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# Knoll

#### Dear Sirs:

We appreciate the opportunity to comment on FASB's Exposure Draft regarding Share-Based Payments. Knoll is among the largest U.S. manufacturers of office furniture. We are headquartered in East Greenville, Pennsylvania with major manufacturing operations in Michigan, Toronto, Canada and in Italy. Knoll employs approximately 2,200 people in the U.S. and an additional 1,100 people internationally. During our long history we have been publicly-traded (1997-2000), private with traded debt and thereby an SEC registrant (2000-2003), and, as now, we have no publicly traded debt and all of our shares are held by a small number of outside private investors and members of management. 183 employees hold stock options in Knoll at various strike prices. We have accounted for stock options in accordance with FASB rules...

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We are strongly convinced that the broad grant of stock options to our employees has been a meaningful differentiator for the success of Knoll versus others in the office furniture business. The accounting treatment outlined by FASB in the Exposure Draft will seriously curtail their attractiveness to our shareholders because it will:

- 1) Require us to issue misleading financial statements that will confuse readers of these documents:
- 2) May reduce our ability to procure materials on the same terms;
- 3) May hinder our ability to attract and retain personnel;
- 4) May make it harder to convince our customers that we are a viable company for them to partner with over the long-term;
- 5) Increase our administrative and accounting expenses for no obvious gain at a time when we can least afford it, and
- 6) Lead to greater challenges for our company to access the public debt and equity markets in the future.

#### **Users Of Our Financial Statements**

Many of the readers of our financial statements today are not very sophisticated. These include our rank and file employees, the purchasing departments of our customers, and our

suppliers. Moreover, as active borrowers from commercial banks, we spend an inordinate amount of time today educating the lenders on the cash and non-cash items in our various financial statements. FASB's proposals for expensing stock options will add tremendous complexity and confusion to our financial statements making it more difficult for many to really understand how our business is performing. For example, summary numbers, such as "net income", "EBITDA", "shareholders equity" take on tremendous meaning to these users, especially those that do not have access to the detailed footnotes of audited statements.

## **Background Context**

We believe it is important for FASB to understand the evolution of the U.S. office furniture industry over the past 25 years to best appreciate our perspective on the impact of its proposed changes on stock option expensing. Highlighted below are important aspects of our industry's current configuration that will create challenges for Knoll if it has to implement the changes described in the Exposure Draft.

1. Office Furniture Industry Growth Patterns. From the period of 1975 to 2000 the office furniture industry in the U.S. grew every year except 1991 reaching about \$12 billion in annual revenue. Prior to 2000 the office furniture business showed no signs of meaningful economic cyclicality. The growth profile is very different for the household furniture industry, which has shown many meaningful economic cycles over the past 25 years.

However, from 2000 to 2003 the industry's revenues declined for 37 consecutive months with annual revenues falling by nearly 40% from its high. Not surprisingly, profitability for many companies also deteriorated substantially, with several of the industry leaders, such as Steelcase and Herman Miller, becoming unprofitable. Knoll, which is considerably smaller than either of these two companies, remained strongly profitable and generated profits during this period above both of these companies combined. We are convinced that our relative success relates to the quality of our management team and their incentive structure aligned with our shareholders. Knoll's operating management owns a significantly larger amount through shares and stock options than our competitors.

- 2. Office Furniture Industry Public Companies. Among the major U.S. manufacturers of office furniture only three (Steelcase, Herman Miller, and Hon) are publicly traded. Knoll was publicly traded between May 1997 and November 2000 (the company went private at that point). Only Knoll has been an aggressive user of debt as part of its capital structure.
- 3. Stock Market Volatility. Please note that only Hon has been consistently profitable (along with Knoll), though its primary market segments tend to be lower end than Knoll's. In fact, most industry observers would place Herman Miller and Steelcase as the only two public comparable companies with reasonably similar business models and target markets, though as highlighted above, Knoll's profitability picture is meaningfully better.

# Financial Statement Disclosure Is Improper Accounting

In our opinion, recognition of employee stock options as an expense in the financial statements is improper accounting. Employee stock options are not a cost to the company, but a contingent (potential) reallocation of market value between our employees and our

shareholders. There is no expense to the company and no cash charge (ever) to Knoll. In fact, if exercised, the stock option will provide cash to the company.

Bringing the market share price of common stock into the P&L would be a material and confusing change for users of our financial statements. There are no other measures in the financial statements that have the potential to create shifts in reported income of the magnitude contemplated here.

## Footnote Disclosure Is Appropriate

We believe that full disclosure of the prospective cost of employee stock options will benefit all users of financial statements. Current FAS 123 requirements for broad based footnote disclosure of the potential cost of employee stock options to shareholders is adequate and appropriate.

