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Letter of Comment No: 5303 File Reference: 1102-100

From: Sent: Glenn Berry [Glenn.Berry@pega.com] Friday, June 25, 2004 4:11 PM

To:

Director - FASB

Subject:

File Reference No. 1102-100



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Ms. Suzanne Bielstein,

Director of Major Projects and Technical Activities Financial Accounting Standards Board File Reference No. 1102-100

I write, on my own behalf, in regard to the proposed amendment to FASB Statement No. 123. I am an interested party in several different roles:

- \* I am an American citizen and am concerned about the general impact this standard will have upon our economy, future technological development, and general standard of living.
- \* I am a long time stock owner of individual stocks.
- \* I and my wife own mutual funds that comprise the majority of our family's net wealth, and am concerned with how the perception of analysts upon which mutual funds rely will be altered by this change in accounting.
- \* I am an employee of a software company with both an ESPP plan with a discount and lookback feature and a broad-based stock option plan in which almost all employees receive grants at hire and more than 50% of the employee headcount typically receives option when periodic grants are made.
- \* I am in Financial Planning & Analysis (FP&A) for this company and perform the annual competitive analysis where I examine the published financial statements of our competitors to determine what a typical financial statement looks like so that we can make appropriate strategic plans.
- I am the FP&A partner to our Human Resources department and am involved in modeling and designing our employee incentive and compensation plans, including salary, short term incentives and long term incentives. The Draft Standard Discussion of specific queries the Board raised form an appendix to my letter. Approach Based on the following two paragraphs, I believe that the fair value approach is the correct approach, but that the implementation methods selected will systematically overstate the value of employee stock options. The Board should postpone issuance of this amended standard until it has identified and incorporated appropriate further adjustments to reflect both the differences identified in the prior paragraph. I believe that the Board is generally correct that equity instruments, including options, have value. They are economically equivalent to a gamble, which has a fair value that can be calculated if the terms and probabilities are known. I believe that the best comparison model for the Board to use in considering the accounting treatment for share based payments prior to the final, irrevocable payment, is a state lottery ticket or other gamble. I believe that this compels a general conclusion that share based payments have value and create expense or liability when issued. I believe that the models available for finding the fair value of market traded options extremely overstate the value of employee stock options, because employees never have access to the time value of an employee stock option and because the employee rarely has a guarantee of continued employment, so that the employer can cancel the option at will by terminating the employee. All models for market traded options fair values intentionally try to capture the time value, which at grant date would normally be nearly all of the fair value of an employee stock option. No model for market traded options that I am aware of contain any correction factor for the ability of the option issuer to cancel it at will. Failure to True-Up on Settlement I also believe that the Board has made a major, fundamental error in not defining and requiring the grant date measure of fair value to eventually be trued-up to the final actual value. All other estimated values, including fair value of market instruments, are trued up to actual values when they are finalized - pension obligations are paid, tradable instruments are traded or settled and gains or losses recognized, etc... The Board should have a compelling reason to violate this fundamental principle. Indeed, the Board's own argument for using fair value on initial grant compels a true-up upon final settlement. The Board

in paragraph C16 properly observed that "the initial recognition of debt issued..." (emphasis added). In that case, there is a final recognition and true-up. Following this comparison of initial accounting the Board says that "The Board sees no reason to measure compensation paid in ... equity instruments on a different basis." This statement by the Board is as true for final settlement as it is for initial recognition. Just as both should initially be done using fair value, both should be trued-up and reflected in the financial statements upon final settlement. Potential Congressional Action While I deplore the effects that I believe this standard will have upon our future, I do not believe the Board should consider those. I do believe that the U.S. Congress should consider them. believe that because Congress should consider a wider range of consequences than the Board, the Board should defer to Congress if Congress chooses to act, and should either refrain from commenting upon whether or not Congress should act or actively affirm Congress' right and duty to act as Congress deems appropriate. My conclusions about the relative roles of the Board and Congress are true for all issues, not only this issue. the Board continues to believe that Congress should refrain from interfering with its activities, it should recognize that it then has a moral obligation to consider the broader consequences upon the economy and future, not merely parochial accounting consequences. I believe neither that the Board, as currently constituted, is competent to consider and balance such consequences nor that it should be reconstituted with a majority membership of non-accounting specialists in order to become competent. I further believe that the Financial Accounting Foundation stands in the same position as the Board on this matter, and thus that the chairman's statement on May 17th and the trustee's statement on June 14th of this year are inappropriate because the failure to recognize that accounting standards are not the be all and end all of existence. Indeed, the statement of June 14th uses a logically invalid argument justifying the importance non-Congressional accounting standard setting based on a prior act of Congress.

Regards,

Glenn Berry Financial Analyst - HR Partner Pegasystems, Inc.

Specific Questions Posed by the Board

Issue 1: I agree with the Board's conclusion that equity instruments have value, and that when issued in exchange for services that value should be recognized as cost over the period of service. Issue 3: I disagree with the Board's conclusion that grant date is the only significant measurement date. While the Board does not use the word "only" in stating its conclusions, the exclusion of any remeasurement upon settlement causes that result. For some share based payments, primarily those directly and immediately in the form of shares, there is no other significant measurement date. However, for restricted shares (or as the Board elects to define them, "Nonvested Shares") and any share based payment with option like features, the settlement or

cancellation date is also significant in fact. The best comparable non-share based instrument is a lottery ticket, which has a fair value when issued that changes significantly upon the lottery drawing, and is accounted for accordingly upon each date. The Board has partially recognized the second significant date by treating the second date as an equity settlement transaction. The logic for treating one date as one type of transaction and the other as a completely different transaction is tortured at best. are two measurements on two dates of a single transaction and should receive identical treatment regarding where in the financial statements the results are recorded. The fair value should be recognized over the period of service. If an option is eventually cancelled, all previously recognized expense should be reversed upon the date of cancellation, whether or not the option had yet vested, because the cancellation is a transaction by which the issuer takes back the previously issued option. If an option is eventually exercised, the expense should be trued up to the actual value received by the employee and the cash received by the issuer should be accounted for as it is presently. While a superior alternative from the standpoint of accuracy would be to further completely reestimate the fair or intrinsic value at all interim dates for which a financial statement is prepared, this alternative is excessively burdensome to administer, and therefore should not be adopted.

