



June 16, 2004

Mr. Robert H. Herz  
Chairman of the Financial Accounting Standards Board  
401 Merritt 7, PO Box 5116  
Norwalk, CT 06856-5116

Director of Major Projects - File Reference No: 1102-100

Re: Proposed Statement of Financial Accounting Standards, *Share-based Payment*, an amendment of FASB Statements No. 123 and 95

Dear Chairman Herz:

Valero Energy Corporation (Valero) is a Fortune 500 company with approximately 20,000 employees and annual revenues of nearly \$45 billion. We are one of the top three U.S. refining companies in terms of refining capacity, and we are a leading marketer of refined products. We market refined products on a wholesale basis in 40 U.S. states and Canada, and on a retail basis through a network of approximately 4,000 retail outlets in the U.S. and Canada. We also sell convenience store merchandise through these retail outlets.

We respectfully request the FASB's consideration of our comments in connection with your deliberations and decision-making process regarding the Proposed Statement of Financial Accounting Standards, *Share-based Payment*, an amendment of FASB Statements No. 123 and 95 (the Proposed Statement). Valero appreciates the opportunity to provide comments on certain issues outlined in the Proposed Statement. Those detailed comments are provided below.

In summary, we do not agree with the conclusions reached by the FASB in the Proposed Statement that would require companies to expense stock options issued to employees as we do not believe this will improve the quality of financial reporting. We understand and acknowledge the theoretical justification for your conclusions, but we believe that the FASB has failed to consider the true reason that most companies issue stock options to their employees. It is clear that the FASB believes that options are issued to employees in exchange for their services. We believe that this is rarely the case, and our reasons are outlined below. In addition, we believe that the FASB has given little consideration to the practical issues that companies will encounter to implement this Proposed Statement and the lack of comparability in reported financial earnings that will result. Due to the complex nature of the calculations that will be required, the investing public will be unable to understand how a company has arrived at a particular result and why that result is different from another company or a competitor. You should note that Valero fully supports the FASB's goal of improving the quality of financial reporting, but we believe that this Proposed Statement does not accomplish that objective for the reasons outlined in this letter.

Our responses that address specific issues identified by the FASB are provided below. For your convenience, our comments are prefaced by the FASB's issue in bold text.

**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. Based on that conclusion, this proposed Statement requires that such compensation costs be recognized in the financial statements. Do you agree with the Board's conclusion? If not, please provide your alternative view and the basis for it.**

No. We do not agree with the FASB's conclusion that stock options issued to employees in return for services result in a compensation cost to Valero or any other company. The fundamental questions that need to be addressed are whether employee services are provided in return for stock options and whether those services result in an economic benefit to the company that should be measured and recorded in its financial statements.

The FASB has argued that an asset – employee services – is created momentarily and the company's use of this asset results in an expense. In its Concepts Statements, the FASB defined an asset as a "probable economic benefit obtained or controlled by a particular entity as a result of a past transaction or event" and an expense as "an outflow of an asset or the occurrence of a liability." We agree with the FASB's theory that, in general, employee services meet the definition of an asset, at least momentarily. However, we believe it is necessary to look further at the definition of an asset and how an asset is obtained. An asset is generally obtained by (i) the receipt of that asset (i.e., cash property or contributed services) in exchange for an equity interest in a company or (ii) by the receipt of an asset (i.e., cash or property) with greater value in exchange for an asset already recorded, such as through the sale of a product manufactured by a company. Because options are a form of equity interest and the company has theoretically received something in return (i.e., employee services), by definition, an asset has been obtained. However, we believe the FASB has failed to consider the more relevant question, which is whether the company will receive an additional economic benefit that it otherwise would not have received as a result of issuing the stock options to the employee. We believe that a company does not receive additional services or economic benefit when it issues stock options to its employees, nor does it necessarily receive a higher quality of service. If stock options were the only significant compensation offered to an employee, then perhaps we would agree with the FASB's conclusion that the value of employee stock options should be expensed. However, most employees provide services in exchange for cash consideration. In fact, very few employees actually "bargain for" stock options in determining whether to accept an offer of employment. Companies rarely promise to issue options, and even if a company typically issues options to its employees, there is no certainty that options will be issued, and the number of options issued is rarely (if ever) negotiated with the employer. There may have been a brief period of time during the rise of the technology industry where stock options were considered part of basic compensation and "bargained for". However, that time has passed and there is less interest in stock-based compensation because most employees are not willing to accept the inherent risks.

