Letter of Comment No: 5832 File Reference: 1102-100

June 29, 2004

Mr. Robert H. Herz, Chairman Financial Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, CT 06856-5116

Re: Comments on Exposure Draft: Proposed Statement of Financial Accounting Standards, Share-Based Payment an amendment of FASB Statements No. 123 and 95
File Reference No. 1102-100

Dear Chairman Herz:

Thank-you for giving the public chance to comment on the exposure draft, as an investor, I'm very interested in the results of this public discussion, and I appreciate the opportunity to share my views on the topic.

After reviewing the proposed amendment to statement No. 123 and the associated arguments posted on the FASB website, I have come to the conclusion that I do not agree with the proposal to expense employee stock options. I arrive at this conclusion based upon the arguments and the implementation proposed within the exposure draft, as well as other potential economic affects. As a consumer of financial records, I value accuracy very highly and it is my feeling that on balance, the proposal adversely affects the accuracy of the financial reports for a majority of the entities covered.

I see employee stock options as a cost borne by the shareholders in the form of dilution. Therefore I do not believe it is appropriate to treat these instruments as an expense of the company. And consequently, a company should not recognize them on their income statement.

I believe for an employee stock option expensing proposal to be effective the entity would have to accurately estimate the future value of the underlying stock. Although the FASB asserts that it is possible to estimate the fair value using pricing models for other exchange-traded options, I disagree. To date, there have not been any models presented that can correctly model all of the restrictions and conditions present in an employee stock option. Some of these restrictions the holder must accept include: black out periods for trading, limits in hedging, non-transferability of the option, limits on investments in companies which are suppliers to the entity, limits on investments in competing companies, total transfer of all intellectual property developed during the holding period to the entity, limits on future employment, and arbitrary termination of the instrument with 30 days notice.

It is also important to note that the stock price, and subsequently the value of the associated option, is dominated by external influences, which can be unrelated to the past

performance of the company or stock. As a matter of fact, virtually all investment prospectuses state that past history is no indication of future performance. Therefore, trying to accurately estimate the fair value of an option based upon past performance is an unreliable endeavor. Even comments in the exposure draft admit the difficulty for estimating instruments from companies with limited histories. Although the FASB arguments readily point out that 483 companies intend to adopt the fair value based accounting method, it also neglects to mention that the 483 companies represent a very small fraction of the more than 7000 companies currently listed on the major domestic stock exchanges. More than 3000 of these companies have market capitalizations less than \$200M and would probably fall into the difficult to estimate domain.

For example, an estimate of fair value following an extended bull market would result in a higher valuation than the same estimate for the same instrument following an extended bear market. Using a fair-value estimate pegged to the grant date without remeasurement also creates a situation where two different instruments with the same vesting date strike price and term can carry different valuations for expense purposes depending upon the grant date.

Employee	Grant Date	# shares	Strike Price	Vesting Date	Expiration
Α	Sept. 1999	1000	\$10	Sept. 2004	Sept. 2005
В	Sept. 2003	1000	\$10	Sept. 2004	Sept. 2005

Take employee A with shares granted at the end of the bull market and compare it to employee B with shares granted in 2003 during the bear. Since they are essentially the same instruments with the same restrictions, conditions and terms, vesting on the same day. If you could find them on the open market, these instruments would have identical valuations upon vesting (basically, the day control is passed to the employees). However, they will have vastly different valuations because of the different grant dates based upon the FASB proposal. Essentially, two identical assets used for compensation (as defined by the FASB proposal) of employee services but with different valuations for accounting purposes. Clearly, this adversely affects the accuracy of the statements if identical assets are allowed to carry different valuations.

Furthermore, the expense of the older options carried by employee A could be avoided by terminating the employment of that employee and not allowing the shares to vest. Imagine what could happen to companies during a downturn when cutting expenses is necessary to boost profits, employees with greatly overvalued shares would be subject to layoff just to clear the books of the over exaggerated fictitious expenses. More than likely, the cuts would hit the most senior employees hardest. In reality, the options would have lost value or could have become worthless because of the affects of the economic downturn, but because of the inaccurate information related to grant date valuation the financial reports would overvalue the expense. The only means for correction would result in the termination of the employee.

In addition, when an option expires worthless, it is clear no value is passed to the employee and the inaccuracy of the model overestimated the true value of the share.

