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June 29, 2004

Director of Major Projects
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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Re: Exposure Draft: Proposed Statement of Financial Accounting Standards
Share-based Payment
File Reference No. 1102-100

To Whom It May Concern:

I am writing in response to your request for comments on the Exposure Draft of the Proposed Statement of Financial Accounting Standards related to Share-based Payment. I am a member of the Small Business Advisory Committee to the FASB and recently participated in the first Advisory Committee meeting held at your offices on May 11, 2004.

I could not be more opposed to the implementation of this new standard for a broad range of reasons. First and foremost, I believe it is bad accounting. Financial statements will become less transparent, less comparable, more volatile, less understandable and less useful to the vast majority of readers. Second, I believe that implementation of the standard will be extremely costly, time consuming and difficult to audit. As one who signs numerous certifications that our financial statements are correct, accurate, in full compliance with accounting standards and SEC regulations and fairly present the financial condition of our company, I am very concerned about a standard such as this which will result in very material changes to our financial statements based solely on our guesses and estimates of future events which may be years off. Finally, I believe that implementation of this standard is bad policy, and will have a detrimental effect on our economy and on a broad range of rank and file employees who today have an opportunity to accumulate wealth through participation in the value they create, and through alignment with the interests of investors.

My specific comments follow:

First, the title of the Exposure Draft is misleading and incorrect. The granting of a stock option is not a share-based payment, it is not a payment at all. An SAR is a share-based payment, since it results in a cash payment based on the price performance of the underlying shares. Similarly, a phantom stock plan may result in a cash payment based on the performance of the underlying shares. A stock option is not a payment at all; rather, it is a right to participate in the creation of value of an enterprise. If no value is created, no payment is made by the enterprise and no value is gained by the option holder. If value is created, again, no payment is made by the enterprise but value is gained by the option holder in direct proportion to the value gained by the stockholders.

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 conclusions? If not, please provide your alternative view and the basis for it.

No. Stock option compensation cost should not be recognized in the income statement. The result will be a reduction in the transparency and comparability of financial statements due to the difficulty and variability of estimating stock option expense. Expense will vary widely from company to company and will, in effect, introduce stock price volatility into the income statement. For many companies, particularly those with broad-based plans, stock option expense will overwhelm actual operating expenses, making prediction of operating results and cash flows difficult if not impossible. P/E ratios will become even more volatile as reported earnings bear less relationship to operating cash flows and to enterprise value. Expensing stock options will introduce into the income statement an item that will never, under any circumstances, become a cash outflow.

The conceptual framework in CON 1 provides that “financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions.” It further states that “...financial reporting should provide information to help investors, creditors and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise.” The argument that stock option expensing will somehow increase the transparency and comparability of earnings is completely backward. Because of the complexity and difficulty of estimating option expense, comparability among financial statements will be diminished, and only those with sophisticated financial analysis capabilities will be able to restate the financial statements to put them on a comparable

basis (i.e. without stock option expense). Even those who possess this level of sophistication will not have sufficient information to make all of the necessary adjustments, since compensation expense will be buried in virtually every operating expense line item and in many of the balance sheet accounts as well (i.e. inventory).

The conceptual framework in CON 5 provides that “revenues and gains are realizable when related assets received or held are readily convertible into known amounts of cash or claims to cash.” The general requirement of certainty in amount and time are not met by this proposed standard.

The conceptual framework further provides in CON 6 that “Expenses represent actual or expected cash outflows that have occurred or will eventuate as a result of the entity’s ongoing major or central operations.” By this definition, the grant of a stock option can never result in an expense since the option will never result in a cash *outflow* from the entity. In fact the option, if exercised, will result in a cash *inflow* to the entity as a capital stock transaction. The economic reality of the issuance of an option is a dilution of the interests of stockholders as the result of sharing a portion of the ownership of the company with employees. This economic effect is already recognized in dilution of EPS and has no bearing on the earnings of the entity, or on its ability to generate cash flows.

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?

No. Current disclosure requirements provide a great deal of information regarding the number, kind and distribution of option grants among employees. Because of the great variability of estimates of option expenses based on different assumptions about stock price volatilities, employee behavior patterns, vesting requirements, interest rates, etc., the option expense calculation will not be in any way comparable from company to company. Thus, embedding such a number into the financial statements will only reduce comparability. With disclosure, the information is there for any reader to use as he or she sees fit. With recognition, the expense estimate will be embedded in the statements where readers will not have the ability to back it out.