We agree that employers should recognize compensation expense for the fair value of consideration given to employees in exchange for their services. That consideration is almost always the negotiated salary between the employee and the employer. Our employees receive cash compensation that is based on an average market computation that we believe represents the fair value of the employee services. We make the decision to provide options to all employees because of the intangible return we receive through loyalty, stewardship and continued employment – none of which meet the definition of an asset. In fact, the substance of such a transaction is self generated goodwill, which can not be recorded as an asset in accordance with current accounting principles. In this situation, we believe it is

inappropriate to associate a value with the option because specific services are not provided in return for this equity interest, and the benefit received by the company is not tangible. Since no asset has been obtained, an expense should not be recognized (i.e., because there is no outflow of an asset). In addition, no liability has been incurred, which is the only other means of recognizing an expense.

As previously stated, we agree with the FASB's theory that employee services, by definition, are an asset. However, there is generally no additional economic benefit obtained by issuing a stock option. The FASB's broad application of this Proposed Statement to all employee stock options fails to consider the true economic substance of such transactions and ignores the fact that, in most situations, the options are not part of the "bargained for" compensation. We believe the true economic cost to the company of issuing employee stock options is the spread between the exercise price and market price on the date of grant. Therefore, we support the use of the grant-date intrinsic value method and disclosure in the financial statements consistent with the APB 25 approach. We believe this is the only method that provides a definitive measurement of the cost to the company at the time the options are issued to the employee. Additionally, this method offers a cost that is consistent with the value of the option in the minds of both the employee and the employer.

**Issue 2: For the reasons described in the Exposure Draft paragraphs C26-30, the Board concluded that 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. We believe the FASB's current proposal of expensing all stock options will provide inaccurate and confusing information to investors, but we believe that clear and detailed disclosures regarding stock option activity and pricing data will provide investors the information to understand how companies are using options and the risk of potential dilution. This can be accomplished without the use of complex option pricing models which will only confuse the matter. Further, pro forma disclosures for non-bargained for options is irrelevant and useless information because it assumes that those options were issued in exchange for employee services.

We would not disagree with the FASB prescribing additional disclosures, such as "above water" and "underwater" option information as of the reporting date and information related to dilution to allow shareholders to better understand the potential dilution of stock options. Such disclosures would provide investors more accurate information regarding stock option activity. Also, the FASB's goal of consistency and transparency may be achieved through additional disclosure information.

The FASB has argued that if disclosure and recognition are equal alternatives, then the concept of only disclosing certain amounts would apply to other costs such as warranties, pensions, and other postretirement benefits. We agree with the FASB's theory that costs that are measurable should be recognized in the financial statements and that disclosure only would not be appropriate. However, as addressed in Issue 1, we believe that only those stock options that are "bargained for" should result in a cost to a company. Furthermore, we believe the attempt to recognize compensation costs for stock options issued to employees results in fictitious amounts being recorded in the financial statements since no additional services or economic benefit are being obtained by the company

**Issue 3: This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments**

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**issued based on the grant-date fair value of these instruments. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?**

No. We support the grant date as the measurement date, but we believe that the intrinsic value should be the measurement attribute. For an option to have a value other than the exercise price at the date of grant, both parties (the employer and the employee) must agree that there is an equal exchange of value. The primary question is whether the employer and employee view the stock option as compensation for services rendered.

