Synopsys, Inc.
700 East Middlefield Road
Mountain View, CA 94043-4033
Tel: 650-584-5000
Fax: 650-584-4391

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SYNOPSYS

June 30, 2004

Ms. Sue Bielstein
Director of Major Project and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Via e-mail at
Director@fasb.org

Re: File Reference 1102-100

Dear Ms. Bielstein:

We appreciate the opportunity to comment on the Exposure Draft of the Proposed Statement of Financial Accounting Standards, *Share-Based Payment, an amendment of FASB Statements No. 123 and 95* (the Exposure Draft or ED). We commend the FASB for its interest in and goal of ensuring that investors receive adequate information regarding employee stock options and their impact on the financial position of an issuer. However, we believe that the ED does not achieve this goal for the following reasons:

- We believe that the recognition of compensation expense for employee stock options will degrade the quality and usefulness of financial statements by reporting as a corporate expense an item for which there has been no cost, as defined by the existing accounting literature, to the issuing company.

- We believe that it is not possible to measure, with the degree of accuracy required for inclusion in the financial statements, the fair value of an employee stock option at the date of grant with the tools available today.

- We believe the FASB proposal will increase competitive pressures in the area of hiring and employee retention because the proposals in the ED appear to be applied in an inconsistent manner between companies (public vs. private companies and potentially between direct competitors).

- We believe that the transition provisions will result in financial statements that are not comparable on a period-to-period basis, decreasing their usefulness and encouraging the use of alternate measures of financial performance (i.e., "pro forma" financial information).

We also believe that the current combination of footnote disclosure as required under Statement of Financial Accounting Standards (FAS) 123, supplemented by the voluntary disclosures implemented by many companies, meets the goal of providing investors with sufficient information related to employee stock options.

Our specific comments related to the ED are as noted below.

Recognition of Compensation Cost

We do not agree with the FASB's conclusion that employee services received in exchange for equity instruments give rise to recognizable compensation cost. We believe that such a recognized cost is contrary to existing accounting guidance and is potentially misleading.

First, accounting guidance defines an expense as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) . . ." (FAS CON6, ¶80) In the case of employee stock options, there is never an outflow of company assets or the incurrence of a liability.

Arguably, there is some cost of issuance of employee stock options. This cost, however, can more properly be defined as an opportunity cost to the shareholders of the company in the form of (potential) dilution. This dilution cost is already reflected in the company's diluted earnings per share – including an expense in the income statement would result in a double counting of the cost.

Second, no reliable method for valuation of such a cost exists. Existing accounting literature requires that an expense be reliably measurable:

> "The asset, liability, or change in equity must have a relevant attribute that can be quantified in monetary units with sufficient reliability." (FAS CON5, ¶65)
>
> "To be reliable, information about an item must be representationally faithful, verifiable, and neutral. To be reliable, information must be sufficiently faithful in its representation of the underlying resource, obligation, or effect of events and sufficiently free of error and bias to be useful to investors, creditors, and others in making decisions. To be recognized, information about the existence and amount of an asset, liability, or change therein must be reliable." (FAS CON5, ¶75)

In the next paragraphs and in the section *Fair Value Measurement* below, we describe our objections to the valuation methodology proposed under the ED.

Third, assuming the use of the binomial valuation model proposed by the ED, any valuation would be, at best, a loose estimate. We acknowledge that a number of estimates are included in the financial statements; however, the estimate of expense related to employee stock options would be very different:

- There are unknown characteristics inherent in an employee stock option such as the cost/value ratio to an employee versus the same such ratio for the issuing company.

- There is no appropriate methodology that adequately values the characteristics of an employee stock option. Both the binomial and Black-Scholes models assume that (i) an option is transferable, (ii) there is a clear market for such transfer or trading, and (iii) the option is short-term. These assumptions are simply not valid for an employee stock option. In addition, the models do not appropriately consider the future services requirement inherent in an employee stock option.

- The proposed option valuation methodologies ignore the benefits a company will receive from the use of an employee stock option: employee retention, innovation, alignment of employee interests with those of the shareholders, and increase in the value of the company's stock. *Please see additional comments with respect to the valuation methodology proposed in the ED noted below.*

- There is no ultimate validation of the value assigned to a stock option, either in the form of actual value received by the employee, assets given up by the company (as there are none) or independent third party valuation of the instrument.

- Finally, no provision has been made for revaluation or adjustment of the initial valuation as better information becomes available. Nearly all other GAAP-based estimates provide for such an adjustment. We are not suggesting that options be revalued or that variable accounting would be appropriate; however, this does appear to present an inconsistent application of accounting guidance.

