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Via email: director@fasb.org

June 15, 2004

Letter of Comment No: 3989
File Reference: 1102-100

Ms. Suzanne Q. Bielstein
Director of Major Projects
Financial Accounting Standards Board
401 Merritt 7
Post office Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 1102-100

Dear Ms. Bielstein:

The Pennsylvania State Employees' Retirement System ("SERS"), established in 1923, is one of the nation's oldest and largest state retirement plans for public employees, with more than 200,000 members and beneficiaries. SERS is among the largest of public and corporate pension funds, with assets of $25.5 billion.

SERS strongly supports the Financial Accounting Standard Board's ("FASB") proposed rule changes in the exposure draft entitled *Share-Based-Payment, an amendment of FASB Statements No. 123 and 95* calling for the expensing of all share-based payments, including stock options.

As a major institutional investor which relies on relevant and reliable financial information to make investment decisions, SERS endorses FASB's goal of achieving the following objectives with this proposal:

- **Addressing the concern that the current method of valuing share-based compensation under Opinion 25 results in financial statements that do not faithfully represent the economic transactions affecting the issuer, namely, the receipt and consumption of employee services in exchange for valuable equity instruments.**
  - Under Opinion 25, issuing stock options to employees generally results in recognition of no compensation cost. This proposed Statement would require public companies to recognize the cost of employee services received in exchange for equity instruments based on the grant date fair value of those instruments.
- **Improving the comparability of reported financial information through the elimination of alternative accounting methods.**
  - Eliminating different methods of accounting for the same transaction leads to improved comparability because similar economic transactions are accounted for similarly.
- **Simplifying of the accounting method for share-based payments by elimination of Opinion 25's intrinsic value method and its many related detailed and form-driven rules.**
- **Achieving convergence with International standards.**

In support of this position, SERS' Board of Directors relies on its public endorsement of the principles of the Conference Board's Commission on Public Trust and Private Enterprise's *Findings and Recommendations on Executive Compensation, Corporate Governance and Audit and Accounting,* which specifically recommends expensing fixed price options. The Conference Board convened the 12-member Commission in June 2002 to address the causes of declining public and investor trust in companies, their leaders and America's capital markets.

The Commission's report on executive compensation indicated that there has been a "perfect storm" in executive compensation – a confluence of events in the compensation arena which created an environment ripe for abuse, citing the fact that "excessive use of stock options – particularly fixed price options – was encouraged by the fact that fixed-price options do not result in a charge to earnings, while they provide the added benefit of substantial tax deductions." The Commission also urged FASB "to move expeditiously to determine appropriate accounting treatment for equity based compensation consistent with the Commission's recommendations."

The recent stock market bubble, coupled with numerous corporate scandals involving accounting fraud, led to the longest duration bear market in U.S. history. Many of the problems uncovered when the market declined were due to the misaligned incentives that stock option mega-grants created for senior executives. Fixed price stock options have essentially become the equivalent of free lottery tickets to corporate management. In many instances corporate executives were inappropriately incentivized to artificially "pump" up short-term earnings and stock prices in order to cash in and "dump" their personal stock option holdings, enriching themselves at the expense of shareowners. Enron, Tyco and Quest showed investors that it is abusive not to show option costs in plain English on the financial statements.

According to a June 1, 2004 article in the Financial Times, a recent study by researchers at Texas A&M University found that "companies that restated their financial results as the U.S. boom faded in 2001-2002 were more likely to have chief executives holding substantial amounts of stock options." The article concludes that this finding "provides evidence that heavy granting of share options to senior executives might have incentives behavior contrary to the best interests of other shareholders."

In spite of efforts to reform the executive compensation excesses of the 1990's, evidence is beginning to surface that corporate America is failing to get the message. Newsweek magazine reports, in a June 14, 2004 article by Louis Lavelle entitled ***Governance: Backlash in the Executive Suite,*** that "even as boards generally have become more responsive to shareholders, some have turned a deaf ear to them. Both Yahoo! Inc. and eBay Inc. gave huge grants to their CEO's this year. Yahoo's Terry S. Semel received an options grant worth $92 million and eBay's Margaret C. "Meg" Whitman was awarded an options grant worth some $25 million." The article goes on to point out that "other companies continue to fight against expensing stock options, although a majority of their shareholders have urged them to."

Shareowners are significantly harmed from current accounting practice under Opinion 25's intrinsic value method of accounting in the following ways:

- First, investors are harmed when they unwittingly make investment decisions based on inaccurate and misleading information about the effect of options on earnings currently provided in corporate financial statements.
- Second, shareowners lose value as a result of management's focus on short-term investment performance rather than long-term value creation in order to artificially boost short-term share prices to trigger their options.
- Finally, investors are severely hurt by the dilution effect on their shares when options are exercised.

FASB's proposal is consistent with SERS position that stock options have a measurable economic cost and that companies should include these costs as an expense on their reported income statements. Companies should also be required to disclose their value assumptions. Providing investors with relevant and meaningful financial information, which accurately reflects the economic impact of stock option transactions will enable investors to make more informed investment decisions and help to restore confidence in the market.

One of the often-repeated criticisms of this proposed rule change is that using a fair value-expensing model would have a significant adverse impact on the value of a company's stock price because it would require some companies to report substantially lower earnings in their financial statements. However, according to a recent Towers Perrin study of more than 300 companies that have already begun expensing options, a company's decision to expense stock options has no impact on its share price.

When the Conference Board's Commission was launched in 2002 there were only six S&P 500 companies that were expensing options on their financial statements. Interestingly, since that time, option expensing has been more widely adopted. For example, as of February 12, 2004, 483 companies had adopted or announced that they will adopt fair value expensing of stock options. Of these, 279 (58%) have market capitalizations in excess of $1 billion and 113 (23%) are S&P 500 companies.

SERS applauds the FASB efforts to improve U.S. financial accounting and reporting standards and its initiative to promote international convergence of high-quality accounting standards.

Sincerely,

Nicholas J. Maiale
Chairman

Peter M. Gilbert
Chief Investment Officer

Cc: Mr. Robert Herz, Chairman - FASB