We believe that an employee has been compensated only when the option has value to the employee or is clearly part of "bargained for" compensation, and the employer believes that it has given something of value. As a case in point, we know of no historical instance in our company where one of our employees voluntarily terminated (quit) because they did not receive options – or that they received less options than they thought they "deserved". Clearly this would be the case if they were under-compensated for past services. With a stock option, the employee can never obtain anything of value unless he ultimately obtains a share of stock and that share is worth more than the cash paid to obtain it. *This economic reality is acknowledged by the U.S. Internal Revenue Service which considers the option to be of no value to the employee and does not tax the employee for the option's assumed fair value.* In fact, the IRS does not attribute value to the option until the employee exercises the option and sells the stock for more than the option's exercise price. From the employer's perspective, it has never given up anything of value unless it ultimately issues a share of stock that is worth more than the cash received upon issuance. Whether an employee will ultimately benefit from the option is not known at the grant date, therefore, we believe it is inappropriate to record a cost at a value that exceeds that which has been agreed to between a willing buyer (employee) and seller (employer).

The question, then, would be: Why would an employer issue options to an employee if it were not for consideration for services provided? At Valero, the answer to that question is clear. We issue stock options to a broad base of employees to foster an attitude of stewardship and loyalty to the company – not to compensate them for services they provide to us. Valero prides itself on providing fair, if not above-market, cash compensation to its employees, supplemented by generous medical and retirement benefits. Stock options help create a "connection" to the company, even if the employee ultimately never becomes an equity holder, that is different from that provided by cash compensation. Employees evaluate the fairness of their cash compensation to determine whether to accept an offer of employment or remain a company employee, not based on the assumed fair value of an option that may be issued to them. An option, on the other hand, helps foster the intangible benefits of stewardship and loyalty. One of the reasons for Valero's success is the loyalty of its employees and the pride that they have in being part of this organization, and we believe that stock options help create this attitude. Our company also has a practice of encouraging our employees to buy and hold our stock, and we actively discourage selling stock acquired through our option program unless it relates to taxes or charitable contributions.

Therefore, requirements for employers to expense stock options as though they are compensatory, will likely result in the termination of these plans and the loss of the intangible benefits they provide. *The creation of accounting rules that require expensing options will have the effect of significantly curtailing or eliminating these programs which benefit a significant number of the "rank and file" employees of our company and many others as well.*

As previously stated, we support the grant-date intrinsic value method as the most accurate method of measuring the cost of issuing employee options.

**Issue 4(a): 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 Proposed Statement does not provide sufficient guidance to ensure reasonable consistency because of the high level of judgment necessary in determining the assumptions. We believe that additional guidance is not necessary, but the problem pertains to the nature of the judgments and the subjectivity of the underlying assumptions. For example, a high level of judgment is required when determining employee behavior patterns such as the expected option term until exercise. The exercise of options in the future may be affected by upward or downward movements in the company's own stock price or the market as a whole, as well as the current economy and the availability of expendable cash for each employee. In order to develop assumptions regarding patterns of employee exercise, it will be necessary to analyze employee exercise history for the correlation between time of exercise and other factors, such as the extent that the option was in-the-money at the exercise date, volatility, vesting schedule and the contractual life. These factors are often not reasonably predictable and require an analysis that is inconsistent with other areas of current accounting literature because the historical patterns are likely not indicative of future behavior. We believe that the FASB's guidance can not assist in such areas of judgment, but rather an extraordinary burden will be placed on the preparer.

In the Proposed Statement, the FASB acknowledged that there is a range of reasonable estimates for expected volatility, dividends, and option term. The FASB has required that expectations about future events be an integral part of determining the fair value of an option. We fail to understand how consistency and comparability will be improved if there are multiple estimates that are acceptable that result in significant differences in the value of the options. We believe that this will only distort and lessen the quality of earnings. In addition, the various assumptions easily lend themselves to manipulation of the amount of compensation costs that will be recorded, and it will be difficult for external auditors to challenge and audit these underlying assumptions and estimates. We believe that these highly subjective assumptions will result in an unacceptable level of estimation in the financial statements.

