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To: Director - FASB

Subject: File Reference 1102-100: Accounting for Stock Options and ESPPs

Letter of Comment No: 5290 File Reference: 1102-100

Dear Chairman Herz, I would like to thank the FASB for both the opportunity to comment and for the great deal of thought and work that went into developing the exposure draft. Because this issue is so complex and the impact is significant, it is critical that the FASB seriously review and consider the input that is given from the financial community otherwise the comment process is a farce. I have worked in the Finance profession for 19 years and have degrees in both Accounting and Finance as well as a Masters in Business Administration and respectfully ask the FASB to consider the points I have outlined below.

I would like to first acknowledge that I have a full understanding that fundamental to the FASB's position stated in the Exposure Draft (ED), is the concept that employee stock options are compensation expense in exchange for employee's service. However, with all due to respect to the FASB, I believe that this is a significantly over-simplified premise which does not account for important differences in the nature of an employee stock option as compared to other types of compensation. Even if we were to assume that employee stock options were regular compensation expense, the "expense" does not meet FASB's current definition of an expense and the accounting treatment proposed under the ED is a significant deviation from how all other elements of compensation expense are accounted for and how other types of expenses are accounted for. This in itself is indicative of a premise that needs to be re-examined. For example why is that:

- 1. It will be one of the only non-cash expenses that do not tie directly to either an asset or liability on the balance sheet?
- 2. It will be one of the few transactions in which the discounted present value of a future event is used instead of recording of a historical event?
- 3. It will be virtually the only transaction that will be recorded before enough of the related uncertainties have been resolved to make reasonably reliable measurement possible?
- 4. It will be one of the only expenses that may not be reversed if it is subsequently nullified in the event of an option's worthless expiration?

The existence of any one of these accounting rarities should give one pause; the existence of all four in the same proposed rule should cause serious doubt on the validity of the entire concept.

## Stock Options Represent an Equity Sharing Arrangement and are not like other forms of Compensation:

The express purpose of employee stock options is to increase the value of the issuers equity, not to compensate the employee. The issuers of employee stock options (i.e. the company's shareholders) recognize that there is a dramatic difference between employees who perform their services in an acceptable manner (and as a general rule receive full wages and cash incentive compensation for that service) and employees who are willing to work long hours, go "above and beyond", think and act like owners and create future value which in turn results in increased value to the issuers. That is why the <u>issuers (i.e. the</u> shareholders) agree to forgo a piece of their company in exchange for this value creation.

If employee stock options were like other forms of compensation than the internal management of the company would be able to issue this "compensation for services" without limit (other than available cash or credit). However, employee stock options <u>are not like other forms of compensation</u> and that is why the issuance of employee stock options are governed by the shareholders of the company as per NASDAQ and NYSE requirements. Companies may not issue equity without the pre-approval of the company's shareholders. Furthermore, it is common for the shareholders to impose additional restrictions regarding the issuance of equity such as per person share limits, types of equity vehicles etc. These facts demonstrate that employee stock options are not similar to other forms of compensation but are an agreement between the issuers (the shareholders) and the employees to share in the ownership of the company for a potential benefit to both the grantor and the grantee. The fact that employee stock options may be a cost to the issuing company has never been in dispute and that cost is already properly accounted for under the treasury stock method. While an employee may receive value in exchange for this equity agreement, it is inaccurate to conclude that this value is like other forms of compensation and should be accounted for as such. These points are extremely critical and I ask that FASB seriously reconsider their premise that employee stock options are fees for services like base wages and cash based incentive pay.

In further support of the fact that employee stock options are fundamentally different than base wages or cash based incentive compensation, studies show that employee stock options are rarely used as substitute for cash based compensation and this is

supported by a study of 490 public companies published in 2000 by Rutgers professors Blasi, Kruse and Sesil and professor Kroumova of the New York Institute of Technology. This study found "no systematic evidence of any kind that companies that adopted broad-based stock option plans reduced their fixed compensation expense in any significant way". Indeed they found that on average, fixed wage compensation levels of this large sample of companies was 8% higher than comparable firms in the same industries that did not offer broad-based employee stock option plans.

All of these facts support that employee stock options are clearly an equity agreement between the issuer and the employee of the company and are unlike other forms of "fee for service" compensation. If employee stock options were regular "fee for service" compensation expense then the FASB would not be struggling with finding a valuation methodology it deems acceptable and which is explainable, realistic and reliable. It is relatively simple to value base salary or cash based incentive pay because this type of "fee for service" compensation is fundamentally different than "equity compensation". It seems the FASB has drawn an over simplified and inaccurate conclusion in order to appease "requests from investors to increase transparency, relevance and comparability of information" in a time when a few companies exhibited extremely poor corporate governance and sometimes illegal activity.

Even if we started with the premise that employee stock options are compensation expense, there is absolutely no reliable method for valuing them. Members of the FASB have themselves stated that Black-Scholes is not a good valuation tool, and instead recommend the use of a binomial lattice model. However, the binomial lattice model is very similar to Black-Scholes and utilizes basically all the same assumptions. In addition, this is a very impractical requirement to place on companies. There is no "turn-key" model that a company can load it stock option exercise historical information in to in order to complete a binomial valuation. I have asked two of the big 4 accounting firms and two nationally recognized compensation firms if they have such a tool, and they do not. In addition, since the FASB proposes that employee stock option are compensation expense, the expense must be allocated across all aspects of the company's operations, which for a large fortune 500 firm, is an administrative nightmare.

I fail to see how expensing a large, future theoretical estimate of todays value of an employee stock options improves the accuracy and transparency of financial statements. The real cost of an employee stock option is already accounted for under the treasury stock method (options increase dilution only when it vests and if the stock price rises) and in fact if employee stock options are expensed and also included in the fully diluted shares calculation then we are *double counting the impact of employee stock options*. How is that accurate accounting?

I must say I am wondering if the FASB has some inherent bias against employee stock options. I say this because FASB has drafted accounting rules that force companies to take an expense but never allow for a credit if the stock option expires underwater and is never exercised. Also, in regards to the proposed tax accounting, if the deferred tax asset is over estimated the difference is expensed but if it is underestimated the credit flows through equity.

I sincerely believe this proposed accounting for employee stock options will greatly impair the accuracy of financial statements, and ask the FASB to reconsider its position.

Regards, Mary Zeigler