Issues 4(a) and 4(d): I agree with the board's conclusion that the expected term adequately reflects the nontransferability of employee share options, provided that an appropriate method of reflecting the risk of non-vesting is also incorporated. The nontransferability means that the employee has no access to the time value of the option, and recognizing the expense ratably over the vesting period reflects the rate at which the employee can get value from the option. As the employee has never had access to the time value of the option, I believe that in adjusting for "expected exercise and post-vesting employment termination behavior", any options that vest but are cancelled or expire

unexercised should be evaluated in such a way as to be evidence of a zero expected term rather than ignored. Presumably there would also be other historical evidence for other terms that should be included, so the total weighted average expected term would not be zero if using a

Currently, the reporting from Equity Edge, which  ${\ensuremath{\text{I}}}$ closed form model. believe to be the software for handling employee stock options that has the largest market share, includes only exercised options. I believe that the Board should add a paragraph to Appendix B illustrating this. Issue 4(b): I disagree with the Board's conclusion that a lattice model is preferable because it offers greater flexibility. It is preferable only if such flexibility is actually used. While there are free implementations of lattice models available on the web, none of these actually have the inputs needed to use the flexibility. A lattice model without such inputs is not preferable over a closed-form The statement should be amended to instruct that a lattice model using such flexibility is preferable to both a closed-form model and a lattice model without the needed inputs, but that neither a closed-form model nor a lattice model without the needed inputs is preferable to the other. Issue 4(d): I agree with the Board's conclusion that compensation cost should only be recognized for instruments that vest. However, I disagree with the Board's conclusion that the best way to do this is to require a continuously reviewed and updated management estimate. It would be less burdensome and equally uniform to require that cost should be recognized for all instruments that may potentially vest in the future, and then to reverse that expense when and if certain instruments are cancelled prior to vesting. To illustrate the burden, a company with 400 employees, a 20% turnover rate (combining voluntary and involuntary turnover), and granting all employees a grant of some size on their date of hire, will have for new hires alone almost 80 different grant dates year. If they have 4 year vesting, they will have roughly 200 new hire grants vesting at any point in time [80 \* (0.8^3.5 + 0.8^2.5 + 0.8^  $1.5 + 0.8^{\circ}0.5$ ) = 211]. The burden of managing estimates of the likely turnover date of half of all employed individuals is too high, especially when there is a simple alternative. Issue 5: I disagree with the Board's conclusion that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment for all instruments whose fair value can not be reasonably estimated at grant date. I believe that the Board's prescribed treatment is the appropriate alternative only so long as the fair value can not be reasonably estimated. If it becomes possible to reasonably estimate the fair value at some date following the grant date, then the intrinsic value should be remeasured on that date and used as per the Board's recommend treatment, and the fair value net of already recognized intrinsic value should be measured on that date and expensed ratably over the remaining period that would have been used if fair value had been measurable on the grant date. Issue 9: I disagree with the Board's conclusion that an award with graded vesting is in substance separate awards, each to be accounted for separately. The Board was correct in concluding that the fair value of the awards needs to be calculated as if they were separate awards, but all parties to the transaction view them as a single award, so the appropriate treatment is to calculate the total fair value of the single award and recognize it ratably over the requisite service period for the final element to vest, provided that at any point the minimum recognized expense is the percentage of the award that has vested, as per prior treatment. Issue 11: I believe that the income tax consequence of a share based payment is a separate transaction from the share based payment, and that they should be fully treated as such. The tax transaction is made with a party different than the party to which the share based payment is made, namely the government, and should be treated no differently than any other tax transaction with the government. I believe that the kludgey treatment the Board has proposed for accounting for income tax effects reflects its failure to reach the appropriate conclusion regarding issue 3, and that the Board should first correct the treatment of Issue 3 as described above and then determine the appropriate accounting for income tax effects given that accounting treatment for the other effects of stock options. I further believe that the income tax effects of options accounting should be entirely contained in the entries for the provision for income taxes, not in the entries for stock option expense. Issue 13: I believe that entities having the information needed to apply the modified prospective method of transition also have all the information needed to elect retrospective application using the rule that grants prior to the effective date of this statement are to be handled according to the treatment used for pro-forma disclosure under prior standards. Accordingly, retrospective application should be permissible as it increases the consistency of an individual entity's financial statements when initially issued. Issue 16: The Board has properly concluded (Issue 1) that the share based payment creates a compensation expense. No other income tax consequence from compensation expense is treated as a financing event. Consistent treatment requires that the income tax consequence from share based payments be treated as the tax consequences of other compensation expense, and thus the Board failed to reach the proper conclusion as to how the cash flows be reported. The treatment the Board creates the appearance of a larger than actual cash outflow for taxes and a larger than actual cash inflow from financing. It is not appropriate to require two false statements that net to the truth, it is better to show the truth on a single line. Issue 18: I have heard second hand that my company's auditor (a partner of Deloitte & Touche LLP) has stated that they believe that no company is properly applying the prior accounting standards. This creates the implication that the prior standards are very difficult to understand. The treatment in new standard is no simpler than the treatment needed for disclosure under the prior standard. Accordingly, I conclude that this standard fails to meet the Board's objective to "issue financial accounting standards that can be ... understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence."