

To: Director, Financial Accounting Standards Board; Director@fa  
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File Reference No. 1102-100, Share-Based Payment

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**Personal Background:**

I recently joined SanDisk Corporation as Executive VP Administration & CFO. Previously, from 1999 through 2004, I was Sr VP & CFO of palmOne, Inc. (Nasdaq: PLMO), formerly Palm, Inc. Prior to Palm, I was with 3Com Corporation (Nasdaq: COMS) for 11 years in executive finance positions including Treasurer and Corporate Controller. Previous to 3Com, I was with a start-up as their controller and CFO, and I began my career at Hewlett Packard where I held several finance positions. All of my positions have been in the Silicon Valley of California, and every company I have worked for has utilized stock options. Each of the last 4 companies has granted stock options to every single full time employee. I also serve on the Board of Directors and am the chairperson of the audit committee for CIPHERGEN Biosystems (Nasdaq: CIPH), a biotech company that grants stock options to all employees.

**Position on Issues in Exposure Draft:**

**Issue 1:**

I do not agree with the Board's conclusion that the granting of employee stock options gives rise to a recognizable compensation expense. I arrive at this conclusion from several different perspectives:

1. At the time that a stock option is granted, there is no way to predict whether the stock option will ever produce value to the employee, and if it does, how much value will be received. There is no way to predict with any reasonable level of accuracy the following factors:
  - a. Whether the employee will remain employed in order to vest in the stock options
  - b. How the company's stock will fare over time
  - c. At what time the employee might choose to exercise the options (assuming the employee vests and the options are "in the money")

In order to recognize an expense, the expense should be probable and estimable. At the time a stock option is granted, I believe that any estimate of future compensation expense meets neither of these standards. I have seen many options granted which will clearly expire worthless, and I have seen options develop into much more value than would have been predicted by a Black-Scholes or Binomial model. A model cannot predict what will happen in the economy or how a particular company will fare in its industry against its competitors. If the models could predict this, investing in the stock market would be riskless. And clearly, a

model can't predict the personal factors that will influence when an employee chooses to exercise a stock option.

2. Clearly employees place value on receiving stock options, but that does not mean that there has been compensation expense. I believe that there has not been expense because the company has not given up any asset nor taken on any liability. What the company has done is grant an equity instrument that "could result in value to the employee" IF the company's stock appreciates and IF the employee remains employed in order to vest, and IF the employee exercises the equity instrument at a time when the stock is valued above the strike price. There are too many IF's here and the value of what has been granted cannot be measured. In contrast, if an employee is given shares outright, subject to vesting (restricted shares), it is much more probable that the employee will receive something of value, and there is a reasonable way to measure the value – the value of the shares can be measured at the date of grant. In this case, it is reasonable to record an expense over the vesting period.

In the case of a stock option, I believe that the only possible method for recording an expense would be to record it at the time of option exercise, and at that time to reflect the difference between the cash received from the employee and the cash that could have been obtained by issuing the same shares at the market price. At that time, an entry could be recorded to:

DR Cash (for option exercise price)  
DR Expense (for market price less option exercise price)  
CR Equity

However, I do not believe that even this expense is appropriate. Recording this expense is recording an opportunity cost – reflecting the additional amount that could have been received by the company by selling the stock in a different manner. I do not know of other opportunity costs that are recorded in the financial statements.

3. Current accounting appropriately reflects the impact of stock options on the company and the investor. Current accounting requires that if the stock option is "in the money", the shares used to calculate EPS will include the number of shares that would be issued upon exercise, less the number of shares that could be repurchased by the company with the option exercise proceeds. This accounting adequately dilutes the earnings per share of the company to reflect that these shares are likely to be issued. If the options are not in the money, the shares for EPS are appropriately not increased. And investors are provided with disclosure in the footnotes as to the number of options that have been granted at various strike prices.

The employee has been given a benefit that may or may not generate value for the employee in the future. When the option is worth something, shares for EPS are incremented. If the stock price slips back below the exercise price, shares for EPS are adjusted downward. And ultimately if the option is exercised, shares will be issued and those shares will dilute EPS. When and if option exercise occurs, the current accounting

reflects everything that impacts the company – the amount of cash received by the company will be recorded on the balance sheet in cash and in paid-in-capital, and the number of shares issued will be reflected in EPS.

**Issue 3 and 4:**

I do not agree with the Board's conclusion that the fair value is the relevant measurement attribute and that the grant date is the relevant measurement date. In addition, I do not believe that the recommended models produce reasonable estimates of the fair value. Arguments:

There is no way to predict the "fair value" of an option. Regardless of the model used (Black-Scholes, Binomial, etc.), it is impossible to predict how a company will fare over an extended period of time, and it is impossible to predict the personal issues that will influence the timing of when an employee chooses to exercise a stock option (assuming the option is vested and in the money). Recording an expense based on a mathematical model that attempts to predict these factors will result in financial statements that are inaccurate, unreliable, and inconsistent from one company to another.

The most important variable in the Black Scholes and Binomial models is the forecasted stock volatility over the expected life of the option. How can one predict future volatility of a stock? Historical volatility is known, but how can history predict what will happen over the next 5 years? 10 years? Also, a high volatility factor leads to a higher expense. But if volatility is in fact high, that may very possibly lead to the option having little or no value – the option may be "below water" during periods that the employee can exercise.

