

Letter of Comment No: 60
File Reference: 1102-001
Date Received: 1-29-03

MEMORANDUM

DATE: January 29, 2003

TO: MP&T Director – File Reference 1102-001
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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FROM: Beth Nickels, CPA, Chief Financial Officer (Herman Miller, Inc.)
Tom Farris, Director of Finance (Herman Miller, Inc.)
Jeffrey M. Stutz, CPA, Mgr. Financial Reporting (Herman Miller, Inc.)

Dear Director:

The following comments are in response to your *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*, dated November 18, 2002 (Invitation). Specifically, these comments address the following issues.

- Issue 2(a): Do you believe that an accounting standard should mandate the use of an option-pricing model for measurement purposes?
- Issue 2(d): Statement 123 and the Proposed IFRS require certain modifications be made to the outcome of an option-pricing model to address certain features of employee stock options. If you believe that other modifications should be made to improve the consistency and reliability of those outcomes, please describe those modifications and why they should be required.
- 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?
- 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.

The Invitation indicates that you are not seeking comments concerning debate over whether stock options granted to employees result in compensation expense. Despite

this, a portion of this letter addresses that topic. We feel this debate continues to be relevant with respect to the quality of financial reporting.

Section 1: Should a Company Recognize Expense From Issuing Stock Options?

The FASB and the IASB have concluded that employee stock options represent something of value and, consequently, result in compensation expense to the issuing company. In formulating our comments to the issues outlined above, we felt it was important to begin by stating our position on this.

It would be difficult to argue against the point that stock options provide value to the employees receiving them. This is the presumption on which all employee stock option plans are based. At issue, however, is the question of who bears the *cost* of issuing these stock options?

Our obligation to the readers of financial statements should not be to report the “worth” of these stock options to their recipients. Instead, it should be to report the cost to the company, if any. Our belief is that an issuing company does not bear the “costs” associated with stock options. Instead, the true cost results from the *potential* dilution in the ownership of existing shareholders. This cost is appropriately reflected in current practice through the calculation of diluted EPS. If a company records expense related to the issuance of stock options, EPS is further reduced through lower net earnings. This “double-hit” on the EPS measure is unfair and misleading. Consequently, companies should not be allowed to recognize compensation expense in connection with the issuance of employee stock options.

The potential impact on shareholders from dilution is a material fact that requires fair and complete disclosure. Fortunately, there is already accounting guidance that addresses this. APB Opinion No. 15 addresses the reporting implications of dilution on the calculation of EPS. Additionally, the disclosure requirements (excluding references to estimating fair values and compensation expense) in paragraphs 46-48 of SFAS 123 provide adequate information to financial statement readers concerning stock option plans.

Issue 17

One suggested improvement to this existing guidance is to require companies to estimate the impact on EPS assuming all outstanding options are “in the money”.

Section 2: Valuation Concerns

Despite our position on the compensation issue, we acknowledge the likelihood that the FASB may not reverse its decision on the topic. Our remaining comments are provided within this context.

If stock options are to be assigned a value for purposes of determining compensation expense, a fair and consistent valuation model must be used. Such a model should be widely accepted in practice as being fair, accurate and consistently applied. Absent this, concerns raised regarding the use of the model would bring into question the value of its

output for use in financial reporting. Unfortunately, many of the option pricing models currently being used today have fundamental problems.

Issue 2(a)

We believe there should be a single pricing model mandated for use in measuring the value of employee stock options. The current practice of allowing companies to use different valuation models creates a comparability concern.

Mandating the use of a single model would not, however, completely eliminate the comparability problem. The values derived from an option-pricing model are merely a function of the input data. Variables such as price volatility, expected life, current stock price, and interest rates combine to generate a valuation result. In current practice today, there is great latitude given to companies in estimating these input variables.

Determining these variables requires the company to predict future events and behaviors. These predictions have a direct impact on the valuation result. This creates the potential for manipulation. It also raises concerns over the comparability of financial statements between periods since these input variables are re-estimated each time the model is used.

To illustrate the sensitivity of the valuation result to changes in input variables, consider the following examples from our company.

1. The Black-Scholes pricing model is used at Herman Miller, Inc. for purposes of developing the required footnote disclosure under SFAS 123 (we account for our employee stock options under APB Opinion No. 25 and, consequently, do not record compensation expense). The disclosure in our 2002 Annual Report stated that our net earnings and EPS would have been reduced by approximately \$6.7 million or \$0.09 per share in fiscal 2002 had we recorded this expense. The options outstanding and exercisable as of the end of fiscal 2002 had a weighted-average exercise price of \$23.07.
 - Assume this expense estimate was recalculated holding all input variables constant except for the estimated expected life of the outstanding stock options. This variable, which is left to the discretion of the reporting company, if changed to reflect a one-year increase for each group of options, results in an expense estimate for fiscal 2002 of \$7.7 million or \$0.10 per share.
 - This shows the sensitivity of the model to a change in only one input. It also illustrates the potential for manipulation and inconsistency that exists under current valuation practices.
2. A change in the market value of the stock can yield arbitrary and misleading results.
 - If the options outstanding at the end of fiscal 2002 were issued at a price of \$14.58 (our 52 week low as of the date of this letter), the resulting expense would have been \$4.0 million or \$0.05 per share. It is reasonable

to assume that the company would have received the same level of employee service under either scenario. Why, then, should a change in the exercise price reduce the estimated compensation expense by \$2.7 million or \$0.04 per share?

- This also illustrates the fact that, under Black-Scholes, options issued at a relatively low price are valued lower than the same options issued at a higher price. This is counterintuitive since one would expect a lower priced stock would have a greater chance of increasing in value than the same stock priced at a higher level (and would therefore be of higher value to the employee).

These examples show how the use of a currently acceptable pricing model can make the comparability of financial information difficult for the readers of financial statements. This supports not only the mandate of a single pricing model, but also tighter rules on the inputs used. The examples also raise questions as to whether the widely used Black-Scholes model is adequate.

Issue 2(d) and 2(e)

The Black-Scholes pricing model was initially developed as a pricing tool for options that are traded on the open market and which have no restrictions on the way they are exercised. Its application as a tool for pricing employee stock options has limitations since these instruments often have use restrictions. Black-Scholes has also been found to overvalue options in situations where a company has a stock that is increasing in price and/or operates in a volatile market.

Once a uniform pricing model is developed, the FASB should consider the following.

- A discount factor should be applied to the value of options priced using Black-Scholes (or similar models) to account for restrictions on use.
- A cap should be applied to the *Volatility* factor used in calculating option values. This would help address the concern over unfairly penalizing companies due to the relative volatility of their stock.

Summary

We believe the fundamental question over whether employee stock options create compensation expense should be re-opened for discussion. If, however, the issue remains closed for debate, it is necessary that changes be instituted in the use of stock option pricing models. Current valuation practices, whether for purposes of actually recording compensation expense or merely disclosing it in the footnotes, allow for too much variation in methodology. The result of this is inconsistent and potentially misleading information that can create confusion for the readers of financial statements.