Letter of Comment No: 5514 File Reference: 1102-100

## **Infosys**°

## Via E-mail

June 30, 2004

Ms. Suzanne G Bielstein

Director-Major Projects and Technical Activities

Financial Accounting Standards Board

401 Merritt, P.O. Box 5116

Norwalk, CT 06856-5116

Proposed Statement of Financial Accounting Standards: Share-Based Payment (File Reference 1102-100)

Dear Ms. Bielstein,

We are pleased to provide our comments on the exposure draft of the proposed Statement of Financial Accounting Standards.

We are a leading global technology services firm and believe that intellectual capital resident in the workforce is a key competitive advantage. The use of broad based stock options not only helps corporations attract and retain talented employees, but also

becomes the primary motivator for employees to act like shareholders. We view the continued availability of broad based stock options principally as means of wealth creation and wealth sharing, and also as an incentive to innovate and develop new technologies. We appreciate and support the Board's objective of promoting international convergence of high-quality accounting standards, but believe that action to change current accounting rules for stock options under US GAAP could deter the growth of emerging and established companies in industries that rely heavily on broad based stock option grants to reward employees. Even though economic and public policy concerns are not within the scope of the Board's research and technical activities, we request that the standard setting process takes a more holistic perspective while evaluating the need for a change in current practice.

We wish to comment on the specific issues addressed below.

Whether stock options granted to employees result in compensation expense for the issuing entity?

We agree conceptually with the Board's basis for conclusions in SFAS 123 that employee stock options have value and that financial instruments given to employees give rise to compensation cost that should be properly included in measuring an entity's net income. However, we do not agree with the conclusion that the *fair value* of stock options can be estimated within acceptable limits for recognition in financial statements even with the use of the binomial lattice model. Our concerns are discussed in detail in the issues that follow. We do not believe that financial statements would be more relevant and representatively faithful if the estimated fair value of stock options which

lacks the necessary attribute of reliability were included in determining an entity's net income.

Whether stock options issued to employees should be measured at something other than fair value?

We believe that the measurement of all elements of financial statements should posses an acceptable level of reliability for recognition of the elements in the financial statements. The fair value of fixed stock options or the benefit derived by the employer issuing them cannot be measured to an acceptable level of reliability. Since this basic requisite is not met, the cost of stock options issued to employees should not be measured at fair value. Measurement of fair value of stock options will involve application of a significant amount of judgment resulting in poor comparability of financial information.

We believe that currently only the intrinsic value method that can provide an accepted level of reliability in the determination of the cost of issuing stock options. We agree conceptually with the Board's basis for conclusions in SFAS 123 that employee stock options have value and that financial instruments given to employees give rise to compensation cost that should be properly included in measuring an entity's net income. The existing valuation methodologies for determining fair value of stock option grants have shortcomings. We appreciate the fact that valuation specialists and the academic community continue to be engaged in the development of new models. We request the Board to support and encourage their efforts so that a reliable and less complex model can be developed for the determination of the fair value of employee stock options.

## Whether the fair value of stock options can be reliably measured?

We do not believe that the fair value of stock options can be reliably measured. Corporations have used employee stock options as a recruitment and retention tool. Any attempt to measure the fair value of these recruitment and retention tools would produce results that are as unreliable as attempts to value the corporation's workforce.

There is no empirical evidence to support the assertion that the results produced by option pricing models are identical or similar to trading values for similar securities in the market place. So it is possible that the value assigned to employee stock options by the option pricing models may not be its true value at all in a market place transaction conducted at arms length.

Option pricing models measure the value of an option based on a number of variables. The models suggest that option fair values are higher when the equity markets are on a cyclical high and lower when markets are on a cyclical low. This will lead to wide distortions in the earnings of corporations if the cost of stock options were charged to earnings on a fair value basis. Volatility of the underlying stock is another variable considered by the options pricing models in valuation. There is considerable difficulty in estimating the future volatility for a corporation stock leading often to wide ambiguity in estimating volatility and consequently in measurement of the fair value of stock options issued. The value of the employee stock option is also dependent on its estimated life or the estimated time period within which the employee will exercise the option. There is considerable difficulty in predicting employee behavior and hence the unreliability of the option value which is dependant on this variable.

The value of stock option to the employee is different from the value of the option to a non-employee who trades options. This has not been factored in by the options pricing models. Volatility of the underlying stock is generally a key factor guiding the decision making of the non-employee options trader but not the employee who has to serve the vesting period, exercise the option and pay the exercise price. Employee stock options cannot be freely traded and generally do not vest for several years. There are other restrictions like non-transferability, performance conditions and "black out" periods. However, the option pricing models were developed for shorter-lived and freely traded options and do not take into account the restrictions inherent in employee stock options. This results in significant overvaluation of employee stock options by the options pricing models.

We appreciate that the binomial model is an improvement from closed form models like the Black-Scholes and that it offers greater flexibility needed to reflect the unique characteristics of employee stock options. However we believe that the improvements are not adequate to enhance the reliability of the model. The proposed statement would require the fair value be estimated using the expected term rather than the contractual term to take into account the non-transferability of employee stock options. We believe that this adjustment will not entirely neutralize the effect of lack of transferability or specific captive conditions under which transaction in employee stock options take place.

Over the years, the Board has taken and implemented significant initiative aimed at improving the quality of reported earnings. If the fair value of stock options, which cannot be reliably measured, were to be included in earnings, it will only distort and lessen the quality of reported earnings. Recording the fair value of stock option grants

arrived at by using subjective assumptions will produce financial information lacking in reliability and value to the users. This will force many users of financial statements to adjust the value of the ambiguous stock option fair value charge from reported earnings before making investment decisions similar to goodwill amortization which many users did not consider as being useful information in analyzing investments. This will lead to more confusion than clarity for the users of financial statements. We believe that the creation of a fictitious expense in the financial statement should be avoided.

## The disclosure alternative under SFAS 123

We believe that the fair value of employee stock options is relevant information and hence support continuation of the current disclosure requirements under SFAS 123. Users who want to make decisions based on the pro-forma information may continue to do so despite the reliability of such information being questionable. It is widely accepted that market factors into account all available information while it attributes value to an entity and hence the pro-forma information will be used by all those who want to factor in the same while valuing an entity.

Ms. Suzanne G. Bielstein

June 30, 2004

Page 7

In summary, we believe that any change in the current accounting rules for stock

compensation is undesirable as recognizing the cost of employee stock options on a fair

value basis is controversial and lacks empirical support. Any move in that direction will

not necessarily lead to an improvement in the quality of financial reporting. However,

we recommend that the pro-forma disclosure provisions of SFAS 123 should be retained

as some users might find the pro-forma information relevant.

We appreciate the opportunity to offer these comments and thank you for considering our

response.

Sincerely,

T. V. Mohandas Pai

Member of the Board and Chief Financial Officer