In the case of Palm, Inc., my former company, the company went public in March 2000, during the "bubble economy". Stock options were issued to all employees at the IPO price on the day of the IPO. The value of the company at the IPO price was approximately \$20B. The company's value now stands at approximately \$1.6B. The options are fully vested, and after a 20 for 1 reverse split, the options have an exercise price of \$760 per share. The stock is trading at approximately \$34 per share. How can the use of estimated volatility factors predict what will happen to the economy overall and to a particular company? Would investors in Palm have been better off if expense had been recorded for these options based upon a fair value estimate on the date of grant? I don't think so.

Finally, if an expense is recorded based on a fair value estimate at date of grant, why is it never adjusted to reflect current reality? Every other significant "estimate" that we record in the financial statements gets trued up as better information is known. Why is this one not adjusted up and down as valuation changes? Is it because it would create significant variability in financial results with no underlying change in the company's assets or liabilities? If the estimate is this subject to variability and impossible to predict, then I propose that the investor is better off with no expense recorded. The investor has all the information needed via the diluted share calculation (which is adjusted every quarter based on which options are in the money) and the footnote disclosure on options outstanding.

**Issue 18:**

The Board asks the question of whether the proposed Statement, taken as a whole, achieves the Board's objective of issuing financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, etc. I think this is a very difficult Standard to understand, even for those of us with sophisticated accounting knowledge, but I believe this is not the most important question to ask. I believe the most important question is will implementation of this Standard result in financial statements that will be easier for the investor to understand?

I believe that this standard will make it even more difficult for investors, even sophisticated investors, to interpret GAAP financials. The expense will vary significantly based upon variables that are difficult to interpret and impossible to predict. In many, if not most, cases, I believe the computed expense will bare little resemblance to the value ultimately received by employees. And the equity section of the balance sheet will reflect Paid in Capital when in fact no shares have been issued and the company has not received an asset.

I believe that if this standard is put into effect, the result will be that sophisticated investors will want stock option compensation expense disclosed on a separate line item so that they can back it out of the income statement. Otherwise it will be impossible to compare the earnings power of one company versus another. Some companies use options extensively and others don't. Diluted shares and equity disclosures appropriately reflect these differences in the use of options, but if an expense is buried in the income statement, GAAP P&L's will be inaccurate, unreliable and inconsistent between companies. Unsophisticated investors (the general public) will likely not understand the impact of this Standard. They will simply see significant reduction in earnings for companies that issue employee stock options and believe that the earnings power of these companies has been reduced.

I believe that other users of the financial statements, such as banks, will also adjust the GAAP financials to exclude the option entries. Banks will likely adjust the equity section of the balance sheet to take out the recorded paid-in-capital. If they don't, how will they establish loan covenants? Paid in capital will continue to increase as the company issues stock options, yet the company has not received anything of value that is relevant to the banks. Also, the amount of paid in capital recorded each quarter for options granted will vary significantly based upon the market price of the stock when options are granted. I believe banks will soon realize that they simply have to back out these entries to arrive at a sensible analysis.

I believe that the result of this standard will be to significantly increase the usage of non-GAAP financials by companies and investors and other users, and this will result in even more cynicism than exists already today about Generally Accepted Accounting Principles.

**Other Issues:**

I would like to raise the following additional issues:

**Cost of implementing this Standard:**

The Board has given some consideration to the cost of this standard for non-public entities and small businesses. The cost of implementing this standard for mid-size and even large public companies will be significant. The result will be a decrease in the "real" earnings of these companies in exchange for financials that are less reliable. The costs will include:

- Costs of implementing new models – for sizeable companies that grant options to all employees, there is no alternative to having the model integrated into the stock option software that the company uses to track its options. This will take time for the software providers to implement, they will charge for it, and companies will have to learn how to use the new software. To account for the stock option expense with an off-line model is simply impossible.
- The cost of measuring expense based upon each vesting period being treated as a separate grant. In many cases, this can mean that each option needs to be treated as 48 different options for calculation purposes (in the case of monthly vesting over 4 years).
- Audit fees will certainly go up. The black-scholes models that are integrated into stock option software are literally “black box models”. Auditors will certainly want to spend more time than they do today reviewing the variables selected for input into the models, and they will want to do more analysis of the output generated by the models. All of this will result in increased audit fees.
- In-house accountants will need training; and the resource requirements for in-house accountants will go up.

**CFO/CEO certification:**

As a CFO, I do not know how I can attest to the accuracy and reliability of stock option compensation expense. In fact I know it is not accurate or reliable. Knowing that the models simply cannot predict the future value to be realized from employee stock options, how can the CFO and CEO certify that the financial statements present in all material respects the financial condition and results of operation of the company?

**Conclusion:**

I have focused on the accounting issues that I believe exist with the proposed Standard. However, I believe it is worth mentioning several other factors:

If this standard is put into effect, I believe that there is likely to be a significant reduction in the use of broad-based employee option plans. Given the magnitude of the expense that many companies will need to record, I believe they will conclude that the risk to stock market value is a risk that they cannot afford to take.

A reduction in the use of employee options will result in less alignment between employee and shareholder incentives. I believe this will gradually lead to less entrepreneurial spirit in companies, less innovation, and less overall competitiveness by companies following U.S. GAAP.

While these impacts are unfortunate, I could support the standard if it produced better accounting. However I believe the expensing of stock options as proposed in this standard is bad accounting and will result in financial statements that are of less value to the investor in evaluating and comparing companies. Instead of improving the transparency of reporting, this standard will lead to a much more cloudy picture.

Thank you for your consideration of my letter.

Judy Bruner