



Via E-Mail

January 31, 2003

Letter of Comment No: 185  
File Reference: 1102-001  
Date Received: 1-31-03

Financial Accounting Standards Board  
of the Financial Accounting Foundation  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

[director@fasb.org](mailto:director@fasb.org)

Re: MP&T Director - File Reference 1102-001

Dear Sir or Madam:

On behalf of my company, Advanced Fibre Communications, Inc. ("AFC"), thank you for the opportunity to submit our comments on the topic, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, Accounting for Stock-Based Compensation, and Its Related Interpretations, and IASB Proposed IFRS, Share-Based Payment*, dated November 18, 2002. The financial reporting of stock options is a significant issue for our Company and we appreciate your consideration in this matter.

AFC is a telecommunications company headquartered in Petaluma, California. We have approximately 850 employees and we are one of the largest employers in our community. We develop, manufacture, and support a family of telecommunications access products and services that enable telephone companies to connect their central offices to customers for voice and high-speed data communications. We are proud of the fact we offer stock options to all our employees, which enables us to attract and retain talented personnel. By giving employees at all levels a chance to share AFC's financial success through equity ownership, we believe that broad-based stock option plans boost productivity and are essential to America's competitiveness and economic growth.

With regard to FAS 123 and its amendments under FAS 148, we commend the Board for requiring quarterly disclosures of information related to employee stock options. Investors should have timely, accurate and meaningful information about employee stock options in order to make informed investment decisions. The Board's action in this regard was therefore a positive step. We firmly believe, however, that employee stock options do not represent an expense. Any attempt to mandate the expensing of options is misleading and inaccurate because there are no models that can accurately compute a "cost" of the options.

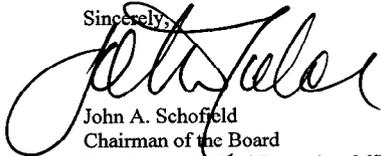
Accordingly, we believe that most modifications of FAS 123 in comparison with the IASB's *Share-based Payment* would not provide any more accurate or meaningful financial information to investors than what is already provided under FAS 123.

Models like Black-Scholes produce wide-ranging, and therefore often misleading, results. These models allow for huge differences in the expense calculation depending on what inputs are used. As you are aware, the volatility of a stock price has a significant impact on the expense calculation. Commonly used historical estimates of volatility can vary over a significant range depending on the length of the historical period and the sampling frequency (e.g., daily, weekly, etc. stock price) selected during the period. For example, AFC's closing stock price has ranged from \$4.44 to \$85.00 over less than a 2-year period (our closing stock price on January 30, 2003 was \$16.66). Accordingly, it would be impossible for us to predict what the volatility of AFC's stock price will be in the future. Thus, mandating a particular model to compute the cost of options would be as misleading to investors as mandating the expensing of options.

We have attached to this letter our comments to the issues presented for the primary similarities and differences of FAS 123 and the proposed IFRS that are relevant to our financial reporting. As previously indicated, we do not believe that most of the principles under the proposed IFRS would provide any more accurate or meaningful financial information to investors than what is already provided under FAS 123. Furthermore, we do not believe that stock options should be treated as an expense and mandating this treatment does not provide investors with any more clarity or accuracy in understanding financial results. The expensing of options would likely require AFC to discontinue its broad-based stock option plan that helps us to retain and motivate our employees.

Again, thank you for the opportunity to comment on this comparison of FAS 123 and the IASB's proposed IFRS. We look forward to working with you in the future to help serve the information interests of investors.

Sincerely,



John A. Schofield  
Chairman of the Board  
President and Chief Executive Officer

Attachment

**Invitation to Comment – Accounting for Stock-Based Compensation:  
A Comparison of FASB Statement No. 123, *Accounting for Stock-Based  
Compensation*, and Its Related Interpretations, and IASB Proposed IFRS,  
*Share-Based Payment* – Issued November 18, 2002**

**Issue 1:** Should broad-based Employee Stock Purchase Plans (ESPPs) which meet certain standards continued to be exempted?

**Response:** Yes. Both the IASB proposal (*no exclusions*) and FASB Statement 123 (only 5% discount *at purchase* permitted to be noncompensatory) should be rejected. We urge the FASB to preserve the existing noncompensatory exemption for broad-based plans in paragraph 4 of Opinion 25 in any new stock option accounting standard.

