

Letter of Comment No: 5 304 File Reference: 1102-100

By e-mail only to:

director@fasb.org

June 25, 2004

Director of Major Projects
File Reference # 1102-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856

Dear Sir or Madam,

Thank you for the opportunity to respond to the Exposure Draft (ED) on the Proposed Statements of Financial Accounting Standards on Share Based payments.

I am responding only to certain specific issues raised by the ED that are key items. These issues do have significant impact on any logical conclusion that is ultimately reached. I hope that the Board will consider these comments in its final review of the proposed statement.

I do agree with the Board's initial and continued conclusion that stock options are meant to be compensatory. But they do not always turn out to be compensatory (have realizable value to the recipient), therefore any methodology that always assumes that positive value will be received (stock prices always rise) must be carefully vetted.

I will more specifically detail agreement/disagreement with the ED on the accounting and reporting for both Stock Options and Employee Stock Purchase Plans.

My experience includes being the CFO of a public company, and completing the filings and public reporting therein required. I have also designed and administered stock option and employee stock purchase plans for a public company, including the required reporting.

I will also respond in the spirit of Chairman Herz's comment in the June 2004 edition of Financial Executive, in which he said "Our mission is quite clear; it is to improve accounting and financial reporting standards." In that same article, he also said "But where I feel fairly strongly is that financial reporting is a product that is there for the customer, and the main customers are the people who use the information to make lending or investment decisions. So ensuring that their information needs are met must be the primary goal, while also being cost effective".

STOCK OPTIONS:

The major concern I have with the ED about this specific subject is that the methodology suggested does not conform to Chairman Herz's commentary and public commitment to improve the quality of financial reporting.

In reality, the granting of an Employee Stock Option (at fair market value) creates no income to the recipient (or corresponding expense to the granting entity) on the date of grant. Effectively, the option says that any price appreciation in the stock from this date forward will be shared between the option holder and the shareholders. But there are numerous terms and conditions to this option grant (vesting, continued employment, etc.), including the requisite increase in price of the stock, for any value to be realizable to the option recipient.

The methodology suggested by the ED is quite contradictory to Chairman Herz's public commitment to improve the quality of financial reporting. Here is an excerpt from an article from the June 2004 addition of Compliance Week. This article was written by Dr. Paul Miller and Dr. Paul Bahnson who are both professors of accounting. "Suppose your stock's value goes up after the options are awarded, after all that's the whole idea. What will happen in your financial statements? Actually, nothing. You will continue to report only the amortization of the old and now obsolete grant date value during the vesting period. The balance of the reported options equity account is not affected nor is the deferred taxes asset despite the fact that a much larger future tax deduction is now expected upon option exercise". On the opposite extreme, a company whose stock decreases in value will be over-stating expense and the value of the future tax deduction. And the recipient will realize no value. Please tell me again why taking an expense when there is no actual gain by option recipient is an improvement in accounting?

Another quote from this same article is: "Don't you dare for one second believe that complying with the new standard will produce high quality financial statements. Nothing could be further from the truth".

How can this methodology improve reporting for those who are either lenders or investors? Putting (indisputably) inaccurate numbers on our balance sheets can not be an improvement in financial reporting for either a lender or an investor!

If we knew stock prices would ALWAYS rise, the methodology suggested has some thread of validity. But since we know stock prices both rise and fall, how can we predict the future accurately enough for financial statement use?

How can any of these models be regarded as accurate enough to be used for financial statement purposes? If these models were accurate enough, would not the inventors of these models be retired and living solely on the profits they generated from the use the model?

SUGGESTION:

The FASB has publicly stated that this ED is not a commentary on corporate governance, but strictly a matter of improving accounting and reporting. Accepting the FASB statements at face value, I propose that the FASB take an intermediate position as a result of this exposure draft.

The intermediate position I suggest is a significant increase in footnote disclosure that would display additional relevant informational items. Those informational items would allow comparatives to be made over a significant period of time without affecting current reporting.

The first additional item to be disclosed would be change in value of both options and of the enterprise. Here is an example.