We believe all of these factors will lead to a degradation of the quality of financial statements resulting in financial statements that are LESS transparent, reliable and useful. Given the fluctuations in the economy and the financial markets over the past few years, it is apparent to us that initial valuations made based, in part, on a prediction of stock price volatility could result in valuations that are materially inaccurate within a period as short as 6 months to a year – due to factors that are beyond the control of the company. This inaccuracy would in turn result in financial statements that are materially in error and misleading, resulting in less transparency of a company's financial statements, potentially increasing the legal exposure for the company and its officers, and increasing reliance on non-GAAP measures of financial results.

Fair Value Measurement

In addition to the comments noted above regarding the reliability of the binomial model, we have the following comments on the valuation methodology proposed in the ED:

The proposed valuation model does not appropriately reflect the economics of employee stock options

The binomial model does not take into account all of the essential elements of an employee stock option; specifically, it does not consider that the instrument is (i) non-transferable and non-tradeable, (ii) subject to forfeiture (because it requires continued employment for vesting and exercise), and (iii) generally long-term. Other factors such as the impact of opening and closing insider trading windows and the lack of diversification in the typical employee's portfolio are also not given recognition in the valuation model.

In addition, the ED states that the valuation is to be made at the grant date. Given the number of factors that cannot be known and must be estimated at the time of grant (*see next section*), and the fact that the employee option must vest and be "in-the-money" for the employee to ever realize any value from the option (i.e., the option may never be exercised and may never result in any value to the employee), a grant date valuation would result in the highest degree of distortion of the economic value.

Inputs to the valuation model are subjective and inherently biased

The ED states that, when determining the inputs to the valuation model, historical experience, adjusted for known conditions, is the best measure. As in the case of estimating volatility, this, in effect, will require companies to estimate their stock price over a likely protracted period, with a degree of certainty, which is simply not practical. In making such an estimate, there is no plausible way to eliminate the bias of the person making the estimate – this will make the estimate subjective and prone to error and manipulation.

Another estimate required for the binomial model – the projection of employee behavior – is highly dependent on the state of the economy and the financial situation of the employee(s). While historical behavior can, with some degree of accuracy, be determined, due to the external nature of the factors affecting it, any projection as to future behavior will be inherently biased to the views of the preparer, subjective, and prone to error and manipulation.

Given that the binomial model is very sensitive to changes in volatility and to a lesser degree, to changes in the employee behavior assumptions, it is likely that a company's external auditors will focus on these subjective assumptions. Without the benefit of hindsight, the estimates noted above are not verifiable and therefore may not be auditable.

A related issue is that the ED does not provide for any adjustment to the valuation assumptions as better information becomes available. As previously noted, this would be one of the only areas of GAAP where a company is not allowed, if not required, to adjust estimates as better information becomes available. If actual experience is different from the estimates, this will result in the recording of a potentially materially erroneous expense in the financial statements – and one that the company knows to be erroneous but has no remedy available to correct it. Note that due to the sensitivity of the binomial model to fluctuations in volatility, it would not take a large swing in the actual versus projected volatility to produce a materially different expense. This presents the issues noted above with respect to officer certifications of financial statements, auditability of the financial statements, and legal exposure for management and the company.

In summary, the subjective nature of the estimates will ultimately undermine the comparability of the financial statements from company to company and potentially, on a trended basis within a company. We believe this is a consequence of the subjectivity of the valuation input estimates and the potential for manipulation of the expense under the binomial model.

Measurement date

To the extent that the "cost" of an employee option is ultimately included in the financial statements, we do not believe that the grant date is the proper date for determination of the value. A grant date valuation will have the highest degree of subjectivity because at that date most of the valuation inputs are estimates or projections. It is at this date that the highest potential for manipulation of the inputs exists, as well. Finally, due to the contingencies that exist at the grant date related to vesting and exercise (i.e., continued employment, market value at the time of vesting and/or exercise), any value assigned to an employee stock option at that date would be purely speculative.

Attribution method

To the extent that the "cost" of an employee option is ultimately included in the financial statements, we do not believe that the use of a graded attribution methodology is appropriate. The graded attribution will result in an excess of 80% of the expense recorded in the first two years of the vesting period. This attribution methodology is incongruous with the straight-line pattern in which employee services are performed over the vesting period and the straight-line vesting of virtually all employee options.

If the FASB ultimately concludes that an expense for employee stock options must be recorded in the financial statements, we believe that the intrinsic value measured at the vesting date is a much more viable approach. An intrinsic value at the vesting is more understandable to the financial statement user, more reliable from an accounting and estimation viewpoint and is more indicative of the economic value of the option. An intrinsic value measured at the vesting date approach would provide the financial statement users with more meaningful information at a reduced level of complexity and cost to the company compared to a fair value at grant date measurement approach.