Our reasons are twofold. First, the existing exemption has caused no concerns, raised no controversy, is of de minimis dilutive effect, and is not part of the current debate on employee stock option efficacy. These ESPPs and all-employee options are benign productivity incentives, approved by shareholders for the purpose of incentive alignment, not compensation. Second, the IASB is concerned about consistency which is ironic since both the IASB and the FASB proposals would maintain a blatant and discriminatory inconsistency between employee stock options and convertible securities which have option features but for which no expense is recorded on income statements. So, until consistency becomes an overriding accounting objective for all similar transactions, there is no reason to discriminate against broad-based plans, when the real objective is behavioral modification for executive options.

\* \* \*

**Issue 2(a):** Should FASB mandate use of an option-pricing model for measurement purposes? If not, what other approaches do you believe would provide more consistent and reliable estimates of the fair value of employee stock options granted and why?

**Response:** All option-pricing models were developed for short-lived transferable options which trade in the public markets. Thus, their accuracy can be verified and modifications made. Such is not the case with employee stock options which have different characteristics than public options. There exists no option-pricing model for employee stock options that recognizes these differences to our knowledge. Both the IASB and FASB propose using option-pricing models developed for publicly traded options to estimate the “fair value” at grant of employee options for expense recognition purposes, with only two modifications to reflect the special characteristics of employee options:

1. Adjustments for forfeiture
2. Use of “expected” option term, to recognize nontransferability

These adjustments do not fully reflect the negative characteristics of employee options, which include:

1. Option is forfeitable until vested -- recognized in adjustment 1 above
2. Option is not exercisable until vested -- recognized in European call valuation models, such as Black-Scholes
3. Option is nontransferable, and once exercised, dies -- addressed by adjustment 2 above, but insufficiently (see later discussion)
4. Option term is truncated if employee terminates after vesting -- recognized by adjustment 2 above, but insufficiently (see later discussion)
5. Miscellaneous -- blackout periods, stock holding requirements, noncompete and forfeiture requirements

Option-pricing models do not purport to measure the *cost to the company* of granting options to employees. There is no “cost” per se that can be measured. Nor do they purport to measure the *value of the options to the recipient*. Rather, option-pricing models purport to measure the *amount of cash forgone* to the company by granting options to employees rather than selling them in the market. This forgone cash, then, becomes the “expense” recognized for the option in the income statement. Yet no evidence is offered, or claim made, that option-pricing models, as adjusted, measure what investors (or employees) would be willing to pay for options with characteristics similar to employee stock options.

We believe option-pricing models, as adjusted, *overstate the “fair value”* of employee options and, thus, the amount of cash forgone by not selling them in the market. “Fair,” as in fair value, means fair to both the buyer and seller. “Value,” as in fair value, means a price at which numerous willing sellers and buyers would agree to trade similar instruments: Since a buyer will not pay more than the perceived value to him or her, investors’ (or employees’) perception of the value to employees *is relevant* to the issue of “fair value.”

In addition to the special characteristics of employee options enumerated above that reduce their value vs. traded options, employees themselves bring certain attributes to the value exchange that result in a *further lowering* of the “fair value” of employee options:

1. Employees tend to be risk averse
2. They are already over concentrated in their employer’s stock

3. They cannot hedge their option position
4. They tend not to be sophisticated investors able to pick “highs” in their stock  
Thus, volatility is of less value to employees than public investors.

With regard to the use of option-pricing models for employee options, this is primarily for the purposes of comparing options granted in one company to a group of peers or the market as a whole, not for determining the real value to employees. In fact, when converting option values to real compensation, it is reasonably common to apply a *significant reduction* to option values determined using option-pricing models.

The major difference between employee options and traded options is that employee options are *nontransferable*. Except for death, they may be exercised only by the employee. They may not be sold to someone else. And once exercised, they die. The FASB’s and IASB’s answer to this difference is to simply allow use of “expected” life, rather than contractual life, of the option in measuring “fair value.” But this does not adequately account for the loss of remaining time value when the employee option is exercised before its end, as is often the case. It measures the difference in time value between expected and contractual life *when the option is granted*. But this is far less than the *forgone time value at the point of exercise* when the option is exercised early.

Given the pervasive view that option-pricing models, as adjusted, overestimate the “fair value” of employee options, we see the FASB as having three choices:

1. Sponsor development of an option-pricing model to more accurately determine the “fair value” of employee options
2. Permit further adjustments to market-based option-pricing models to reduce the “value gap” for employee options.  
  