Other "at risk" compensation (sales commissions or profit sharing) is not expensed based upon opportunity cost and neither should it be the case for share options. Since most young start up companies fail, a majority of the options granted in the high tech industry expire worthless. To peg a positive valuation on all of the options granted based upon the valuation models is flawed, and to allow the expense to go uncorrected even when an option expires worthless is unacceptable. Any attempt at valuation at grant time should not be considered gospel, but the first approximation of the actual value, which should be readjusted until the option vests. To ignore reevaluation of the instruments based upon more recent data hinders the accuracy of the financial reports.

It would seem that under the proposed guidelines, the accuracy of the financial statements would be negatively impacted the greatest at the points in time when accuracy is needed the most. Initial Public Offerings (IPOs), sustained bear markets, during times of high volatility, and during company collapses/bankruptcies. At IPO, since the entity would have very little basis to form an accurate model, any attempt at fair value estimates would cloud the financial reports. Sustained bear markets can make sizeable chunks of outstanding share options worthless although the associated expenses valued at the grant dates would be carried forward at its previous full value until fully vested. Finally in the case of a company in trouble and rapidly heading toward bankruptcy, the un-remeasured expenses associated with previously granted share options would increase the rate of loss on the income statement although no cash outflows would be occurring, and the real value of the outstanding share options would most likely be approaching zero.

If compensation costs are expensed against income, then tax benefits should also apply to income. The proposal seems unsymmetrical; in one direction the impact affects income while the opposite direction affects paid in capital.

Although the desire for improved accounting guidelines exist, new rules from an overly activist body can result in what amounts to constructive termination of programs highly beneficial to the nation's economy. Inasmuch as the accounting process was develop to record transactions and fairly present the financial conditions of an entity and not to outlaw or impede legal commerce, I would urge the board to reconsider its implementation of options expensing proposal and to heed to warning of both employees and companies that state that these rules will eliminate these programs if enacted.

I would like to see the FASB perform due diligence by applying the proposed rules to the financial records of a statistical sample of the companies existing between 1994 and 2004 to see if their assumption of accuracy is correct. Hind sight is 20/20 so it should be easy to tell if the preferred models can accurately estimate the correct value of share options. Please be sure to include small companies as well as large companies and IPOs as well as bankruptcies, since these rules apply to all companies, and not just the best performing companies in the S&P 500.

The problem with Enron and Worldcom was not the lack of accounting for stock options but rather the inability or unwillingness of the auditors to identify inaccuracies in the financial statements. I fear that the addition of stock option expensing would only give

scoundrels another tool to manipulate financial reports and to hide their fraud behind unverifiable evaluation models. At the very worst it seems like a "get out of jail free" card for the auditors to hide behind.

For my purposes, disclosure would be more useful than expense recognition for stock options. I would prefer to see the exact amounts detailed for outstanding options including the strike price, vesting schedule and term (expiration date). These number would be ultimately transparent, easily verifiable and could be used by analyst to assess the impact of stock options on the financial situation of an entity without having to rely on the validity of an unknown options pricing model chosen by a third party. Since options are approved by most board of directors in their monthly meetings, most company should have ~120 (10 years 12/year) entries in total to detail all of their outstanding options.

I also disagree with Section 15 of the proposal that allows a company to include as compensation any share transferred from any shareholder to any employee of the company. This is clearly a payment from a third party and should not be included as part of the entity's expense. It would seem that if the company were to set up a share based "trophy" to be passed around in recognition of work performed, they would be able to expense the same share multiple times as the "trophy" is passed from one employee to another.

In closing, I'm against expensing stock options because of the following:

- 1. Options are not an expense to the company but a cost to the shareholders in the form of dilution.
- 2. Option expensing relies on the accurate estimation of the future value of a stock, which is impossible.
- 3. The methods for valuation at grant time lead to in accuracies in the financial reports and have not been proven to be accurate for a majority of the entities covered by the proposed rules.
- 4. The methods for valuation hinder transparency and inject inaccuracies that are problematic during independent analysis and auditing.
- 5. The proposal has inconsistencies which should be corrected
- 6. Better alternatives exist which are more accurate and more transparent. (Disclosure methods).
- 7. From an economic standpoint, stock options align shareholder and employee goals, and have proven to be effective economic engines. Unfortunately, as presented this proposal leans toward "constructive termination" by its activism.

Sincerely Yours,

A.R. Yee Los Gatos, CA