Letter of Comment No: 5849
File Reference: 1102-100

TIME WARNER TELECOM

DRIVING YOUR NETWORK

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

RE; File Reference No. 1102-100

To Whom It May Concern:

Time Warner Telecom Inc., headquartered in Littleton, Colo., is a leading provider of managed network solutions to a wide array of businesses and organizations in 44 U.S. metropolitan areas that require telecommunications intensive services. One of the country's premier competitive telecom carriers, Time Warner Telecom integrates data, dedicated Internet access, and local and long distance voice services for long distance carriers, wireless communications companies, incumbent local exchange carriers, and such enterprise organizations as healthcare, finance, higher education, manufacturing, hospitality, state and local government, and military. Please visit www .twtelecom.com for more information.

We are responding the Board's invitation to comment on the *Proposed Statement of Financial Accounting Standards Share-Based Payment, an amendment of FASB Statements No. 123 and 95.* The proposed Statement addresses the accounting for transactions in which an enterprise receives employee services in exchange for equity instruments of the enterprise. This proposed statement would eliminate the ability to account for share based compensation transactions using APB No. 25, *Accounting for Stock Issued to Employees*, and generally would require instead that such transactions be accounted for using a fair-value-based method.

Time Warner Telecom uses the intrinsic value method as provided under APB No. 25 and discloses the pro forma effects of adopting SFAS No. 123 in the footnotes to our financial statements.

We note that the Proposed Statement's objective is to "recognize in an entity's financial statements the cost of employee services received in exchange for valuable equity instruments issued, and liabilities incurred, to employees in share-based payment transactions". The reasons stated for issuing this proposed Statement is to improve the comparability of reported financial information through the elimination of alternative accounting methods, to simplify GAAP and to converge with International standards so as to provide high quality, transparent and comparable information to users of financial statements. We have benefited from strong capital markets in the U.S., and recognize the critical role that high quality and transparent financial statements play in the effectiveness and efficiency of our capital market system and it is from that perspective that we express our concern about the proposed Statement's requirement to recognize an expense related to employee stock options. For the reasons articulated below, we do not believe that requirement would accomplish your stated objective of improving the quality, transparency, and comparability of financial reporting.

While we respect that the Board is currently seeking comments on specific provisions of the proposed statement, we believe the general matter of expensing options and the impact on employee stock plans as a result of this accounting treatment needs to be stated. We understand that certain political and other environmental factors may ultimately lead the Board to reconsider mandating the expensing of employee stock options; the current Invitation to Comment alone is evidence that the Board is not through analyzing this issue. We urge the Board to consider all factors as it further deliberates this important matter. Our general comments regarding the expensing of stock options are addressed in this letter. In addition, we have several responses to the Board's specific questions is in the attachment.

We believe that the integrity of financial statements is compromised by the use of fair value estimates of expenses that are never ultimately reconciled to an amount of cash or other goods or services paid out by a company. Further, we believe that the available option pricing models, including the Black-Scholes and Binomial Lattice models, do not and cannot accurately predict the ultimate value attributable to services received by the corporation. In fact, companies with higher volatility in their stock price will expense significantly more than companies with lower volatility, even if the value the employees of both companies receives in the exercise of options is equal. As an example, emerging companies whose stock price exhibits high volatility will result in significantly higher valuations that may never be realized. Finally, the stated goal of providing increased transparency and comparability is not met, given the seemingly infinite number of variables in the markets. This new requirement will penalize technology companies such as Time Warner Telecom.

Mandating option expense in income statements creates a distorted view of the measurement of an entity's income or loss for two reasons:

> First, expense amounts not ultimately settled in cash have no grounding. The grant of an employee stock option does not constitute an economic cost to the company. In fact, the issuance of employee stock options normally has no measurable cost to a company, but rather has future benefits to the entity and its shareholders. When we grant an employee stock option, we do not experience an outflow of assets or a decline in asset value as a result of the stock option grant. Imputing an expense into our income statement would imply that there is an economic cost; that there is an incremental cash outflow required to generate operating revenue when there is no such economic cost and no outflow has or will occur.
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> Second, the dilutive effect of stock option grants is already included in the calculation of EPS. Therefore, including the expense is a double impact on EPS. We believe that if expensing of employee options is mandated, a large segment of the investment community will discount or completely ignore these non-cash expenses. If the intent of financial statement standards is to promote financial statements that present meaningful, accurate and transparent financial information to investors and other parties of interest, requiring option expense based on estimated fair value will ultimately create confusion, not clarity. To illustrate our point, please consider our recent history with SFAS No. 123 pro-forma expense.

