Letter of Comment No: 4767 File Reference: 1102-100



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VIA EMAIL TO: director@fasb.org

June 17, 2004

Ms. Suzanne Bielstein
Director of Major Projects
Financial Accounting Standards Board (FASB)
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File No. 1102-100

Dear Ms. Bielstein:

As the investment manager of the Florida Retirement System (FRS) and its 850,000 participants, as well as a sponsor of the Financial Accounting Coalition for Truthful Statements ('FACTS'), the State Board of Administration (SBA) is pleased to comment on the Financial Accounting Standards Board's (FASB) exposure draft regarding share-based payments, which calls for the expensing of all share-based payments, including stock options, awarded to employees.

The SBA fully supports the proposed rules detailed in the exposure draft and applauds the FASB's efforts to advance this much-needed reform. The SBA firmly believes that financial reporting standards should be shaped solely by what provides the most relevant, comprehensive information about a company's financial condition—not by what results in the most attractive reported numbers. The financial treatment of stock option incentive programs utilized by U.S. companies is a significant issue for the SBA, as well as other large institutional investors. A central component of the policy debate is the impact stock option issuance (and subsequent exercise) by corporate employees has on a stock's value.

The SBA believes that stock option issuance, without recognition on the financial statements, is "dilutive" to existing shareholders and should be treated as compensation that is paid to a company's employees. The following text is excerpted from a recent Institutional Shareholder Services¹ (ISS) research report:

¹ Institutional Shareholder Services, Inc. (ISS) is a provider of proxy voting and corporate governance services. ISS serves more than 950 institutional and corporate clients worldwide with its core business—analyzing proxies and issuing research and objective vote recommendations for more than 10,000 U.S. and 12,000 non-U.S. shareholder meetings each year. ISS's core businesses include global proxy services and database and research tools for institutional investors.

"Information about the value of stock option compensation is critical for investors not only for assessing the risk and return of investing in a particular company, but also in making capital allocation decisions across different investment opportunities. If start-up or cash-poor companies want to attract investors (whom they need as much as good managers), it is inappropriate to do so by understating, or hiding, the full cost of doing business. Compensating management is, by companies' own statements, a critical element for success. Therefore, such companies would do better to explain their corporate strategies and how they will succeed despite the cost, thereby attracting knowledgeable investors who have adequately assessed and are willing to accept the investing risks, rather than disguising those costs.

Recognition and measurement of an expense in the company's income statement will not prevent it from using employee stock options to compensate employees. Rather it will make the estimated value of those options explicit to the employee, company management, its shareholders and potential investors so that each can use that information in their respective decision-making."

The SBA routinely votes in favor of shareholder proposals that ask board of directors to adopt expensing policies and/or mandates stock option expensing. Organizations such as The CFA Institute², the Council of Institutional Investors³ (CII) and the International Corporate Governance Network⁴ (ICGN), of which the SBA is a member in each organization, strongly support stock option expensing, as do numerous large institutional investors. Finally, some distinguished investment managers such as Warren Buffet have publicly announced they favor stock option expensing.

Over the last several years, in conjunction with other corporate governance reforms, momentum has been building for stock option accounting reform. Many companies have voluntarily adopted an expensing policy (e.g., General Electric, General Motors, Citigroup, Coca-Cola and Microsoft)

² The CFA Institute (formerly the Association for Investment Management and Research, or AIMR) is a global, non-profit organization of more than 68,300 financial analysts, portfolio managers, and other investment professionals in 116 countries of which 56,000 are holders of the Chartered Financial Analyst® (CFA®) designation. Membership also includes 127 Member Societies and Chapters in 46 countries.