– See our response to Issue 2(d) below, or
3. Abandon the goal of measuring the “fair value” of employee options as unachievable in the absence of a public market for employee options. Instead, adopt the *“minimum option value method”* (MOVm) which clearly and simply measures the value of allowing the employee to delay payment of the option’s exercise price, risk free.

The problem with the fair value approach proposal by both the FASB and the IASB is that it does not result in a “fair value” for an employee option at grant. Thus, the objective of “leveling the playing field” between fixed-price options and other forms of equity incentive will not be achieved. Practice will be *biased against options* because few companies will be willing to incur an expense for a form of compensation significantly greater than the value perceived by recipients. Instead, the FASB and IASB will have

been used by the behavioral modificationists who want to see stock options eliminated as a form of employee incentive.

\* \* \*

**Issue 2(b):** If you agree that an accounting standard should mandate the use of an option-pricing model, do you believe that a particular model should be mandated? If so, which model should be required to be used and why?

**Response:** No particular option-pricing model should be mandated; we believe this provides flexibility as new models evolve.

\* \* \*

**Issue 2(c):** If you agree that an accounting standard should not mandate the use of a particular option-pricing model, do you believe that additional disclosures should be made to improve the user's ability to compare the reported financial results of different enterprises? If so, what types of additional information should be required to be disclosed?

**Response:** We do not support the additional disclosures required by the Proposed IFRS.

\* \* \*

**Issue 2(d):** What modifications to option pricing models should be made to improve the consistency and reliability of measurement?

**Response:** Here are our recommendations for alternative modifications to option pricing models, or to their outcomes, to close the value gap and "improve the consistency and reliability of measurement":

1. Cap volatility for individual stocks at industry norms; further reduce "fair value" outcomes for maximum term by a predetermined 40% to recognize all the miscellaneous negative characteristics of employee options vs. traded options
2. Use *vesting date* as the expected option term
3. Measure "fair value" using maximum contractual term, and expense such value over the vesting period as proposed. But then allow an adjustment to income at option exercise or expiration for the "fair value" of the option *at that point* less intrinsic value (i.e., option gain realized), if any
4. Eliminate the highest 1% of the valuation scenarios of market-based option-pricing models on the assumption that they are not likely to be achieved but have a

disproportionate effect on the resulting estimates, particularly of high-volatility stocks

\* \* \*

**Issue 2(e):** Do you believe that additional guidance for selecting the factors used in option-pricing models is necessary to provide added consistency and comparability of reported results? If so, what types of guidance should be provided and in which areas?

**Response:** We do not think additional guidance is necessary.

\* \* \*

**Issue 3:** Should there be different measurement dates for equity instruments granted to employees and nonemployees?

**Response:** No, there is no reason to distinguish the measurement dates for equity grants to employees and nonemployees.

\* \* \*

**Issue 4:** Should the fair value of equity awards granted to nonemployees that include performance conditions be measured as of the grant date?

**Response:** Yes, the same as for employees (see our responses to Issues 5 and 6). All equity grants should be valued as of the grant date (IASB approach). Changes in the value of an equity instrument after the grant date are on account of an equity interest, not compensation.

\* \* \*

**Issue 5:** Is the notion of “issuance” (FASB approach) conceptually of importance in the design of a standard on stock-based compensation?

**Response:** No, we favor the IASB’s approach which focuses on the fact that an equity instrument exists as of the *grant* date, and its value does not change based on whether or not conditions for vesting are met. We agree with the IASB that equity instruments should not be remeasured at a vesting date. This conclusion also drives our response to Issues 6 and 7.

\* \* \*

**Issue 6:** Should an equity instrument subject to vesting or other performance conditions be deemed issued, as defined by Statement 123, at the grant date?

**Response:** Yes, see our response to Issue 5. Estimates of the probability of vesting, both with respect to continued employment requirements and performance earnout, can be reasonably made as of the grant date, and then need not be “trued up” based on actual vesting (IASB approach), except as recommended in our response to Issue 12.

\* \* \*

**Issue 7:** Should the effect of forfeiture be incorporated into the estimate of “fair value,” as proposed by IASB, or should reversals of prior accrued expense be permitted when forfeitures occur (SFAS 123 approach)?

**Response:** Yes, see our response to Issue 6. The effect of forfeiture should be incorporated into estimates of “fair value” at grant (IASB approach) and then reversals of prior accrued expense should *not* be permitted when forfeitures caused by employment termination actually occur (IASB approach). Unamortized expense should be cancelled as of any reporting period in which forfeiture occurs.