Cumulative

Ontions Granted

Options Granted				
And exercisable	In the Money	Cumulative Increase in		
From FY XX	value of those options	Enterprise Market Value		
FY 01 1,500,000	150,000	2,500,000		
FY 02 2,500,000	0	(1,500,000)		
FY 03 3,500,000	0	1,000,000		
FY 04 5,000,000	3,000,000	25,000,000		

In this particular example, the shareholders allowed option recipients to potentially receive \$3 million of value, but the shareholders received \$25 million of value over the same period

The second item that would be displayed would be a comparison of stock price that was modeled versus actual stock price.

Grants in FY XX	YR1	YR2	YR3	YR4	YR5	YR6
FY 02	10.5	11.0	12.5	14.0	15.0	17.0
FY 03		12.0	13.5	15.0	17.0	21.0
FY 04			6.0	7.0	8.0	9.0
ACTUAL	12.5	11.5	4.0			

By taking this approach, the FASB would meet its obligations to improve reporting while at the same time, proving or disapproving the effectiveness of the ED approach. Since this approach would provide the additional information that FASB currently desires put onto the balance sheet; there can be little risk to taking this approach while there could be great future rewards.

- 1. If the approach of the ED is proved to be accurate over time, that would eliminate the basis of any future controversy, however
- 2. If the ED approach is proven inaccurate, it would preserve financial reporting that was historically consistent, and still provide the FASB the future opportunity to refine/redefine methodologies that might work with a degree of accuracy that as high enough and "provable" though historical footnote reporting that it was acceptable to be used in financial statements

This incremental approach would validate <u>what works versus what does not</u>. This is a highly controversial subject that involves much more estimating and guessing that generally used in current financial reporting standards. And this would also remove much of the "emotionality" currently displayed in some of the earliest responses to the ED.

EMPLOYEE STOCK PURCHASE PLANS (ESPP)

The ED approach, that anything over a 5% discount, is compensatory and needs to be expensed is based on what I believe to be distorted comparatives.

If one would consider the ESPP to be a follow on public offering (rather than a benefit) where the offering is modest in size, and then consider the costs that would included in such an offering (underwriters, accounting and legal), the sum of those three costs would generally range between 12% and 20% of the gross amount raised.

That was the comparative I used a number of years ago when establishing an ESPP for a public company. The Board of Directors wanted to see how the discount compared to the cost of an offering. The 15% discount was highly comparable to external expenses to be incurred when compared to a similar sized public offering.

Therefore, if the net proceeds to the company were approximately the same as would be received in a similar sized follow on offering; why is there a need to expense one type of offering and not another?. Should there not be consistent accounting treatment?

To ensure there is no abuse of the process or logic, I also recommend the FASB set specific criteria for the ESPP to qualify as a type of public offering, such as:

- 1. Limiting the number of shares that may be purchased any one person in any year period to no more than \$25,000 in purchase price
- 2. Limiting the amount of compensation that may be directed to the ESPP to 10%
- 3. Requiring a minimum 1 YR holding period for any Section 16 person

The suggestions are analogous to the IRS requirements.

If there is some desire to ensure this truly is a wide spread "rank and file" benefit that does not benefit only highly compensated individuals, then one might add to the above criteria the exclusion of Section 16 persons from participating.

IN SUMMARY

The overall concept is correct, while the proposed methodology is highly suspect and subject to major inaccuracy. This is especially true with smaller issuers, where stock prices are known to be much more volatile.

The objective is truly noble, but we have not found an approach that is accurate enough to be acceptable to all parties at interest.

Taking an intermediate approach (using the proposed methodology, but in footnote reporting would prove/disprove the contentions about (in) accuracy while providing the requisite data for those who might want it)

CLOSING COMMENT:

I have conducted my own, informal survey of both lenders and analysts (investors), and they have (unanimously) responded that this ED is "horse puckey". They can now get what they need from financial statements and footnote disclosure.

The ED is viewed by them as a backdoor attempt at corporate governance. AND, they feel this ED, if adopted will increase their workload because they will now have to sort out "real" from "accounting ledger main". One respondent even said that this may cause increased reliance on NON GAAP based reporting, which is the exact opposite of the result intended.

I urge the FASB to reconsider their approach and move to an intermediate step of using footnote reporting.

A comparison to the task at hand (the ED) can be made to the question: How do you eat an elephant? The answer is one bite at a time.

Thank you for your time and consideration.

If you have any questions or comments, please feel free to contact me.

Sincerely,

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