If current disclosure is deemed inadequate, let’s improve the disclosure, not ruin the income statement. Of the many people and organizations I know who are adamantly opposed to stock option expensing, not a single one objects to improved disclosure. This is because they all believe that providing investors with *useful* information is good for our companies and our capital markets.

Measurement Attribute and Measurement Date

Issue 3: This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Paragraphs C16–C19 and C53 explain why the Board believes fair value is the relevant measurement attribute and grant date is the relevant measurement date. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

No. Although it may be appealing on a theoretical basis to require recognition on the grant date at fair value, the practical realities are daunting. This method will require a huge amount of estimation and calculation on a quarterly basis and will be extremely difficult, if not impossible, to audit. Good accounting practice requires that amounts be reasonably certain in amount and timing before they are recorded in a company's books. Option expense is neither reasonably certain in timing or amount.

A far more practical approach would be to recognize expense at fair value on the date of exercise. This would eliminate all estimation and guesswork regarding the probability and value of exercise and yield a clear, one time, auditable expense calculation that would not require an army of consultants to verify.

Fair Value Measurement

Issue 4(a): This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure the fair value of equity and liability instruments awarded in share-based payment arrangements with employees. In the absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk-free interest rate (paragraph 19 of Appendix A). Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model (paragraphs B13–B30). Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?

No. The statement provides almost no guidance that will ensure consistency of application. In fact, consistency of application is virtually impossible because the nature of the fair value calculation is only a theoretical estimate of what a market participant might pay for such an instrument. Unlike virtually every other accounting measure, which is based on actual, measurable cash events, the fair value estimate of a stock option is a theoretical measure of an event which never happens.

Although you have been advised by “valuation experts” that tools exist to make these theoretical estimates, these tools are extremely complex, unproven, and not commonly used in practice. The large number and broad range of assumptions required to arrive at a valuation using these models will result in vast differences of application and valuation, and will by definition not be comparable. The accounting firms will require extensive backup for each assumption in order to render an audit opinion. While the “valuation experts” will, of course, advise you that this can be done, it can only be done with extensive support from the “valuation consultants” – a conflict if ever I’ve seen one.

The rank and file accounting staffs of the vast majority of public reporting companies are not equipped to implement this requirement without substantial expense and support, and FASB has provided little or no guidance on how to implement the requirements. The Exposure Draft should explicitly permit the use of the Black-Scholes model and should provide examples of adjustments that could be made (and are currently being made for footnote disclosure) to recognize the shortcomings of the model. Small companies, in particular, will have a very difficult time implementing and auditing a lattice model approach. Paragraphs B13-B30 serve only to add more questions relating to the many parameters which must be considered for each of the major assumptions to the lattice model. This only broadens the range of issues to be addressed. Proper guidance would narrow the range by providing answers to these questions.

Issue 4(b): Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. 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 it offers greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?

No. While a lattice model may be an improvement over the Black-Scholes model from the standpoint of greater flexibility, it is subject to the same and even greater problems with respect to the number, complexity and uncertainty of assumptions required. Most small technology based companies have very limited accounting staffs, and limited cash resources to apply to theoretical exercises such as this. For small companies the cost of implementation far exceeds any benefit that would result from the calculation of a theoretical non-cash cost estimate. Auditors will require the use of a preferred method unless it can be demonstrated that use of the method is not possible. This places a tremendous burden on companies trying to implement a new and complex standard.

The FASB should explicitly allow the use of the Black-Scholes model and provide guidance on adjustments that could be made to recognize the shortcomings of the model in its application to employee options. This approach would at least be able to be implemented by most filing companies, and would provide an audit safe harbor.

Issue 4(c): Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. 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. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

Estimating volatility is one of the most difficult problems in implementing any fair value model of stock option expense. It is also the single factor with the largest impact on the resulting expense estimate and is the most difficult number to audit. Different companies will use different methods and assumptions to estimate volatility and thus the results will not be comparable. Companies will have an incentive to select a method that minimizes volatility, and hence option expense. This is an excellent example of an area where the FASB has not provided nearly enough guidance. Paragraphs B24-B26 only raise additional questions. One of the largest components of volatility in the technology and biotech sectors is market volatility. This is a component over which companies have neither control nor any predictive ability.