\* \* \*

**Issue 8:** Should failure of an equity holder to satisfy conditions required to earn an award affect recognized compensation expense?

**Response:** No, if the failure relates to employment termination (see our response to Issue 7). Yes, if the failure relates to failure to meet a performance condition (see our response to Issue 12).

\* \* \*

**Issue 9:** Do you agree that the result of the IASB’s approach to calculate the fair value of equity instruments of nonpublic entities would be closer to fair value than minimum value?

**Response:** We are a public company and therefore this issue is not applicable.

\* \* \*

**Issue 10:** Which is the preferable method to accrue grant date compensation expense over the vesting period: the service-based method (FASB approach) or the units-of service method (IASB approach)?

**Response:** The units-of-service method seems conceptually superior but is extremely difficult to understand and explain, hence undermining credibility. Since the FASB’s service-based method has caused no practice problems and is well accepted, we recommend it be retained.

\* \* \*

**Issue 11:** If you support the IASB's units-of-service attribution method, do you believe it ascribes an appropriate value to services received prior to forfeiture?

**Response:** No response because we do not support IASB method.

\* \* \*

**Issue 12:** Should the actual outcome of performance awards affect total compensation expense (FASB approach) or not?

**Response:** Yes, actual outcomes of performance-based equity grants should affect total compensation expense. Specifically, an estimate of the probability of meeting any performance vesting conditions should be incorporated into the value determination *at grant*, just like forfeiture estimates for continued-employment conditions. Then, these grant-value estimates *per share* should not be "trued up" based on actual outcomes (see our response to Issue 6). However, there should be an adjustment at vesting for the *actual number of shares earned (or forfeited)* based on the performance outcomes. Without a requirement to reconcile actual shares issued to prior accruals, there could be the bizarre outcome of employees receiving *far more* or *far less* shares than had been recorded as expense. The result would be to exacerbate swings in operating earnings and to reduce the reliability of reported earnings. An analogy to the IASB's approach would be to require that accruals of target bonus amounts not be reconciled to actual bonuses paid because the company got the services from the employees anyway.

\* \* \*

**Issue 13:** When the expected life of an employee option runs beyond the vesting period, do you believe expense should be amortized over the option's expected life or do you believe it is reasonable to amortize expense over the vesting period as is proposed by both the FASB and the IASB?

**Response:** Since the employee's right to the option's gain is fully earned and accrued as of the vesting date, any delay in exercising is an investment decision on the employee's part and does not relate to compensation for services. Consequently, we recommend the FASB and IASB substitute vesting date for expected option life in the option-pricing model assumptions.

\* \* \*

**Issue 14:** Do you believe the measurement-date criteria for equity transactions with nonemployees in EITF Issue 96-18 accurately reflect the economics of the transaction?

**Response:** In our response to Issue 3, we said grant date valuations should be used consistently. Also, we believe grants to outside directors should be treated no differently than grants to employees.

\* \* \*

**Issue 15:** Should the actual tax benefits received by employers in connection with equity awards be recognized in the income statement (IASB approach) or not (FASB approach)?

**Response:** We favor the IASB's approach of recognizing actual tax benefits received, whether more or less than the tax benefit based on the fair value at grant. This reflects expense and cash flows that actually occur, and hence will result in more representationally faithful and accurate income statements. The FASB's historic approach of directly crediting to capital surplus realized tax benefits that exceed recorded tax benefits is flawed and should be immediately abandoned.

\* \* \*

**Issue 16:** Do you believe that the additional disclosure requirements proposed by IASB, in addition to those required by Statement 123, will be useful?

**Response:** We do not believe the additional disclosures proposed by IASB, having to do with how valuation estimates were arrived at and how actual outcomes differed from estimates, offer useful or important information to investors or other users of financial statements. It is up to the auditors to watchdog the assumptions, not investors. The other information suggested in paragraphs 84 - 86 would be interesting but also not useful or important. Simplified *information which would be useful* to investors is (1) options/SARs granted each year as a percentage of average shares and share equivalents outstanding during the year ("run rate"), (2) options/SARs outstanding at year end as a percentage of total shares plus options outstanding ("overhang"), and (3) the dilutive effect of equity incentives on Basic EPS (dollar amount per share and percentage).

\* \* \*

**Issue 17:** Please describe any additional disclosures that you believe should be required in order to inform a user of financial statements about the economics of stock-based compensation arrangements.

**Response:** We are not aware of additional disclosures that would be useful to users of financial statements.