Regardless of the valuation methodology ultimately selected, the FASB should conduct significant field testing before any final pronouncement is made. This will serve to identify practical implementation challenges and highlight the implications of any final standard.

Consistent Application to All Companies

The ED states that the preferred valuation methodology is the lattice model; however, the FASB did note that some companies may not have the required information available to be able to use the lattice model. The implications here are (i) that not all companies will be required to use the lattice model and (ii) that if the information required by the lattice model is available in a usable form, the lattice model must be used. This will result in an inconsistent application of the ED recommendations among companies, some of which may be competitors, resulting in an unfair advantage/disadvantage among the companies. Additionally, the ED is silent with respect to any phase-in requirements that would require all companies to develop or obtain the information required by the lattice model. What will occur here is that smaller, younger companies, public and private, will continue to use the less complex Black-Scholes model or an intrinsic value model to value their employee stock options and larger, more established companies will be required to implement the very complex, subjective and costly lattice model.

The ED also provides for an extended transition period for non-public companies that did not use a fair-value-based model under SFAS 123. In addition, these non-public companies will not be required to apply the provisions of the ED to the non-vested portion of their awards outstanding as of the date of adoption. This results in an easier, less complex implementation for these non-public companies.

The stated justification for the proposals described in the preceding two paragraphs is to "mitigate the incremental costs those entities would incur in complying with its provisions." As a preliminary comment, we believe that the FASB should consider that if the lattice valuation model is so complex and expensive to comply with that it requires a sophisticated finance team to implement and a "big 4" accountant to audit, then it is flawed as an accounting standard and will not be understandable by ordinary investors.

A primary issue raised by the disparate application of the ED proposal is that many companies in the same product markets and in competition for the same limited pool of highly skilled employees will apply different accounting standards. The smaller, younger companies not using the lattice model will have the advantage of being able to use as a principal recruiting tool the ability to give out large numbers of employee stock options without recording expenses on an equivalent basis to their principal competitors. This results in an inherent and sanctioned competitive advantage for the smaller, younger companies. We believe this is not an appropriate outcome for accounting guidance. More importantly, we believe that this is a policy decision not an accounting decision, and one that should not be made by the promulgators of accounting guidance.

Finally, the existence of an "out" to not using the lattice model will result in significant and potentially unintentional non-compliance, which will undermine the effectiveness of the accounting standard.

Transition

Assuming that the FASB moves ahead with finalization of the ED as proposed, we believe that companies should be allowed to adopt the proposed Statement under either a modified prospective transition or a retroactive transition.

Under a modified prospective transition, companies would be allowed to restate reported net income for prior periods to include expense for prior awards granted, modified or settled on a basis consistent with the pro forma disclosures required by Statement 123. Importantly, this transition method would mitigate comparability issues in a company's period-to-period financial statements as a result of the ramp-up effect that is incumbent in the prospective-only transition method.

Additionally, we believe that companies should be permitted to restate prior period financial statements under a full retroactive transition, if it is practicable to do so. Under such a transition, all valuations would be performed on a similar basis and attribution would be on a similar basis period-to-period (assuming the graded vesting proposed in the ED is ultimately adopted). From a comparability and trend analysis viewpoint, this is the most appropriate accounting treatment. This approach would allow valuation methodologies, tax consequences and recognition patterns to be consistently applied in a company's financial statements.

Impact to the Employee

As a final note to the FASB, we would like to comment on the implications of the ED to the average employee. Synopsys believes that broad-based employee equity participation is a significant employee motivator, contributing in a very meaningful way to productivity, retention and innovation. In addition, we believe that stock options contribute to the alignment of employee interests with the interests of non-employee shareholders, ultimately increasing the value of the company for both.

Because implementation of the recommendations proposed in the ED will result in significant non-cash charges recorded in the financial statements, Synopsys will operate at a disadvantage to those companies that do not maintain a broad-based option plan. As a result, it is inevitable that our option program, and those of similar companies, will be curtailed. We believe that this will negatively impact employee motivation, innovation and retention. Option issuances are a current topic of active discussion between Synopsys and our shareholders, who under current Nasdaq rules must approve all stock option programs. The future of our option program, as well as the rest of our employee compensation structure, should be determined through these discussions, not by accounting guidance.

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We are concerned that the recommendations proposed in the ED will have serious negative implications for the credibility of financial accounting and financial statements. We urge the FASB to reconsider its position, seek alternative valuation methodologies, and ensure through detailed field testing that it completely understands and considers the implications of its recommendations.

We appreciate the opportunity to provide these comments to the FASB and hope that it will reconsider its proposal.

Sincerely,

Steven K. Shevick
Chief Financial Officer
Synopsys, Inc.