If, however the FASB mandates a particular method to estimate volatility, it will clearly not fit many of the companies forced to use it (e.g. the use of historical volatility mandated under FAS 123). This problem is inescapable, and is one of the strongest reasons that option expensing is a bad idea that will result in less comparability and less utility of earnings reports.

Issue 4(d): This proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant date fair value. For example, to take into account the nontransferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option's contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option's fair value? Please provide the basis for your position.

Asking companies to estimate the exercise behavior and post-vesting employment termination behavior of potentially hundreds or thousands of employees is not accounting, it is stargazing. When possibly the largest single expense category on a company's financial statements is determined by such guesswork, the resulting financial statements will cease to be transparent, comparable or useful.

Issue 5: In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date (paragraphs 21 and 22 of Appendix A). Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value? (Refer to paragraphs C66 and C67 for the Board's reasons for selecting that method.) If not, what other alternative do you prefer, and why?

No. This method effectively makes the stock market value of the company an element in its income statement. It may for some technology companies be one of the largest components of the P&L, moving up or down quarter to quarter with the whims of the market. A better alternative would be APB 25.

Employee Stock Purchase Plans

Issue 6: For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?

Yes, I agree with the principle. However, if companies are forced to expense the difference between the employee purchase price and the fair value on the date of purchase, I think these plans will cease to exist.

Attribution of Compensation Cost

Issue 7: This proposed Statement would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?

Again, on a theoretical basis recognition over the service period seems appropriate, but in practice it is not feasible. First, what is the relevant service period? Is it the year of grant? the vesting period? the holding period? Is it different for each employee, depending on how the employee views the grant? Second, recognition of what? Even though a theoretical fair value estimate can be calculated, there is no way of predicting at the grant date that any value will actually be realized.

Issue 8: Determining the requisite service period would require analysis of the terms and conditions of an award, particularly when the award contains more than one service, performance, or market condition. Paragraphs B37–B49 provide guidance on estimating the requisite service period. Do you believe that guidance to be sufficient? If not, how should it be expanded or clarified?

No, the guidance is not sufficient. See answers to Issue 7 and Issues 4a-4d above.

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 for 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. This will create a nightmare of complexity for anyone involved in administering broad-based plans. We currently have over 7,000 individual option grants, each with monthly vesting over four years. If each vesting tranche must be valued separately, I will have over 330,000 valuations to make each quarter, each with multiple assumptions about future employee behavior, interest rates, and stock market volatility! This will bring my accounting department to its knees.

Modifications and Settlements

Issue 10: This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments (paragraph 35 of Appendix A). Paragraphs C96–C115 explain the factors considered by the Board in developing those principles and the related implementation guidance provided in Appendix B. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.

Again, these principles are perhaps theoretically appropriate, but entirely too complex to implement successfully and consistently. The approach taken in APB 25 would be preferable.

Income Taxes

Issue 11: This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income tax effects and paragraphs C128–C138 describe the Board’s rationale. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, Share-based Payment. Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?

Your discussion in paragraphs C128–C138 demonstrates, again, the problem of trying to force-fit an expense notion onto what is fundamentally a capital transaction. The ED would require maintaining a deferred tax analysis at the individual employee level. While this may be feasible for corporations where only a few top executives receive stock options, it will be a crushing burden for companies with broad-based plans who will be

required to maintain tens or even hundreds of thousands of calculations. If you revert to APB 25, the tax accounting becomes clear.

Disclosures

Issue 12: Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives (paragraph 46 of Appendix A). Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives (paragraphs B191–B193). Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.

Any disclosures that provide meaningful information to investors are welcome. In fact, those of us who oppose stock option expensing would welcome additional disclosures as the preferred alternative. Unfortunately, a significant portion of the proposed additional disclosures in paragraphs B191-B193 deal with documenting the extensive and subjective assumptions required to develop a stock option expense estimate using the lattice model. Other than providing fodder for plaintiff's lawyers, I don't see how these guesses about future employee behavior or future stock market volatility are at all useful to an investor interested in performance of the enterprise.

