Karen Salmansohn

From: Sent: To: Subject: Director - FAS Saturday, Fet Karen Salmar FW: Invitation

Letter of Comment No: と12

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----Original Message----

From: Kelvyn Cullimore Jr. [mailto:Kelvyn@dynatron.com]

Sent: Friday, January 31, 2003 5:32 PM

To: Director - FASB

Subject: Invitation to Comment on FASB 123 and proposed IFRS

Dear FASB Director,

With regard to the Invitation to Comment on Accounting for Stock-Based Compensation I offer the following observations and comments. These comments are offered from the point of view of a micro-cap public company whose options are not traded.

General Observations

1. We fail to understand the urgency of standardizing with European accounting standards with regard to Stock-Based Compensation. The current method of disclosure provides adequate information for comparative purposes. Those reviewing financial statements do not need to be spoon-fed. The financial statement note on Stock Based Compensation adequately portrays the information any analyst would be seeking. And if the capital markets of Europe are any indication of the effect of such accounting rules, why should we be so anxious to embrace them?

FASB acknowledges the tremendous opposition in the United States to the concept of expensing stock options and that the current practice of disclosure was agreed to by FASB only to "bring closure" to the issue and avoid the imposition of legislation to prevent such a rule from being implemented. With such opposition, would it not be prudent to be encouraging our European trading partners to consider harmonizing with our approach rather than vice versa?

2. Clearly the issue is problematic as shown by the inability of FASB and IASB to agree on such fundamental issues as Issuances and Forfeitures, Measurement Dates, Attribution, ESOP's etc.... It seems that if the experts at FASB and IASB who are in favor of imposing standards on accounting for stock-based compensation cannot agree on how it should be done, it will certainly be confusing to those less than expert who will be reading the statements that incorporate the new standards. Isn't the purpose of financial statements to try to provide a clear understanding of the company's performance and status? Attempting to achieve a harmonized effort to reflect the "expense" associated with stockbased compensation is so fraught with problems that even if a compromised methodology were to be agreed upon by the accounting boards, it would undoubtedly result in more confusion of financial statements -- not less. There are those who believe that some representation of the "expense" is better than no representation of the "expense". This is an invalid argument that ignores the fact that present disclosure requirements already provide information relative to the "expense".

Specific Comments

Issue 2: Determining the "fair value" of any stock option is at the heart of the entire debate over accounting for stock-based compensation. Despite FASB's previous rejection of arguments relative to "fair value" the fact remains that the standard of FASB 123 does not establish the "fair value" or the cost of a stock option to the company or the optionee. The establishment of a formal or mandated model still leaves the door open for

manipulation of several of the factors in the option pricing model -- specifically, the determination of the volatility of the underlying stock, the "expected life" of the option, and the risk free interest rate.

While we remain adamantly opposed to any accounting standard that would mandate the expensing of a stock option, if one were to be imposed it should be uniform in its application. The entire point of imposing such a standard would be to try to make financial statements more comparable. Using a single model would accomplish that more efficiently than allowing multiple models or methodologies. The problem is, no model can presently be relied upon to consistently represent the "expense" of stock options given the "assumptions" that must be made relative to volatility, expected life and risk free interest rates.

If a standard must be imposed, a more fair approach may be a combination of disclosure and transactional accounting. The disclosure portion would be implemented much as it is now. The transactional component would recognize the actual expense of an option upon exercising of the stock option. This approach would at least avoid the inconsistencies in financial statement presentation based on faulty future assumptions as would be the case with the current FASB or IASB proposed standards. For small companies like Dynatronics, the cost of any option (assuming there even is one) is only realized upon exercise of the option. While FASB may have some basis for rejecting that argument, the reality is that if the employee does not ever exercise the stock option, they never realize any value and the company never realizes any cost. The company may realize some value in the fact that the option may have served as an incentive for the employee to be employed, but how is that value established? It certainly isn't accomplished through the Black-Scholes method. In the end, the only cost to the company is the opportunity cost of having issued the stock at exercise at a lower value than the current market price. If FASB feels strongly that an opportunity cost should be expensed (which it never has before) then perhaps some sort of transactional entry could be required at the time the value of the option is actually realized upon exercise.

Regardless of what model may be imposed, additional disclosures should be required to insure that the issuers assumptions in arriving at the cost are clearly stated. Otherwise, the door is left open to manipulate variables to arrive at a more desirable outcome.

Issue 3 and 4: Intrinsically, the value of an option to an employee or a non-employee do not really differ other than by the characteristics of the option terms themselves. Those different characteristics would be taken into account in any valuation model. However, the nature of an employee as a direct participant in the growth of the company and the long term incentive typically associated with employee stock options should position them for more favorable accounting treatment much as ISO's receive preferential tax treatment now.

