

Letter of Comment No: 6423
File Reference: 1102-100

June 25, 2004

Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856-5116

**Project: Share-Based Payment
Reference Number: 1102-100**

Share-Based Payment-an amendment of FASB Statements No. 123 and 95

Dear Ms. Bielstein:

We appreciate the opportunity to provide the Financial Accounting Standards Board with our comments on the Exposure Draft (ED) of the Proposed Statement of Financial Accounting Standards on Share-Based Payment, File Reference No. 1102-100, dated March 31, 2004.

Issue 1: The Board 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, the ED requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusion?

Response: Yes and no. We agree that stock-based compensation costs should be reported in the financial statements. However, it is not clear to me whether certain current period stock-based compensation costs should be immediately expensed or should instead be reported as an asset on the balance sheet similar to goodwill (subject to periodic evaluation for impairment).

Before we begin our discussion of this issue, let me make it plain that we believe that employee services received in exchange for equity instruments give rise to a compensation cost that should be reported in the financial statements as the services are performed. In many cases, the current period compensation cost should be immediately expensed. In other circumstances, however, the cost should be capitalized and remain on the books subject to a periodic impairment test.

For example, stock purchased by employees at a discount under an employee stock purchase plan should be viewed as a form of compensation. In this case, however, the discount on these

voluntary purchases made by employees could be considered to be more in the nature of an asset (not an expense) because the purpose of these plans is to generate increased goodwill among the employees. It is likely that the employees will work at the same performance level whether or not they participate in these plans. However, the employees may be more likely to remain in the employment of companies that provide these plans than those that do not. Also, they may be more willing to work additional hours and weekends and promote the company in their off-hours than if they did not participate in these plans. In our view, compensation provided to employees through employee stock purchase plans translates into an additional willingness to work for the company. The actual services provided by the employee is then compensated through other means. Shareholders usually vote in favor of these plans because they believe they add value to the company. Thus, a case can be made that the estimated fair value of these plans, as measured by the discount on actual stock purchases, should be reported as an asset (subject to impairment tests) rather than as an expense, as it represents the additional value of the willingness of the workforce to work additional hours for the company.

Similarly, in many circumstances, the value of stock options granted to employees may also be seen as an asset, rather than as an expense. Though this view of stock-based compensation costs was not explicitly discussed in the June 24, 2004 FASB roundtable discussion on stock-based compensation held in Palo Alto, California, we believe that many of the discussants implicitly hold this view. For many entrepreneurs and investors in startup companies, the value of stock options granted to employees is viewed as an asset that represents the additional value that these employees will provide to the company through their services. As such, in the view of these entrepreneurs and investors, stock option compensation is different than cash-based compensation because it creates an owner where before none existed. As owners, these employees are willing to work longer hours than they otherwise would work.

Now we fully understand that compensation costs should be matched to the period in which the associated revenue is generated. In most cases, this compensation is expensed in the period in which it is earned. We think that in the case of certain stock option grants, it is possible to view the current period compensation cost as an asset that will remain on the books, subject to periodic impairment evaluation.

We think that this assumption underlies the proposal of some Silicon Valley executives who suggest that fair-value expensing should only apply to the five most highly-paid executives in a company. Though the actual number of executives to whom immediate expensing is appropriate seems too low, we think that this proposal is based on the recognition that stock options granted to highly-paid executives as a substitute for cash bonuses is different than stock options granted to production or R&D employees as an incentive to remain in the employment of the company and as an inducement to work additional hours. For the latter type of stock option grants, the compensation cost associated with the value of the grant perhaps can be viewed as an estimate of the asset value of these additional services rather than as an expense.

We admit that we occasionally are of the opinion that all stock compensation costs should be immediately expensed. At other times, however, we lean towards the viewpoint expressed above. We wish the FASB would grant investors, executives, employees, analysts, and academics more time to debate this issue. We think that debating as to when the fair value of the option grants are

more properly viewed as assets instead of as expenses will lead to a better understanding of the nature of these costs and has a better chance of finding a common ground among all interested parties.

