



David N. Terhune
President

January 31, 2003

Letter of Comment No: 189
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MP&T Director
File Reference 1102-001
Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: 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*

To Whom It May Concern:

As President of Applied Extrusion Technologies, Inc., I am writing on behalf of the Company, its employees and shareholders. The issue of stock options and the related accounting is very important to our ability to continue to motivate and compensate the key employees in our organization. My background is financial, having started my career with Arthur Young & Company; I am a CPA and have followed the positions related to the accounting for stock options with keen interest.

AET is the largest manufacturer of oriented polypropylene films in North America, an industry that participates in the speciality chemical sector. We operate in a cyclical business which is dependent upon economic conditions, as well as conditions in our industry. The recession of 2001 and the subsequent economic impact and inventory destocking that took place after the September 11 terrorist attacks have adversely affected our cash flow which, among other things, limits our ability to use cash compensation to attract and retain key employees. The ability to make equity-based compensation, and in particular stock options, available is a crucial component of our compensation structure.

In this context, we wish to strongly urge the FASB not to adopt a mandatory system of fair value accounting, but rather to continue to adhere to the current FASB Statement 123 regime, in which entities are given the choice of accounting for stock-based employee compensation using a fair value based method or an intrinsic value based method under APB Opinion 25. Like most U.S. corporations, particularly in the high technology sector and other industries in which cash is in short supply, AET has elected to employ intrinsic value accounting of its stock-based employee compensation and to provide the pro forma footnote disclosure of the effects of fair value accounting, as mandated by Statement 123.

As discussed in greater detail below, we believe that the adoption of mandatory fair value accounting for stock options (i) would generate uncertainty and confusion where currently there is none, (ii) is not needed for investors and the markets to understand the economic impact of stock options, and (iii) would create irrational disincentives to a form of compensation that has been crucial to America's recent economic successes and our nation's ability to sustain an entrepreneurial spirit and a competitive advantage in attracting and retaining human capital generally and top intellectual talent in particular.

Together with many other commenters, we oppose the mandatory application of fair value accounting on a number of grounds, including:

(a) Long History of Successful Application of Intrinsic Value Accounting.

We believe that the intrinsic value approach of Opinion 25 has provided a workable, easily grasped and consistently applied method of accounting for stock options and other stock-based compensation. It is well understood both by business managers and investors, and does not depend on the application of economic valuation models of dubious validity. To the extent that the intrinsic value approach generates anomalous results (see, e.g., the treatment of performance-based options), we are of the opinion that these readily could be rectified without a wholesale abandonment of intrinsic value.

(b) Fully Diluted Earnings Per Share Approximately Measures the Impact of Options on Shareholders. Current measures of fully diluted EPS, which count in the denominator of the EPS equation shares underlying stock options, provide investors with an accurate and meaningful picture of the true economic impact of stock options on their ownership interest. The greater the intrinsic value of options at any time, the greater the extent of the dilution.

Although we understand that expensing stock options does not necessarily result in "double counting" of the cost of these options to shareholders, we believe that the application of the option pricing models typically used under fair value accounting would, in fact, result in exaggerating the EPS impact of stock options. This is because Black-Scholes and similar models contain, in effect, a risk weighted present value of much of the post-grant capital appreciation — and shareholder dilution — that fully diluted EPS is intended to capture.

(c) Option Pricing Models are Inherently Speculative and of Minimal Utility When Applied to Employee Stock Options. The volume of the literature debating this topic, including, we might note, the extensive array of detailed questions and open issues

contained in the Invitation to Comment, provide ample evidence to us that the particular features of employee options, together with the vagaries of predicting volatility based on past history, make the development of an accurate and meaningful employee option pricing model impossible as a practical matter.

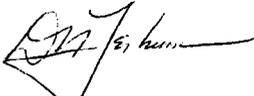
As you are well aware, Black-Scholes and other option-pricing models were developed for the valuation of short-term exchange traded options. The longer duration of employee options make projections of volatility even more speculative. More important, the particular features of employee options, including vesting, transfer and forfeiture restrictions, as well as legal and other impediments to hedging or settlement, severely depress the value of employee stock options in a manner that is immensely significant but difficult to quantify with precision. Finally, consistent application of these models by different entities is unattainable and will result in less, not more, clarity and comparability of financial disclosure.

(d) Fair Value Accounting Would Create Artificial Penalties to Using the Most Effective Incentives Available to Entities. Ultimately, we are convinced that an at-the-money stock option does not reflect a cost to the issuing entity and that, in the absence of accounting rules that might otherwise distort economic behavior, enterprises seeking to foster employee alignment with shareholder interests and the creation of shareholder value would continue to employ stock options widely. This is particularly true in industries like AET's where cyclical factors put cash at a premium and require the use of long-term incentives that can bridge business cycles and promise a meaningful return to employees. We believe that investors in an enterprise, when viewing stock option grants contemporaneously, understand that no economic cost is being incurred by the enterprise issuing the options, and that at-the-money options do not represent a current shift in shareholder value to the option recipients. The real issue for the investors is whether the options will generate capital appreciation that will justify the potential dilution they represent. We believe the current system of accounting for, and disclosing the dilutive effects of, stock options more than adequately addresses this issue.

(e) The Accounting Profession Should Resist Misguided Outside Pressures. The arguments both in favor and against the use of stock options in the popular media and Congress are and have been animated more by socio-political agendas and populist outrage at admitted failures in corporate governance than by sound economic thinking. Many of the most visible and vociferous supporters of "expensing stock options" have little or no understanding of stock based compensation accounting, whether employing fair value or intrinsic value, and mistakenly believe that adoption of new standards would help combat corporate abuses and illegal behavior and align the accounting and tax treatment of stock options. Abuses in option granting practices are best addressed by corporate governance initiatives, whether by the securities exchanges or through developments in state corporation law standards. Similarly, insider-trading violations associated with stock options and other stock-based compensation are properly the subject of Federal securities law changes, like those instituted by the Sarbanes-Oxley Act. The FASB already properly recognizes that artificial consistency between accounting expense treatment and tax deductibility is not a relevant or appropriate consideration.

We urge the FASB not to permit the current public backlash against all things perceived to be connected to the "bubble" economy of the 1990s to affect its consideration of this important issue. Stock options have been a crucial contributor to the success of the United States economy, and are integral to the entrepreneurial culture and business environment that distinguishes our country from those that are more risk averse. Current accounting for stock options reflects economic reality and provides investors with consistent, accurate information regarding the impact of stock options. Mandatory application of fair value accounting is inappropriate and would artificially distort economic behavior.

Sincerely yours,

A handwritten signature in black ink, appearing to read "D. N. Terhune", with a long horizontal flourish extending to the right.

David N. Terhune
President