³ The Council of Institutional Investors is an organization of large public, labor funds and corporate pension funds which seeks to address investment issues that affect the size or security of plan assets. Its objectives are to encourage member funds, as major shareholders, to take an active role in protecting plan assets and to help members increase return on their investments as part of their fiduciary obligations. Founded in 1985 in response to controversial takeover activities that threatened the financial interests of pension fund beneficiaries, the group began with 20 member funds. Today the Council has over 130 pension fund members whose assets exceed \$2 trillion, and more than 125 honorary international participants and educational sustainers. It is recognized as a significant voice for institutional shareholder interests.

⁴ The ICGN was formally founded on March 29, 1995 in Washington DC. The International Corporate Governance Network (ICGN) is an international network of institutional investors, shareholder advocates and corporate governance experts collectively holding more than US\$10 trillion in assets.

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prior to any formal FASB rulemaking. Furthermore, the International Accounting Standards Board⁵ (IASB), which has jurisdiction for global accounting principles, has already proposed a mandatory expensing policy to be effective next year. Any setback to the FASB's proposed expensing rule will significantly impede the convergence between current FASB and IASB efforts to develop consistent financial reporting systems across global capital markets.

The integrity of audited financial statements is critical to the SBA and our thousands of pension participants and beneficiaries. We strongly believe your approach is the most appropriate one for companies operating in the United States and will result in a reliable estimate of the cost of stockbased compensation arrangements. We are pleased that the proposed disclosures provide financial statement users meaningful information about the number and value of share-based payments and the methodology used to value the awards. Taken together, the information should improve investors' ability to evaluate the costs, and value, represented by these awards.

While the proposed disclosures of the variables used to estimate fair value are helpful, we recommend that the FASB consider expanding the disclosure of volatility to include three years of data on actual volatility, as determined by some consistent standard. While past volatility may not be representative of future volatility, such disclosure would greatly enhance investors' ability to gauge the reasonableness of the volatility assumption.

We believe requiring all options to be expensed, along with meaningful disclosure of relevant assumptions, will result in high-quality, comparable financial statements. The SBA applauds the FASB's work toward developing first-rate accounting standards and believes your reform proposal will improve how U.S. financial markets function.

If you have any questions, do not hesitate to contact me.

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Sincerely,

Coleman Stipanovich

Executive Director

Sarah Teslik, Executive Director, Council of Institutional Investors cc:

Claude Lamoureux, Chairman of the Accounting & Auditing Practices Committee,

International Corporate Governance Network

Appendix: ISS/The CFA Institute Survey

⁵ The International Accounting Standards Board (IASB) is an independent, privately-funded accounting standard setter based in London, UK. Board Members come from nine countries and have a variety of functional backgrounds. The Board is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. In addition, the Board cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.

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APPENDIX

[Institutional Shareholder Services (ISS) & The CFA Institute (formerly the Association for Investment Management & Research, or AIMR) Survey from 2001]

In 2001, as the debate about expensing employee stock options heated up, the CFA Institute sent a survey to 18,000 members to determine their views on the issues. Over 1,900 investment professionals responded, including equity and fixed income analysts at investment management firms (26 percent of respondents) and brokerage houses (15 percent), as well as investment managers for institutional or private clients (38 percent). Seventy-five percent of respondents were from North America, 13 percent from Europe and 10 percent from the Asia-Pacific region. Disclosure of information about stock option plans was shown to impact a significant number of analysts and portfolio managers with 85 percent of respondents saying the firms they evaluate have such plans.

The survey results supported our hypotheses and provide considerable evidence to support upgrading the required accounting treatment:

- 88 percent of respondents believe share-based or stock option plans are compensation
- 83 percent said the accounting method for all share-based payments (including those given in employee stock option plans) should be expensed in the income statement
- 74 percent said that the current accounting requirements need improving; a majority said that expensing should be required while some said disclosures should be enhanced to give better information about potential dilution and the cash impact of related stock repurchase plans and exercised options.
- 81 percent use information about the value of stock options when evaluating a firm's performance and determining its value. Two-thirds use the information wherever it is disclosed, while 15 percent use it only when recorded as an expense.