Issue 3: The ED requires that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

Response: We believe that the compensation cost should be initially based on the grant-date fair value of the instruments. As long as the company's stock price equals or exceeds the company's grant-date stock price (i.e., the option is "in-the-money"), the compensation cost recognized in the current period should be based on the grant-date fair value. As described below, however, if the company's stock price drops below the exercise price (i.e., the option is "underwater"), then the compensation cost recognized in the current period should be adjusted downward to reflect the reduction in the incentive component of the employee's compensation package.

It is clear to me that employees who own underwater options do not work with as much enthusiasm as they do when they own options that are in-the-money. In-the-money options induce fundamentally different effort levels from employees than underwater options. As long as an employee's options are in-the-money, the employee will be willing to work longer hours and with more intensity to increase the value of the options. When the option is underwater, however, frustration and apathy set in and the employee is not willing to work as hard.

This behavior is asymmetric. It appears to me that employees will work with the same amount of effort when they own options that are barely in-the-money as they would when they own options that have doubled or tripled in value. This observation is based on the assumption that companies incentivize employees with stock options to work at their maximum performance effort. If the stock option increases in value, this maximum performance level cannot be increased further (i.e., there is no maximum beyond the maximum). When company stock prices decline, however, employees work with less effort and enthusiasm, and this decline in their performance level can be estimated by the decline in the value of the options.

For example, in the June 24, 2004 FASB roundtable discussion on stock-based compensation, Deborah Nightingale of Sun Microsystems (SUNW) mentioned that she currently holds SUNW options with exercise prices in excess of \$40 per share (issued during the calendar year 2000). Since the current price of SUNW shares is about \$4.40 per share, these options are severely underwater. Yet, under the ED, Sun Microsystems would continue to recognize the grant-date fair value of these options in 2004. We cannot believe that anybody in their right mind could truly believe that the SUNW is receiving services from these employees that are based on the grant-date fair value of the options.

In fact, the ED's requirement that the compensation cost associated with underwater options should be based on grant-date fair value is one of the primary objections to the ED. We think that everyone at the June 24, 2004 roundtable discussion (including analysts, investors, company managers, academics, and FASB members) realize that these underwater options are not

providing employees with an incentive to work at a level equal to the amortized portion of the grant-date fair value. Yet FASB board member G. Michael Crooch's response to Ms. Nightingale's objection was to ask Ms. Nightingale whether she would support an exercise-date mark-to-market revaluation for the upside as well.

We believe that Mr. Crooch's response is indicative of the accounting profession's bias that mark-to-market accounting must be symmetric with respect to increases and decreases in the fair value of the employee's compensation. But we disagree with that view. When the firm issues options, they expect to receive a certain dollar value worth of services. If the options increase in value, the employee will continue to provide the expected value of services. If the options decline in value, however, the employee will provide a lower level of effort. This difference should be reflected in the compensation cost recognized during the period in which the options decline in value.

To measure the current period option cost, we recommend the following procedure.

Step 1. At the end of each quarter, revalue the options using the most recent information regarding estimated exercise dates, risk-free rates, volatility, current value, and any other pertinent information.

Step 2. Calculate the compensation cost for the current period based on the revalued option. This estimate of the current period compensation cost is estimated by dividing the recalculated value of the option over its remaining useful life (which could be different from the option's original useful life).

Step 3. Compare the current period compensation cost estimated in Step 2 (based on the revalued option) to the current period compensation cost based on the original grant-date fair value. The lesser of the two values will be the current period compensation cost.

Notice that under our proposed system that the current period compensation cost only reflects the value of the services provided in the current period. There is no revaluation of prior period service value reflected in the current period compensation cost. That is, if the option value declines, the cost recorded in the prior period should not be adjusted in the current period because the employee is assumed to have provided services at a higher performance level in that prior period.