Issue 5, 6, 7, & 8: The concept of issuance is critical in the establishment of any standard for stock-based compensation. Incorporating vesting issues and forfeiture issues is also critical. It seems ironic that in an effort to accurately state the "cost" of stock options, assumptions must be made about what might or might not happen in the future. In the case of Dynatronics, there has been many times in our history when stock options have not even been "in the money". Trying to predict the volatility of our stock to determine if there is any value to an option on its grant date is virtually impossible. Incorporating such guesses as factual representations of our financial condition would not only be an inaccuracy but would so misrepresent our financial condition as to defeat the very purpose for which the standard was originally imposed. Based on this type of logic, should we also try to project the future value of certain stock holdings we have in other companies and report that on our financial statement based on the same type of model?

To value a stock option on the grant date is an exercise in speculation and has no place in a formal financial statement. Just as in any statistical model, the larger the company (your sample size) the more accurately one can predict future trends such as forfeiture or even stock volatility. In a company of our size there is insufficient data to allow an accurate estimate of forfeitures or stock volatility. To incorporate a forfeiture assumption in any valuation model would, again, be an exercise in speculation.

If, as stated in FASB 123, issuance occurs when the issuer receives valuable consideration, then the grant date is certainly not the Issuance date. In our case, every employee is granted options at the date of hire. They vest in four years. The option is

like a contract with the employee. If they stay for four years, the options may be exercised. If not, they forfeit the option. It is intended as a long term incentive. If they leave early, they are not allowed to exercise options equal to the percentage of the four years they completed. It is all or nothing. Therefore, the value the company "contracted" for of four years of employment is not realized. No compensation is paid because the value bargained for was not received. Similarly, with a non-employee, if the services for which the options are issued are not provided and the options canceled, there is no expense.

Trying to determine issuance dates, forfeiture rates, value of options due to stock volatility and satisfaction of terms of the options granted all seem to argue in favor of a disclosure approach instead of an expense approach since there is so much of speculation involved in determining those characteristics — especially for a small company like Dynatronics. And since the effect of "expensing" the options can be orders of magnitude higher on a small company with modest or no profitability, it would seem logical to exclude this "expense" since it would skew the operational performance of the underlying company. What comparability would there be if Dynatronics operating profits were extinguished by the recognition of stock option expense when the effect on a larger competitor was not nearly to scale. Should the reader of the financial statement assume that the demise of Dynatronics was imminent due to the issuance of stock options? This absurdity is further emphasized when the argument is taken to an extreme of large options being issued every year. If those options are exercised they actually bring in more capital to the Company. Yet the recognition of the option expense at the grant date would lead the financial statement reader to believe we may not be a "going concern". This entire issue appears to be an exercise in form over substance.

Summary

During this past year Dynatronics issued 90,000 options to employees which represents about 1% of our total outstanding shares. The footnote disclosure revealed that utilizing the Black-Scholes method of valuation our net profitability would have been reduced by 35% as a result of expensing those 90,000 options. Had we issued 270,000 options we would have totally extinguished our profitability. It seems unlikely that large cap companies would experience such a charge to their earnings. It is a matter of scale. Any new accounting standard that forces the expensing of stock options without taking into account the confounding effect that would have on small company financial statements will create more confusion than it solves.

Present models cannot accurately predict the forfeiture rates or volatility rates for small companies. Nor do they take into account the very important factor that options in companies like Dynatronics are not traded on the open market. No present model builds in a discount for the fact that the stock option is of no value to the employee until it is exercised. Likewise the company has no expense until it is exercised. Even then, the expense is only an opportunity cost which costs have not traditionally been recognized in accounting literature. Any model ultimately adopted in a standard must, at a minimum, include a discounting factor for the lack of liquidity associated with non-traded options and options that result in the issuance of restricted stock.

We implore the FASB to not allow their objective of global harmonization to override the common sense of the current status quo on this issue. Disclosure is not only more economically palatable than expensing of stock options, but it more fairly and consistently represents the financial condition of the company. Otherwise, the possibility exists that while a small company is strengthening its capital base through the issuance and exercise of options, it is simultaneously reporting excessive losses due to stock option expensing that may obscure the real operating performance of the company. Certainly global harmonization should not take priority over accurate presentation of financial outcomes.

Our financial statements are becoming like a Christmas tree. Every accounting pronouncement is like another ornament being hung on the tree. Some have helped to make the tree more beautiful. But pronouncements such as the Accounting for Stock-Based Compensation have an obscuring effect that will soon make the true nature of the tree undetectable. Instead the observer will see primarily the image of the ornament decorators and not the value and intrinsic beauty of the tree itself.

I believe I represent many small public companies in America when I beg you to not make our job more difficult. The regulatory impositions associated with the Enron fall out

(i.e., Sarbanes-Oxley, etc...) are already burdensome. A standard for expensing stock options would be back-breaking to many companies. While it is not FASB's policy to consider economic impact of their decisions, they cannot in good conscience ignore the consequences of their actions. Stock options are a vital tool in the economic development of any small company. Requiring stock options to be expensed will undermine innovation and entrepreneurship. Please do not place the goal of global harmonization of this particular standard as a priority over fairly representing the financial condition of the thousands of small public companies who would be impacted by such a standard. At a minimum, we would ask that an exemption be considered for any company with a market capitalization under \$500,000,000.

Sincerely,

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