#### **Grant Date Fair Value Is Problematic**

We disagree that if companies' recognize their employee stock options' costs on the P&L that "grant date fair value" is the appropriate methodology. We do not believe that grant date is the correct time to start the clock because of the highly contingent nature of employee stock options. There is no intrinsic value that an employee can capture prior to meeting both the conditions of exerciseability and value. While there is some theoretical extrinsic value to the stock option, our employees can never capture this extrinsic value because their stock options are not transferable, and further vesting is contingent on their active employment with Knoll. To be clear, we are not advocating variable accounting or a "mark-to-market" of the changes in intrinsic value over time.

# "Fair Value" Is An Improper Description

We think that "fair value" is an unfair characterization. At best, option pricing models provide a "theoretical value". Fair value, by definition, requires a willing seller and a willing buyer. Moreover, as a private company, Knoll's employee shareholders and option holders have no liquidity in the underlying common shares. Unless and until Knoll is sold or has its IPO, the value of the underlying shares is not realizable.

## **Option Pricing Models Are Problematic**

We have always believed that Black-Scholes overstated the value of our employees' stock options. However, it is relatively simple to calculate. Binomial models, as we understand them, are considerably more complex to use, will require us to capture considerably more data about exercise behavior (none of which is likely to be meaningful to the specific situation we find ourselves in today in terms of the evolution of the office furniture market, the gyrating value of our common shares, and the private-to-public-to private nature of our shareholdings over the past 8 years), and will not guarantee "fairer values."

Estimating "future volatility" for the purpose of these option pricing models is beyond challenging. We defy FASB, our accountants, or any 3<sup>rd</sup> party appraiser to argue that one future volatility number is superior to another for the purposes of these calculations. As we described earlier, there are few comparable public companies from an industry perspective, few from a profitability or leverage perspective, and few other industries that have demonstrated the same growth and deterioration pattern over the last 5-10 years. Forcing us to pick a number to fulfill the modeling requirements adds substantial fiction to our financial statements with a broad range of potential outcomes.

Implementation of lattice models will be a huge challenge and expense for our company. Discussions with our accountants as to how they would implement the Exposure Draft suggests that they don't have a clue, but they are prepared to undertake lots of studies, at our expense, to try to figure it out.

Accountants today have enough difficulty getting the historical costs accurate. In the litigious environment within which they work, asking them to predict the future is unfair. FASB or the SEC must provide safe harbors to prevent total chaos. As we aspire to return to the public capital markets at some point in the future, we operate the business today similar to that of public companies, especially regarding Sarbanes-Oxley. Forcing our CEO and myself to certify the financial results with the future forecasts required under the option pricing models is also problematic as we cannot have confidence that these models fairly reflect the "expense" of employee stock options.

## **Intrinsic Value Method Is No Alternative**

We strongly disagree that the intrinsic value method with re-measurement is an appropriate accounting treatment. This approach will lead to variable accounting. Variable accounting is a horrendous outcome for us.

Variable accounting penalizes companies, such as Knoll, that perform well, by reducing their reported income to reflect increases in their share price.

We aspire to have an IPO in the near future. Variable accounting destroys the trend lines that are important to investors in valuing our company. We are aggressive bank borrowers. Our credit agreements require certain financial performance levels or metrics to avoid acceleration of loans. Variable accounting creates havoc in this regard.

While, in theory, our bankers can make adjustments to their language on loan covenants to omit the impact of these charges, it defeats the purpose of the financial statements if we keep our books one way for lenders, and a different way for other constituencies.

We also have an exit potential for our shareholders via merger with a public company. FASB's intrinsic value method would make us less desirable to such an acquirer as it would pass along variable accounting to them.

Finally, the intrinsic value method does not reduce the implementation cost substantially because we will have to seek a 3<sup>rd</sup> party appraisal of our common share price each reporting period to satisfy our auditors. This appraisal expense is likely to be similar to the expense and much of the burden of implementing the "fair value" method.

In short, an alternative that creates variable accounting is not a real alternative.

### **Suggested Modifications**

We recommend that FASB meaningfully amend its treatment for non-public companies as follows:

1) Extend the implementation time period by at least an extra year to allow them to develop adequate alternatives for incentivizing employees, as stock options as we use them today, will be very difficult for most companies, including ours to issue. With the expected crunch of work with few knowledgeable practitioners, and limited internal resources, we will need the added time to prepare.

2) Allow Boards of Directors using an appropriate methodology to determine "fair value". This will limit 3<sup>rd</sup> party expense (which we estimate at \$50,000 per year on top of a probable equal amount of incremental internal expense), but allow Boards to seek outside assistance if they want.

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We appreciate the opportunity to share our thoughts with FASB. We hope that FASB will take these inputs seriously and reconsiders its proposed treatment for expensing stock options before it damages the credibility and usability of financial statements, and forces companies like Knoll to suspend their use.

Sincerely,

Barry L. McCabe

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Senior Vice President and Chief Financial Officer