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Letter of Comment No: 5021 File Reference: 1102-100

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Financial Accounting Standard Board 401 Merritt Norwalk, CT 06856-5116

RE: Exposure Draft No. 1102-100 Share Based Payments.

Dear Sirs:

I am a Certified Public Accountant currently employed in industry and I have analyzed your exposure draft in depth and wish to share my comments. I strongly disagree with your conclusions and recommend that you withdraw the exposure draft. First of all, I do not concur with your assumption that stock options are an expense. Accounting literature defines an expense to exist when there are outflows or other using up of assets or the incurrence of liabilities, or some combination of both, from delivering or producing goods or services or carrying out activities that constitute the company's ongoing or central operations. In effect, an expense exists when assets go down or liabilities go up. Secondly, an expense needs to be measurable. Traditionally, accounting has recorded what has happened, not a projection of what might happen, using an unproven formula. In the case of a stock option, ultimately what happens in the event the stock price actually goes up, is that the employee (if vested and still employed) will exercise the option resulting in a cash inflow, an increase in an asset, and an increase to paid in capital, both of which are "good things" and certainly not an expense. The only "bad thing" is an increase in the share count, which under FAS 128 and previous APBs was properly accounted for all along as a dilutive security. Therefore, one may ponder whether we should record an asset at the time of the grant, but certainly not an expense. Clearly the exposure draft is flawed when it considers this an expense.

The next major issue in the exposure draft has to do with valuation. To value an option, one needs to value the intrinsic value and any call premium associated with the life of the option. Since most all stock options are issued at fair market value at date of grant, the intrinsic value is zero. The only other potential value is the call premium. In order to be able to value the call premium, there must be a viable market to value it. In the case of a stock option, there is not. The option is non-transferable and subject to vesting, forfeiture, continuous employment and other restrictions. An option must be transferable to have a call premium in the real world. Furthermore, the CFO of our company sought counsel from several experts in valuing derivative equity securities, and all agreed that an employee stock option as normally issued has a call premium of zero. To apply financial models such as Black Scholes or binomial to these types of securities is factually wrong. They are used to value short-term transferable securities. Let us not forget that many options expire worthless, yet your requirement will force us to record an expense regardless of the outcome.

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The next issue I would like to address is the misrepresentation to not only the income statement by recording something that is not an expense but the impact on the balance sheet. By expensing an option, we record a reduction to retained earnings, but then increase contributed capital by a non-cash event. It seems logical to me that the only time a stock option should impact contributed capital would be when capital, i.e. cash, is actually contributed, which is at the time the option is exercised, not granted.

A few remaining comments have to do with the practicable application of your new proposal. First of all, I believe it will be extremely expensive and difficult to implement, near impossible to audit, and be subject to a lot of errors and judgment. How does that make financial statements better and how does this serve users of financial statements? Companies that have a highly volatile stock will bear a much greater cost than low beta stocks making comparisons essentially useless. I am also surprised that you didn't exclude employee stock purchase programs. Even with a 15% discount, these programs are a very effective and low-cost mechanism to raise capital for a company. By the time you add up the costs to underwrite the security, legal, audit, printer, management time, etc., the costs for smaller companies to raise capital can easily reach 15%. To include these programs in your exposure draft is not practicable.

I also must ask, how will the government react to expensing of stock options? If they are an expense, shouldn't they be deductible for tax purposes by the issuing corporation at the time of the grant? The answer is no as the cost is not measurable, nor is there a corresponding income to the employee equal to the formulaic expense. So once again, we do not have a good match of expenses and income.

In conclusion, I believe the FASB came to the correct accounting treatment in FAS 123 and FAS 128 providing for supplemental disclosures of stock options and letting the cost be correctly reflected as a dilutive security in EPS calculations. I strongly disagree with the exposure draft as written and respectfully request that it be withdrawn.

Sincerely,

John A. Ludrof, CPA

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