

June 29, 2004

Robert H. Herz, Chairman  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856-5116

Letter of Comment No: 5477  
File Reference: 1102-100

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Dear Chairman Herz:

The purpose of this letter is to express my concern that the FASB's position with respect to the accounting treatment of stock based compensation is theoretically flawed and will result in unnecessarily misleading financial reporting.

In particular, I am referring to the requirement to recognize expense relating to stock option grants and discounts provided under employee stock purchase plans.

**Stock Options**

(Note: To simplify the discussion, I am generally referring herein to traditional stock options issued with "at market" strike prices, with typical vesting provisions. The arguments can be adapted for other circumstances, but to address those here unnecessarily complicates the discussion, without adding to the substance of the issues.)

The expensing of stock options is flawed for at least three principal reasons. First, the issuance of stock options is not an expense of the company; it is, instead, a capital transaction. Second, recognition of expense relating to stock options and the inclusion of the same stock options in the calculation of fully diluted shares in the earnings per share calculation is logically flawed. Third, the guidance provided for valuing stock options does not necessarily yield a "fair value" result and also has the consequence of adding overall stock market risk to a corporation's operating results. These concepts are more fully developed below.

***The issuance of stock options is not an expense of the company.***

The issuance of stock options will never result in an outflow of or reduction in corporate funds or other corporate assets. This is a fundamental requirement for the recognition of an expense. The stock option transaction simply never meets this requirement. To the contrary, upon the exercise of a stock option, assets flow into, not out of, the corporation. Accordingly, the issuance of stock options is not an expense of the corporation. Instead, it is a capital transaction in the company's stock and should be accounted for as such.

To the extent that stock option grants affect shareholders as a group, the grants should be comprehended in dilution calculations, not in arriving at net income of the corporation. Under present rules, that already happens naturally. Upon the exercise of an option, cash paid for the exercise becomes an asset of the corporation, the issued shares become part of the primary shares

outstanding and any dilution to other shareholders is implicitly included in any subsequent per share measures. Prior to exercise, options are quite effectively included in the calculation of fully diluted shares and fully diluted earnings per share through the well conceived treasury stock method.

***Recognition of expense relating to stock options and the inclusion of the same stock options in the calculation of fully diluted earnings per share is logically flawed.***

If logic is abandoned and stock option expensing is, after all, to be mandated, then the error of this should not be compounded by continuing to include the same options that create an expense on the corporation's books in the denominator of the of fully diluted earnings per share calculation under the treasury stock method. Such double counting is logically flawed and the result would be an inaccurate and misleading financial measure. The logic of this seems so obvious that it doesn't need further clarification. If stock option expensing is mandated, the treasury stock method of computing fully diluted shares outstanding needs to be modified to exclude the stock options that give rise to the expense.

***The prescribed methods for valuing stock options are flawed and have unintended consequences.***

It has been well documented that the methods prescribed for determining the valuation of stock options are flawed and do not result in the best approximation of "fair value" – as would be determined in transactions between willing buyers and sellers. There are a number of theoretical flaws in the prescribed methods, including the facts that employee stock options aren't freely transferable and that there isn't a ready market for them, to name a few.

A simple example demonstrates the point very effectively. Say today's closing price of the stock of Quinton Cardiology Systems, Inc. (Quinton) was \$10.0 per share. Say yesterday's closing price was \$10.50 per share. There was no new information and there were no fundamental changes in the business between yesterday and today – the stock price fluctuation was purely externally based. Under either the Black and Scholes method or a binomial (lattice) method, an option granted yesterday, with a strike price of \$10.50, would be valued higher than an option granted today, with a strike price of \$10.00. This is an economically unsound result. Clearly an option to purchase Quinton stock at \$10.00 per share is worth more than an option to purchase Quinton stock at \$10.50 per share. The prescribed valuation models would yield the contrary result, however.

There is also a more subtle issue related to the proposed valuation methods that is often overlooked. The use of the stock's price volatility in determining the value of options inherently introduces overall stock market risk into the company's operating results. To the extent that the fluctuations in the overall stock market affect the volatility of an individual company's stock's price and to the extent that this affects the value of the options that are charged to expense, the overall stock market performance will have a direct impact on the company's operating results.

While the use of stock price volatility may be an appropriate factor to consider in the valuation of stock options, the fact that overall market volatility would affect the operating results of an individual company again highlights the misguided notion that stock option grants are an expense of the company in the first place.

Much has been written on the issue of how to value options by those more versed in valuation theory than me, so I won't attempt to solve the issue here. I will only suggest that more time and debate be allowed before the wrong standards are mandated.

### **Employee Stock Purchase Plans**

Discounts provided on sales of stock through approved employee stock purchase plans are, like stock option grants, capital transactions. They are not operating transactions of the corporation. As with stock options, the dilutive impact of such transactions is already naturally reflected in per share calculations under existing accounting pronouncements.

Further, the issuance of stock at a discount to employees should be treated no differently than the issuance of stock at a discount to other parties. Under current accounting rules, discounts provided to underwriters or brokers in stock sales are always recorded as direct equity transactions, as the related equity issuances are recorded at the net price realized by the company. As is quite appropriate, these equity issuances are not recorded at the gross price, with the discounts being charged as compensation expense for the services of the underwriters or brokers. It simply doesn't make sense to treat sales of stock to employees differently than sales of stock to others.

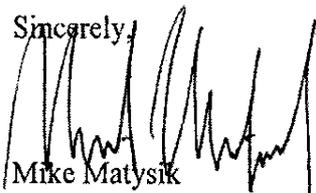
### **Conclusion**

In conclusion, the FASB should reconsider its position and rescind the decision to require mandatory expensing of stock based compensation. Existing rules already adequately and appropriately deal with the accounting and reporting issues relating to stock based compensation.

It seems that the FASB has succumbed to the temptation to react to broader social concerns regarding the use of stock based instruments as a form of compensation. In so doing, it has inappropriately overstepped its charter and forgotten its obligation to its constituents to help assure appropriate financial reporting. The proposed requirement to expense stock based compensation is simply not theoretically sound and would result in inaccurate and misleading financial reporting. Social issues should be left to the forces of the market, the government, the press, and society in general for debate and resolution.

Please do the right thing and rescind the decision to mandate the expensing of stock based compensation.

Sincerely,



Mike Matysik

Senior Vice President and Chief Financial Officer  
Quinton Cardiology Systems, Inc.