Letter of Comment No: 3770 File Reference: 1102-100

June 15, 2004

Via email to director@fasb.org

Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: Exposure Draft on Proposed Statement of Financial Accounting Standards - Share Based Payment

Dear Director:

On behalf of EMC Corporation, I am pleased to provide the following commentary on FASB's exposure draft covering shared-base payment.

EMC agrees with FASB's underlying premise that stock options have a value and that value should be recognized in the financial statements. We believe investors should be able to see the cost of all compensation vehicles employed in an organization. While the FASB's actions attempt to achieve this result, we disagree with four aspects of the exposure draft:

- 1. The short timeframe required for implementation.
- 2. The inclusion of existing outstanding stock options at a value that clearly is not reflective of their worth.
- 3. The transition rules that provide for inconsistent treatment for expensing existing outstanding stock options versus newly granted stock options.
- 4. The manner in which stock option expense will be recognized.

### 1. Short timeframe required for implementation

The exposure draft aims to measure stock options at their fair value. Fair value is best determined by observable market prices of identical or similar equity instruments. However, most companies do not have options that are publicly traded. If a company has publicly-traded stock options, it is unlikely that their terms are similar to those granted to employees. In the absence of such market data, an option pricing model should be employed.

Since the introduction of FAS No. 123, the use of a Black-Scholes, or closed-form model, has been standard fair. The movement to a binomial model, which is viewed as preferable in FASB's exposure draft, is a step in the right direction. There is a clear need for a more robust model that better reflects the volatility of the market. The migration to a binomial model will allow for improvement in stock option valuations; however improvement will only be achieved to the extent the underlying data utilized in the model

reflects both historic and expected experience. The time needed to gather the data, perform an in-depth analysis and evaluate the likelihood of changes from historical experience to future expectations will be significant. FASB needs to be cognizant of the timeframe needed to ensure appropriate data is available.

Once the data is available, companies then need to have a lattice model, which is a form of a binomial model, to determine the stock option values. There is currently a lack of readily available software packages in the marketplace to perform this type of modeling. This will place a heavy burden and cost on companies to either divert internal resources to build a model or to rely on a limited number of third parties who possess the capabilities to do such modeling. This situation becomes even further exacerbated by the fact that FASB does not intend to issue a final pronouncement until the fourth quarter of 2004. Given the potential for changes from the exposure draft to the final release, it is premature for businesses to rush to make significant investments until the rules are finalized. We recommend FASB defer the effective date of the pronouncement for at least one year from its final issuance.

# 2. The inclusion of existing options at a value that clearly is not reflective of their worth

The exposure draft requires that all stock options be expensed commencing in 2005. This includes both existing outstanding unvested stock options and newly granted stock options. We believe the inclusion of outstanding unvested stock options will result in financial results that are not meaningful. Our basis for this conclusion stems from both the dramatic change in the market over the last several years as well as the transition rules provided for in the exposure draft.

EMC, like most hi-tech companies, grants stock options to attract and retain talented professionals. During the late '90s and 2000 timeframe, EMC granted stock options when its stock was trading in the \$60 to \$100 price range. The use of the Black-Scholes model placed a significant value on these stock options. Each quarter, EMC has disclosed the impact to its financial statements of expensing stock options. The quarterly charge for EMC's stock option expense averaged \$93 million for 2003. At least 70% of each quarter's expense was comprised of stock options which been granted when shares of EMC's stock traded for \$25.00 or more. In fact, the majority of the expense related to stock option grants that had exercise prices in the \$60 to \$90 price range. During 2003, EMC's stock price averaged under \$11.00. While we agree these options have nominal value, we believe that inclusion of an expense of this magnitude would distort our financial statements. To assume that stock options that today are underwater by \$50 to \$80 are still worth their values when originally granted is optimistic at best.

FASB should reconsider its implementation guidance. We believe the most practical approach would be to require expensing for only stock options granted after the effective date of the pronouncement.

# 3. The transition rules that provide for inconsistent treatment for expensing existing stock options versus newly granted options

The transition rules provided in the exposure draft are problematic. Stock options that are outstanding prior to the pronouncement's effective date will be treated in a different manner than stock options granted after the pronouncement's effective date. The exposure draft requires existing outstanding stock options that are not yet vested to be expensed over their remaining vesting period. The measurement of the value for these awards would be the same as when the stock options were originally granted. For most companies, that will be a Black-Scholes methodology. The preference of the exposure draft for new stock option grants is to migrate to a binomial model. Given that FASB has already concluded that the Black-Scholes model is limited in its ability to determine fair value, we do not believe inclusion of cost for prior options under a Black-Scholes model would provide meaningful financial information.

Another difference lies in the attribution method; that is the method employed to spread the value of the stock options over their vesting period. Existing unvested stock options would also follow the same attribution method that was employed when the stock options were granted. Under today's standards, stock options are typically expensed on a straight-line basis over the vesting period. The exposure draft requires stock option grants that vest over multiple years to be considered separate grants. Each "sub-grant" is required to be expensed over its vesting period. As an example, if a stock option is granted that vests over four years, 52% of its value will be expensed in the first year after it is granted, 27% in year two, 15% in year three and only 6% in year four. Even though the employee needs to work over the four year time frame to earn the stock option, the expense is recognized assuming a greater portion of the value is earned in the earlier years. Instead of dealing with these inconsistencies, we recommend the pronouncement only require prospective grants to be expensed.

#### 4. The manner in which stock option expense will be recognized

While the attribution example demonstrates inconsistencies from a transition perspective, it also is inconsistent with how management of most companies really thinks about the manner in which stock options are earned. Compensation cost should be recognized as awards vest. We believe a straight-line methodology of recognizing cost is more appropriate.

#### **Conclusion**

Stock option accounting is a complex area. While a need does exist to recognize the cost of stock options, all constituents need to be sure that our market regulators provide a sound vehicle to measure, recognize and report the costs. Let's make sure we have a sound answer before forcing change. The exposure draft is a first step in the right direction. Let's make sure the final rules appropriately address all the issues of concern before any action is taken.

Sincerely,

Mark Link VP & Chief Accounting Officer