Thus, this proposed method is not the same as "mark-to-market" accounting. Though the fair value of the option is adjusted to market value for the purpose of calculating the current period compensation cost, the current period compensation cost does not reflect prior period adjustments due to revaluation. Thus, over the life of the option, the sum of the compensation costs recognized in each period may not add up to the total fair value of the option as measured on either the grant date or the exercise date.

We believe that our proposed methodology will remove one of the primary impediments to general acceptance of reporting stock option values on financial statements. Moreover, we

believe that our proposed methodology is a better measure of the value of the services provided by the employee during each reporting period.

Issue 4(a): The ED indicates that the fair value of equity instruments awarded in share-based payment arrangements with employees is best estimated by the observable market prices of identical or similar equity instruments in active markets. In the absence of observable market prices, the ED requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk-free interest rate. Due to the absence of the observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. 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?

Response: Recent academic research shows that many companies strategically manage their estimates of expected volatility, option holding periods, and risk-free interest rate to reduce the estimated fair value of option grants at the grant date. The incentives to engage in this type of behavior is enhanced by the lack of "truing up" the grant-date fair value to the exercise-date fair value. The ED should recognize the potential for strategically managing the data and assumptions used to estimate the fair value of option grants by providing some constraints on the measurement of these inputs.

Moreover, it is evident that using more sophisticated models to measure fair value impose a significant cost on the companies that are measuring these values. To enhance comparability across companies and reduce overall compliance costs, the FASB should provide companies with safe-harbor values that can be used as inputs in valuing stock options.

For example, to reduce the variability of estimated risk-free rates across companies, the FASB could (on a monthly basis) issue a report that states the expected risk-free rates that are to be used by companies in calculating option grants of different expected option holding periods. These expected risk-free rates could be used as inputs to both closed-form models and lattice models. For example, companies that use lattice models to estimate fair value could use probabilities of different interest rates that average to the FASB provided rates. Though this type of explicit guidance would reduce some of the flexibility that underlies the attractiveness of the lattice models, it would aid in the acceptance of the reported values as a basis for comparing the performance of different companies.

Please see our response to issue 4(c) with respect to measuring volatility.

Please see our response to issue 7 with respect to measuring estimated average option holding periods.

Issue 4(c): The ED requires enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24-B26 to their specific

facts and circumstances. In that regard, the ED provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

Response: We believe the Board should require a specific method of estimating expected volatility. Recent research has revealed the companies often adjust their volatility measures to reduce the grant-date fair value of their options. For example, it is common practice for companies that use historical measures of volatility as an estimate of future volatility to remove the 10 or 20 trading days each year with the highest and lowest returns from their volatility calculation as outliers. It is also clear that historical measures of volatility may not be valid in the case of firms that have significantly increased in size, analyst following, institutional coverage, etc.

We recommend that the Board require firms to use industry measures of volatility. Again, on a monthly basis, the FASB could issue a report showing expected volatility measures for a variety of industries over different time periods. Companies could then use these measures in calculating the fair value of their options. Companies in more than one industry could perhaps use a weighted-average of the volatility measures of the different industries that they are involved in.

Even if the FASB does not require companies to use these industry volatility measures, the Board could provide these measures as safe harbor values that can be used as inputs in valuing stock options. This information would be especially helpful to young companies that have little track record to indicate future volatility. Obviously, the volatility of stock returns in a year that the company engages in an IPO will be different from that company's expected future volatility. In this situation, industry volatility measures will probably provide better estimates of future volatility than the company's historical volatility. Thus, to ensure conformity and reduce strategic measurement of volatility, the FASB should make this information readily available to all firms.

By providing a safe harbor measure of volatility, the FASB may also lessen the probability that a company could be sued for not adequately measuring the fair value of their stock options.

Issue 6: The ED establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?

Response: Yes, we believe that employee stock purchase plan transactions are compensatory if the employee is entitled to purchase shares at a discount. However, we also believe that this compensation cost is more properly recognized as an asset, not as an expense. See our response to issue 1, above.

Issue 7: The ED requires that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in

exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?