In 2003, we reported a net loss of $89 million. Had we included the SFAS No. 123 pro-forma expense amount, our loss would have increased dramatically to $147 million. The $58 million increase in loss relates to non-cash compensation calculated using the Black-Scholes valuation model. By contrast, we paid approximately $157 million in cash compensation to employees in 2003. At the end of 2003, we had approximately 19 million options outstanding. Due to a significant decrease in the trading price of our stock, only 214,000 options were exercised in 2003 and we received cash of $2.2 million related to those option exercises. Actual employee compensation included in employee W2's for 2003 was $1.2 million. Nearly all of our current options are out of the money by a significant margin. We cannot predict, nor can any option pricing model predict, how many options will ultimately be exercised. But we are comfortable in concluding that a reader of our financial statements would not have better understood our business, results of operations or prospects for the future by seeing $58 million in non-cash expense in our income statement.

We believe that stock options give employees at all levels a stake in the success of a company and encourage hard work and entrepreneurial spirit that fuel innovation, increase productivity and boost shareholder returns. We also believe that stock option programs are good for shareholders because employees are rewarded only if their company's stock value increases.

We also believe stock options have proved to be a valuable tool to increase jobs and grow the U.S. economy. Companies across the industry sectors have successfully used options to attract talent and more closely align interests of employees with those of the companies. Mandatory expensing may discourage use of options, thus discouraging entrepreneurship and business development. More than an accounting issue, many believe it is an economic issue that would have far-reaching negative consequences on many U.S. industries, hurting workers, competitiveness and innovation.

We appreciate the opportunity to comment on the proposed statement. We urge the Board to consider these comments as it deliberates share-based payment issues and proceeds to the issuance of a final standard. Please do not hesitate to contact me or Randy Lazzell, Controller, Financial Management at 303-566-1691 with any questions on our comments.

Sincerely,

Jill Stuart
VP Accounting & Finance and Chief Accounting Officer
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Attachment

Specific Issues discussed in the proposed Statement and our responses

Recognition of Compensation Cost

Issue 1: The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13-C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusion?

> *No. It is our view that an income statement expense should not result from the issuance of an equity instrument that does not give rise to an outflow or decrease of corporate assets. If expensing were mandated, we could only rationalize it based on the accounting of the service received (which we would not support as we do not believe the service should be measured at something other than the corporate asset given in exchange).*

Issue 2: Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair value based method of accounting had been used. For the reasons described in paragraphs C26-C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?

> *Paragraph C29 of the proposed Statement argues that our financial statements would be more transparent if the fair value of employee stock option grants were included in our income statement. We disagree. In fact, we believe that expensing options would result in a more distorted picture of our actual performance and economic condition. In fact, we believe that the granting of employee stock options has no measurable cost to a granting entity, but rather has future benefits to the entity and its shareholders.*

> *Investors and other users of our financial statements indicate that they care most about our ability to generate future net cash inflows and that their primary interest in the financial statements we provide is that they accurately depict our ability to do so. We believe that our investors would find financial statement information that has no bearing on our ability to generate future cash flow irrelevant or confusing and that they would adjust for non-cash impacts when analyzing our financial statements, thereby debasing our published financial statements. In addition, different methods of expensing options by different companies will make it very difficult, if not impossible for investors to analyze comparable results, thereby further creating the necessity to remove this expense from their analysis.*

Issue 4(b) Do you agree with the Board's conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because if offers greater flexibility needed to reflect the unique characteristics of employee share options? If not, why not?

> *Given our history of the distortion between the reality of option valuation models and real cash-based compensation, we recommend an approach that ultimately reconciles the*

value to a cash-based transaction. In the past three years our FAS 123 calculations resulted in pro forma compensation of $58 million, $68 million and $75 million in years 2003, 2002 and 2001, respectively using the Black Scholes model. In the aggregate during those three years, employees exercised approximately 6% of the outstanding options and realized $1.3 million, $0.058 million and $48 million in compensation income for years 2003, 2002 and 2001, respectively. The lattice model, while adding greater flexibility, adds more complexity and would still result in the distortion described above because we believe these models are less precise with highly volatile stock.

Issue 4 (c) If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24-B26 to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. We agree with this statement. However, we believe that projecting future volatility is no more than a guessing game. However, we believe that past volatility is not the best measure of predicting the future and that other factors should be considered.

Attribution of Compensation Cost

Issue #9: For the reasons described in paragraphs C89-C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost of awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That 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. Do you agree with that accounting treatment? If not, why not?

No. The company's intent was to spread the grant ratably over the service period and therefore give the employee the opportunity to realize some benefit equally over the service period. Under the Board's graded vesting, the earlier periods are burdened with more expense and therefore not matched to employee rewards.