I suggest that additional disclosure requirements be developed to enhance the understanding of the dilution impact of stock options and that all disclosures related to the determination of a theoretical value of stock options be limited to those currently provided.

Transition

Issue 13: This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board's rationale for that decision is discussed in paragraphs C157–C162. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?

No comment on transition.

Nonpublic Entities

Issue 14(a): This proposed Statement would permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at the settlement date) rather than the fair-value-based method, which is preferable. Do you agree with the Board's conclusion to allow an intrinsic value method for nonpublic entities? If not, why not?

No. If you want comparability, consistency and transparency why create different treatments for different classes of companies.

Issue 14(b): Consistent with its mission, when the Board developed this proposed Statement it evaluated whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on nonpublic entities and made several decisions to mitigate the incremental costs those entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or the intrinsic value method (with final measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provide them additional time to study its requirements and plan for transition. Do you believe those decisions are appropriate? If not, why not? Should other modifications of this proposed Statement's provisions be made for those entities?

If comparability and transparency is the goal, permitting different classes of companies to use different methods and different transition rules does not support the goal.

The Board has not come close to recognizing the costs of transition and compliance that will be incurred by all companies across the board. In my opinion, these costs far outweigh any benefit that might be realized by this new standard (and I actually believe there will be a detriment to users of financial statements). In addition to the substantial amount of time that will be required of accounting staffs at each company, most companies will have to retain valuation consultants to assist with the development and implementation of these new, complex models. Few accounting professionals today are familiar with lattice models and fewer still are competent to estimate employee behavior and stock price volatility over long periods into the future.

The Board has also failed to recognize the difficulty and cost of auditing these new estimates. Particularly for smaller companies with broad based option plans, where the

option expense estimate will be a very material component of earnings, auditors will be very reluctant to sign off on these material estimates without extensive documentation and analysis.

Small Business Issuers

Issue 15: Some argue that the cost-benefit considerations that led the Board to propose certain accounting alternatives for nonpublic entities should apply equally to small business issuers, as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934. Do you believe that some or all of those alternatives should be extended to those public entities?

No. If you want comparability, consistency, and transparency, why create different treatments for different classes of companies.

Cash Flows

Issue 16: For the reasons discussed in paragraphs C139–C143, the Board decided that this proposed Statement would amend FASB Statement No. 95, Statement of Cash Flows, to require that excess tax benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid (paragraphs 17–19). Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?

No. It makes no sense to arbitrarily divide the tax benefits into two categories and account for them differently. Other than making work for accountants, consultants and auditors, this provides no useful information and there is no rationale for treating a portion of the tax benefit as a financing cash flow rather than a reduction of tax obligation. It is, in fact, **not** a financing cash flow and it is, in fact, a reduction of tax obligation.

Differences between This Proposed Statement and IFRS 2

Issue 17: Certain accounting treatments for share-based payment transactions with employees in this proposed Statement differ from those in IFRS 2, including the accounting for nonpublic enterprises, income tax effects, and certain modifications. Those differences are described more fully in Appendix C. If you prefer the accounting treatment accorded by IFRS 2, please identify the difference and provide the basis for

your preference. If you prefer the accounting treatment in the proposed Statement, do you believe the Board nonetheless should consider adopting the accounting treatment prescribed in IFRS 2 in the interest of achieving convergence?

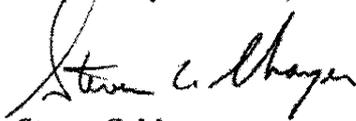
No comment on this issue.

Understandability of This Proposed Statement

Issue 18: The Board's objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?

No, not even close. The proposed statement is long and complex and will require a substantial amount of time to digest and implement. It will require the use of complex mathematical models that are unfamiliar to the accounting profession and belong instead in the realm of applied mathematics and financial analysis. The audit firms will weigh in with interpretations that will add additional complexity and the costs of implementation and audit will be astronomical, all for a number which is already available in the notes, has little value, and will be backed out by every competent financial analyst to arrive at a conclusion on financial performance, risk and enterprise value.

Respectfully submitted,



Steven C. Mayer
Executive Vice President and
Chief Financial Officer

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