Response: No, we do not believe that the requisite service period is the appropriate basis for attribution because the company will naturally expect employees to perform services at the increased level as long as they own the options. Instead, we believe that the compensation cost should be recognized over the expected holding period of the option. That is, the fair value should be recognized over the period between the grant date and the expected exercise date. Moreover, we believe that the company should redetermine the expected remaining holding date each period. We will discuss each of these points in turn.

When the company values the options at the grant date, one of the inputs is the expected holding period of the option. For a variety of reasons, for employee stock options, this period is typically less than the maximum life of the option. Since the fair value is estimated using the expected holding period, the compensation cost should also be recognized over this same period because the company expects the employee to perform at the expected service effort level over the entire holding period.

It does not make sense to me that the employee will suddenly perform at a lower level of effort after the option vests. To me, as long as an employee holds the option, he or she will continue to perform at the expected level of effort (that is, unless the option is underwater -- see our response to issue 3). Since the company typically expects the employee to hold the option beyond the vesting date, the recognition period should be the expected holding period, not the vesting period.

This proposed methodology has another side effect. Under the current method, companies have an incentive to forecast an estimated exercise date as early as possible, thereby reducing the value of the option and the related compensation cost. If the recognition period is the total expected holding period, then the company that wishes to manipulate its earnings faces a dilemma because the shorter holding period will both reduce the total fair-value of the option and increase the portion of the option value that is recognized as current compensation cost.

Second, as time passes, the company should update the value of the options using changes in the expected exercise date. If stock prices decline in value, the expected exercise date will increase. As stock prices increase, the expected holding period may decline. These factors will affect the value of services received by the company during the reporting period.

Issue 9: The ED considers an award with a grading vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?

Response: We agree that awards with grading vesting schedules should be valued separately. However, we do *not* believe that compensation costs should be front-loaded to reflect the

different vesting periods. Instead, we believe (as discussed more fully in our response to issue 7) that the total value of the compensation received through option grants with graded vesting schedules should be allocated over the expected holding period of the options. Obviously, if some options are exercised earlier than others, then the associated costs should be recognized over the shorter period. If the employee is expected to continue to hold the vested options, however, the option value should not be recognized over the shorter vesting periods.

If an employee is expected to continue to hold options after they vest, it is unclear to me why the employee would provide a lower level of service in the post-vesting periods. For example, take the case where an employee receives 400 options that vest ratably over a four-year period and is expected to exercise the options after five years. Under the ED, the compensation cost will be $\$100 + (\$100)/2 + \$100/3 + \$100/4 = \$208$ in the first year, \$108 in the second year, \$59 in the third year, and \$25 in the fourth year. Is it really likely that the employee is providing services in the fourth year equal to $25/208 = 12\%$ of the value of services provided in the first year? Under the methodology proposed in our response to issue 7, the compensation cost will equal $\$400 / 5 = \80 per year (as long as the options remain in-the-money). We believe that our proposed methodology better approaches the economic substance of the transaction than the ED's method, which distorts the economic relationship between the portion of the employee's compensation costs recognized in the current year and the value of services provided by the employee.

Issue 12: Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required?

Response: No. The new disclosures are clearly inadequate.

In analyzing and valuing current outstanding options, the most useful schedule is the schedule that shows the number of shares, weighted average exercise price, and weighted average remaining contractual life for each price range of options. Why are you removing this schedule? This schedule enables the investor to separately analyze the value of different stock option grants. You are removing all references to this historical data and are not replacing it with better information. We strongly recommend that you retain that schedule and supplement it with additional fair value information as of the balance sheet date.

