exceed the vested portion, which is equivalent to the fair value of the liability to the employee at any point in time.

This is equivalent to expensing on a straight-line basis. In no way does the employee, after completing two years of service, have the right to 81% of the option, and under this Proposed Statement, the employer would need to reverse 31% of the expense upon termination of the employee.

While large enterprises may have enough participants to "smooth" the impact of such reversals, smaller public and nonpublic entities may experience large swings in their expense figure, including periods with a net credit to expense.

- 4. The Proposed Statement actually contradicts the theory behind accelerated amortization. Paragraph 17 of the Proposed Statement states ".... The effect of those restrictions is taken into account by recognizing compensation cost only for instruments for which the requisite service has been rendered. That is, no compensation cost is recognized for instruments that employees forfeit because a service condition or a performance condition is not satisfied...." However, as the Proposed Statement is currently written, compensation expense *is* recorded prior to the requisite service being performed, and is then reversed if that employee terminates earlier than anticipated.
- 5. Finally, we have also heard the argument that this expensing model has been in place for approximately 20 years without being challenged before. If this were a valid argument, we would not be revisiting APB 25 today, and therefore the argument warrants no further consideration.

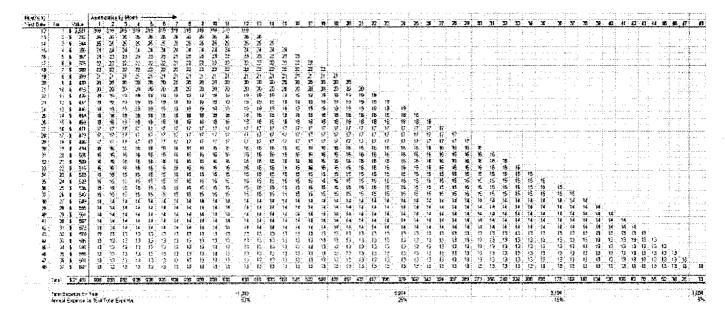
Therefore, we recommend that the value of the instrument granted be charged to compensation expense based on the percentage of the total grant actually vested during the period. This will result in more accurate matching of the expense to the true obligation of the employer and the services rendered by the employee. In addition, because no expense will be recorded prior to vesting, it will eliminate the need to estimate forfeitures in the determination of the fair value calculation, thereby reducing one of the many estimated variables and increasing accuracy.

We also do not believe that an award with a graded vesting schedule is in substance separate awards, each with a different fair value measurement.

In order to express our concern with this proposed accounting treatment more clearly, we will use an example of the most common form of stock option grant in Silicon Valley:

Assume an option is granted to Employee A on 1/1/05 for 10,000 shares with an exercise price equal to FMV of \$5.00 which vests 25% on 1/1/06, and 1/48th each month thereafter, fully vested in four years. The option has a ten-year term. For purposes of this example, the employer believes Employee A will exercise in full at each vesting date, and will not terminate during the term of this award. Assumptions for the other variables are: average risk-free interest rate of 4%, volatility of 75%, and dividend yield of 0%.

In applying the proposed Statement, this grant must be assigned 37 values (one value for the portion that cliff vests at the end of the first year, and one value for each month of vesting thereafter). For simplicity, fair values have been estimated using a Black-Scholes model, and the following amortization table:



We would like to note here that we believe the complexities and computation time required to perform these valuations using a lattice model far exceed the expertise of even an above-average accounting department at a small- to mid-sized entity. We can in no way see how such a precise computation of an estimate based on a large number of estimates provides any meaningful increase to the reliability of the resulting valuation.

Applying the closed-form Black-Scholes model, the result of valuing 37 options is a value of \$21,400, which is just slightly lower than a value calculated assuming a single option with a weighted average life of 2.17 years, which is \$22,200. Given the number of estimates going into this calculation, a difference of 4% does not warrant the added complexity in the calculation.

Therefore, we recommend that the valuation of a grant with ratable vesting based on a weighted average life, rather than splitting the grant into multiple grants, be permitted as a valuation approach. At a minimum, due to the complexity of the required computations, we ask that you amend the proposed Statement to clarify that for grants with monthly vesting, valuation by annual vesting (in this example, splitting the grant into 4 rather than 37 awards) is acceptable.

Response to Issue #14(a):

We agree that an alternative method of accounting should be permitted for nonpublic entities for which is it not possible to determine values for one or more of the required inputs to an option valuation model. However, we do not agree that the intrinsic value method is the best alternative. We propose that the minimum value method, as allowed under FASB Statement

No. 123, be retained as an alternative accounting method for nonpublic entities. Many, if not most, nonpublic entities will not be able to estimate a volatility for their shares. Generally, the primary investors in a nonpublic entity are active members of the Board of Directors, who approve all option grants and the fair market value/exercise price of those grants. Because there is no public float, and therefore no liquidity to the holder of an equity instrument of a nonpublic entity, both the closed-form and lattice models significantly over-value the equity instruments of these companies. The minimum-value method properly computes the time value of money for the exercise price, which is independent of the liquidity issue.

The Board's proposal to allow the use of the intrinsic value method with remeasurement until settlement contradicts paragraph C53(a), which confirms the conclusion in FASB Statement No. 123 that "the appropriate measurement date for compensation cost from equity instruments awarded to employees is the grant date." We believe that this conflict is resolved by the use of the minimum-value method for nonpublic entities.

Response to Issue #18:

We do not believe that the Proposed Statement, taken as a whole, meets the Board's objective of issuing financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge. While it is certainly possible for those possessing a reasonable level of accounting knowledge to understand the Proposed Statement at a basic level, the application of the Proposed Statement will require a level of expertise that most accountants do not possess. For example, most accountants do not possess the background in mathematics to understand the intricacies of a lattice model. Many accountants do not possess the skills to allow them to make appropriate estimates of future volatility and the expected term of an option, as defined in the Proposed Statement. This will result in many nonpublic and small- to mid-sized public entities incurring significant cost to hire outside experts, as often as quarterly, to provide these skills. Accordingly, many companies will find themselves in the position of including in their financial statements amounts that they do not fully understand, and which may have been provided to them by outside valuation experts. In the world of Sarbanes-Oxley Section 302 and 906 certifications, this is a significant problem.

Thank you for your consideration of our comments.

Sincerely.

Kristine A. Howard Technical Vice President Horn Murdock Cole

Kristine a. Howard

Senior Technical Director Horn Murdock Cole

Manue Elaly

Maureen E. Earley