**Issue 4(b): 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?**

No. We do not believe the methodology proposed by the FASB will result in a reliable method of measuring stock option costs. The foundation of the proposed methodology is dependent upon assumptions that include a high degree of judgment and variability. The variability in the assumptions made by different management groups will result in less accuracy and comparability among peer companies. This does not benefit the average investor, but it puts them at a disadvantage when attempting to make informed investment decisions.

The option pricing model that has been recommended by the FASB (the lattice model) is unreliable and is dependent upon predicting future stock prices and behavior patterns of employees. These option pricing models were designed to value short term, tradable options and not employee stock options. The choice of methodology and the use of various underlying assumptions will result in a lack of consistency and comparability among companies. For example, the FASB contends that the measurement of expected volatility of a company is important in determining the fair value of options. In the FASB's proposal, this estimate not only contemplates historical volatility, but includes expectations regarding future volatility. The Proposed Statement also provides additional factors that

must be considered when determining expected volatility. It lists the implied volatility of exchange traded options on the company's stock, the length of time the business has been public, the tendency of volatility to return to its "mean" or long-term average, and "appropriate and regular" intervals for price observations. Therefore, volatility under the Proposed Statement will not be constant, but will likely change from year-to-year. We believe that the level of judgment necessary and the estimates that accountants will be asked to make in this determination are not consistent with other areas of current accounting.

We also believe the lattice model is overly complex and the data necessary to populate this model will not be readily available. Most companies do not have the infrastructure in place to gather this data, nor do they have the expertise in house to develop the assumptions. Based on our initial assessment, we believe the following activities will be required, at a minimum: (i) perform data extraction of employee exercise behavior, other employee behavior patterns, historical stock prices, (ii) conduct a thorough analysis to refine the assumptions included in this model, (iii) purchase and/or develop new information systems or software packages for tracking and analyzing the necessary data, (iv) consult with professional groups to develop models and assumptions, and (v) allocate additional resources and train personnel who will be responsible for these calculations. We believe that the implementation of this Proposed Statement will have a negative impact on companies due to the additional costs that will be incurred. Therefore, we conclude the costs of implementation of this Proposed Statement will exceed the benefits when the result of the effort is misleading and unreliable financial statements.

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Public companies incur a heavy burden when they adopt and continue to apply new accounting pronouncements that require a significant amount of data accumulation, analysis, and the development of highly subjective assumptions about the future. We believe that this burden will eventually have a negative impact on shareholder returns and the marketplace because of the high cost of applying these pronouncements, and financial statements will become more difficult to understand and potentially unreliable. We believe that it is unacceptable that the FASB continues to issue broad based principle statements that require highly subjective judgments that result in less accuracy, especially when the U.S. Congress has required executives to certify that their financial statements are accurate and the SEC has pleaded for more "plain English", straight forward disclosures. We support Congress' effort to hold the executives of the company accountable for their financial statements, but we do not understand the different objectives of these groups and why they seem to conflict with one another.

Alternatively, we support the framework of the Enzi Reid Bill that has been presented to the U.S. Congress. We particularly agree with the following provisions of this bill and encourage the FASB to consider these alternatives.

- When an option is exercised, expires, or is forfeited, the company would reconcile the actual expense to the company to the amount expensed on the grant date.
- The Secretary of Commerce and the Secretary of Labor conduct and complete a joint study on the economic impact of mandatory expensing of stock options before the issuance of the proposed Statement.

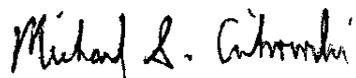
We wish to express our appreciation for your consideration of our comments and Valero's perspective on the purpose of stock options. We understand that the long-standing position of the FASB is that the

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financial statements should reflect the time value of an option, not just its intrinsic value. However, we respectfully request that the FASB carefully consider the affects this Proposed Statement will have on the economy and the entrepreneurial spirit that exists in corporate America today. Our position, as outlined in this response, is that this Proposed Statement will result in less accurate financial information and will only be an additional burden on the companies that must comply with these rules.

If you have any questions regarding our comments, please feel free to contact me at (210) 345-2146.

Sincerely,



Michael S. Ciskowski  
Executive Vice President and  
Chief Financial Officer