More formally, we recommend that you retain paragraph 48 shown on page 37 of Appendix A and supplement it (**in bold**) as follows:

For options outstanding at the date of the latest statement of financial position presented, the range of exercise prices (as well as the weighted average exercise price (and the weighted average remaining contractual life shall be disclosed. If the range of exercise prices is wide (for example, the highest exercise price exceeds approximately 150 percent of the lowest exercise price), the exercise prices shall be segregated into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that

may be received as a result of option exercises. The following information shall be disclosed for each range:

The number, weighted average exercise price, weighted average remaining contractual life, **weighted average fair value, weighted average estimated remaining exercise date, weighted average estimated risk free rate over the remaining estimated holding period, and weighted average estimated risk-free rate over the remaining estimated holding period of unvested options.**

The number, **weighted average exercise price, weighted average remaining contractual life, weighted average fair value, weighted average estimated remaining exercise date, weighted average estimated risk free rate over the remaining estimated holding period, and weighted average estimated risk-free rate over the remaining estimated holding period of vested options.**

This information will give the analyst a better understanding of the value of current options and a better ability to forecast changes in the value of future option grants. We cannot emphasize enough the importance of this schedule as well as our surprise and frustration that you are proposing to eliminate this schedule.

In addition to supplementing this schedule, the following information would be helpful in analyzing options:

Information on how the company incorporates projections of future forfeitures into the determination of their current period stock option compensation cost. Do they base expected forfeitures on historical information? If so, over what period of time? What is the company's estimate of annual forfeitures? This is valuable information that we need to see to determine whether the company is properly estimating its compensation costs.

In the year that options are granted, state the number of options granted under various vesting dates. In addition, for each type of option, provide the weighted average expected holding period. This will help the analyst determine the validity of the option values determined by the company.

Where is the stock option expense shown in the income statement? If the analyst desires to change or modify the company's method of calculating stock options, he or she needs to know the apportionment of the total stock compensation expense among the various income statement accounts. This information would also be useful when making projections.

Issue 13: The ED requires the modified prospective method of transition for public companies and would not permit retrospective application. The Board's rationale for that decision is discussed in paragraphs C157-C162. Do you agree with the transition provisions of the ED? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of the ED? If so, why?

Response: There are several issues here.

The first issue relates to the proposed effective date. The ED states that the statement "shall be effective for awards that are granted, modified, or settled in fiscal years beginning after (a) December 14, 2004 for public entities and nonpublic entities that used the fair-value-based method of accounting under the original provisions of Statement 123 for recognition or pro forma disclosure purposes and (b) December 15, 2005, for all other nonpublic entities." For a variety of reasons, we believe the December 15, 2005 effective date is too early. First, as discussed in the June 24, 2004 FASB roundtable discussion on stock-based compensation held in Palo Alto, California, this early enactment date will lead to substantial out-of-pocket implementation costs and the increased probability of implementation errors. Second, after the final proposal is enacted, companies that rely on stock option plans will need to review their plans to determine whether their compensation policies need adjusting. This determination will be costly and time consuming. In addition, once companies review their plans, it will be costly and time-consuming to renegotiate compensation packages with their employees. As a result, we believe it will be cost-effective (from a cost-benefit standpoint) to delay the effective date for companies that currently do not use the fair value method from fiscal years beginning after December 15, 2004 to fiscal years beginning after December 15, 2006.

Second, as discussed in our response to issue 7, the appropriate service period is the expected holding period of the option, (instead of the vesting period). As such, during the initial year of its enactment, companies should report the compensation cost relating to all outstanding vested and unvested options, as well as newly issued options. This cost should not include costs relating to prior periods.

Third, retrospective application should be required for the purposes of the *cash flow statement*. It will be relatively easy for the company to restate the cash flow statement in terms of the new rules. It could be very difficult to analyze the cash flow statement if companies report their income taxes in different sections of the cash flow statement.

Fourth, retrospective application should be allowed for companies that wish to do so. This type of adjustment will be especially useful for analysts and investors.

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Again, we appreciate the opportunity to express our views on this issue to the FASB. We would be pleased to discuss any of our comments with the Board or the FASB staff. We can be reached at our telephone numbers or email addresses shown below.

Sincerely,

Michael Calegari
Associate Professor of Accounting
Santa Clara University
mcalegari@scu.edu
408-551-1694

James Sepe
Associate Professor of Accounting
Santa Clara University
jsepe@scu.edu
408-554-4036