

Letter of Comment No: 41
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VIA Email to director@fasb.org

Financial Accounting Standards Board
PO Box 5116
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RE: File Reference 1101-001

Thank you for consideration of the following comments pertaining to your recent Exposure Draft titled "Accounting for Stock-Based Compensation – Transition and Disclosure"

The exposure draft outlines three transition alternatives to accompany a voluntary adoption of the fair-value method of accounting for stock-based employee compensation. Each of these alternatives seems logical and rational.

While each of the alternatives is plausible, I do not believe the Board should allow different options for the adoption of fair-value accounting. Comparability of financial statements is already a challenge, and this Exposure Draft will extend for at least 4 years, (a typical vesting schedule) the time period until reasonable comparisons can be made between companies that have adopted fair-value accounting.

If one of the three prescribed alternatives were to be required, I believe that option (b) is the most appropriate. This option would result in the full cost of stock-based employee compensation being recorded from the date of adoption forward, without the complexities associated with restating prior year financial statements.

Many business professionals expect the IASB to soon issue a proposal that will require companies to recognize the fair-value of stock options granted as an expense. Given the goal of international convergence of accounting standards, a logical assumption would be that the FASB might soon thereafter propose an amendment to Statement 123 that would require, as oppose to make elective, similar provisions.

In the event that a subsequent amendment to Statement 123 is proposed, I strongly encourage you to revisit the recognition and measurement criteria of that statement. Particularly in the technology sector, fair-value estimates performed as of the grant date have proven to be materially unreliable. In addition, because these estimates are never adjusted or "trued-up", the financial statements of most technology companies will be very misleading if such estimates are required to be recorded in financial statements.

Consider the following two brief examples. Had Microsoft been recording stock option expense based on grant date estimates of fair value over the last three years, they would have recorded approximately \$9 billion (pretax) of such expense, and reduced reported net income by 24%. At the same time, the true dilutive cost of these options to date has been negligible, given their average strike price of \$71, relative to the current Microsoft stock price of \$56.

The Cisco numbers are even more telling. Had Cisco recorded stock option expense based on grant date estimates of fair value over the last three years, they would have reported a net loss for the 3 year period of \$783 million, as opposed to the originally reported net income of \$3.5 billion. The underlying stock options however, have resulted in virtually no dilution, and are now significantly under water with an average exercise price of \$37, relative to the current Cisco stock price of \$12.

It could be that the future stock prices of Microsoft and Cisco rise, to the extent that the original grant date estimates of fair value closely approximate the true dilutive cost of these options. Equally likely though, would be the case in which these options have no true cost. The point is that at this point in time we simply don't know, and in my opinion, unreliable estimates of this magnitude should not be recorded in financial statements.

Given the last three years' results in the equity markets, it is no surprise that the fair value of stock options measured as of the grant date is materially different from the true dilutive cost of such options. However, the limitation of measuring fair value as of the grant date is not simply a function of down markets. Throughout most of the 1990's, fair value accounting as of the grant date would have actually understated the dilutive cost of stock options by a material amount. The fact is, I can find no time period during the last decade when fair values measured as of the grant date were remotely close to the true dilutive cost of stock options issued by technology companies.

The differences between employee stock options, and the publicly traded options for which Black-Scholes and other option pricing models were designed have been well documented and debated in the past. It is not worth repeating those points here. What is interesting is the fact that when Statement 123 was originally issued, it appears that the Board presumed that option pricing models would continue to evolve in terms of providing reliable estimates of the value of employee stock options (Paragraph 154). While this presumption was reasonable at that time, such improvements simply have not occurred, and option-pricing models continue to yield very unreliable estimates of the ultimate dilutive cost of stock options.

In summary, certainly for the technology sector, financial reporting will take a significant step backward if companies are required to record "fair-values", estimated as of the grant date, in their financial statements. This would be particularly discouraging given that the value of stock options, determined on some alternative measurement date, in fact could reliably represent their true dilutive cost. It would be inappropriate to make the case here for alternatives to "grant-date" measurement, but I look forward to presenting this argument in the future. Please provide the opportunity to do so.

Sincerely,
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