Karen Salmansohn

From: Director - FAS
Sent: Monday, Febr
To: Karen Salman
Subject: FW: (File Refe

Letter of Comment No: 166
File Reference: 1102-001
Date Received: 2-1-03

InterScan_SafeStamp.txt

-----Original Message-----
From: Jeff_Rodek@hyperion.com [mailto:Jeff_Rodek@hyperion.com]
Sent: Saturday, February 01, 2003 4:36 PM
To: Director - FASB
Subject: (File Reference No. 1102-001)

Background

Originally, employee stock option plans were used primarily by start-ups and turnarounds where cash was short and/or the upside opportunity was much larger than the downside risk. Options became a critical component of the total package to attract top talent to these situations, as they needed to motivate management teams to work long hours under adverse conditions to create value from scratch or make the tough decisions necessary and take the personal/professional risk to rebuild a company's momentum, credibility and value in the marketplace.

In the 1980's and 1990's, the use of options became more widespread, first among the majority of the employee base of most technology firms, and later among the upper echelons of more traditional industrial and service firms. While traditional firms have relied more heavily on "tried and true" cash-oriented compensation plans, technology companies have favored relatively leaner cash, more highly variable, equity-oriented compensation packages. Stock options contributed significantly to the technology and productivity boom of the late twentieth-century. Options are a tremendous vehicle to drive discretionary effort focused on improved performance that is in the best interest of shareholders. On the downside, the resulting dilution to shareholders, if the grants are too large and/or executive compensation is excessive, have led to controversy.

Current Environment

The key design point of a stock option plan is to provide a "variable" (as opposed to "fixed") compensation program that makes managers and employees think and act like owners by paying them like owners. Owner incentives are not a cost to be minimized but a share of value to be maximized.

Hyperion's Philosophy on the Use of Stock Options

Hyperion's total compensation program has four key components:

fixed cash compensation (i.e., base salary); variable cash compensation (e.g., bonus or commission); stock options; and employee benefits (e.g., medical plans, 401(k) plan, etc.). For many employees, and for senior executives in particular, potential gains from the exercise of stock options represent a substantial portion of an individual's total compensation package and potential for capital gains tax treatment. Our total compensation targets are established using industry benchmarks.

As noted in the Hyperion Fiscal 2003 Stock Option Policy, the Company grants three distinct types of employee stock options: new hire options, annual performance options, and discretionary merit options. Employee stock options provide significant performance and retention incentive, and if granted properly, result in no charge to the Company based on current accounting standards. It is important to note that stock options, when exercised, transfer real economic value to our employees. These options do dilute earnings per share, and we weigh performance and retention incentive value against the cost of dilution each year when we develop our annual employee stock option budget. Obviously we also look at our forecasted earnings growth to determine an options budget.

We believe our option practices are in line or slightly better than our peer group and acceptable by technology industry standards based on an independent benchmark study. In fiscal 2001, Hyperion granted 8% of its options to its five highest paid officers vs. 19% average among its peers. In fiscal 2002, our top five highest paid officers, including a newly recruited COO and CMO, were granted 29% of total options. Peer data is not yet available for 2002. The Company awarded options to 81% of total employees in FY2002. In addition, we have amended our option plan to prohibit option repricing without shareholder approval. In November of 2002 we received a recommendation to vote for our stock plan changes and additional shares by ISS.

Hyperion's Views

Hyperion believes that the real issues underlying the controversy surrounding stock option accounting are the ethics, integrity and option excesses of the management and boards of selected companies. At the heart of the issue is shareholder dilution and abusive executive compensation practices. .

While GAAP doesn't require companies to record as expense the fair value of options granted (only disclosure required in their footnotes), it should be noted that profitable companies must account for the dilutive impact of "in the money" options as part of their diluted EPS calculation.

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Methods of calculating the expense of option grants are very problematic, for example Black-Scholes.

Problems and/or challenges with using Black-Scholes Option Pricing Model

- Future stock price volatility is based on subjective assumptions including: number of years of historical results; future term
- No recognition of expirations
- Assumes options can be freely traded. Employee stock options are non-transferable.
- Assumes three- to nine-month timeframe even though most stock options vest over several years (typically three to five years)

As a result, many investors or analysts will resort to pro-forma calculations to try and create "apples to apples" comparisons. This is exactly the wrong direction.

Possible Solutions to the Options Abuses and/or Disclosure Problems

- Enhanced 10-K and 10-Q disclosures that highlight options granted to five highest paid officers, five year option grant history with comprehensive analysis of option distribution and dilution impact.
- Improved disclosure of Companies' option philosophy to shareholders, such as limiting net option grants to 3% of outstanding shares per year.
- Option plan modifications in one or more of the following ways: to prohibit repricing of options for top executives or for all option holders; to prohibit below market grants, and to prescribe shorter option terms (e.g. 5-6 vs. 8-10 years).

The impact of stock options is already recognized in the dilution of EPS. Improved disclosures and shareholder approval of plan terms and conditions would improve an incentive program that overall is very valuable but could be improved by increased disclosures of usage and corporate incentive philosophies and benchmark comparisons. A dramatic change to force companies to expense options would unduly penalize many companies who have contributed enormously to corporate productivity and who also have created some of the most passionate work environments in the world. Improve disclosures but do not force an imprecise expense calculation to arbitrarily reduce the usage of a very valuable incentive tool that when used properly excites employees to work in the best interest of shareholders.

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