Karen Salmansohn

From:

Director - FASB

Sent:

Saturday, February 01

To:

Karen Salmansohn

io. Karen Samansonii

Subject: FW: Invitation to Comn

Letter of Comment No: |98 File Reference: 1102-001 Date Received: |-3|-173

----Original Message----

From: Robert Wong [mailto:wong@gene.COM]

Sent: Friday, January 31, 2003 9:02 PM

To: Director - FASB

Subject: Invitation to Comment- File Ref No. 1102-001

On behalf of our Executive Vice President and Chief Financial Officer of Genentech, Inc., I am attaching a response to the *Invitation to Comment* regarding accounting for stock based compensation. In addition, we are sending a signed copy of this letter to you via overnight courier.

Thank you for the opportunity to comment.

February 1, 2003

VIA E-MAIL AND OVERNIGHT COURIER

MP&T Director- File Reference 1102-001 Financial Accounting Standards Board 401 Merritt 7, P.O. Box 5116 Norwalk, Connecticut 06856-5116

Re: Invitation to Comment on Accounting for Stock Options

We appreciate the opportunity to comment on the *Invitation to Comment* on accounting for stock options, dated November 18, 2002. There are significant differences between the IASB's proposal and SFAS 123, particularly the concept of mandatory expensing of stock options through the income statement proposed by the IASB. We are concerned with this approach for several reasons: 1) the dilutive effect on earnings per share would be double counted in both the income statement and weighted average shares outstanding calculation, 2) the valuation tool available to calculate the fair value of stock options is flawed and will give misleading and confusing information to investors and shareholders, and 3) the expense impact will stifle the entrepreneurial spirit of growth companies. We believe that the mandatory expensing of stock options using the fair value tools available will not improve the transparency, reliability, or comparability of financial statements.

EPS Dilution

The cost of employee stock options is already included in the calculation of weighted average diluted shares outstanding. This calculation includes the potential dilution impact that "in-the-money" option shares represent. Weighted average diluted shares outstanding is the basis for calculating the diluted earnings per share, the widely accepted performance measure used by analysts and investors. The long-standing approach to calculating diluted earnings per share using in-the-money option shares is a better measure of cost because the in-the-money option shares are most likely to be exercised, thus diluting earnings per share. Mandatory expensing of stock options through the income statement, as proposed by the IASB, will overstate the cost of stock options because some options may expire out-of-the-money (and never be exercised) and some options may be cancelled. In addition, under the proposal by the IASB, mandatory stock option expensing will double count the dilutive effects of earnings per share through both the reduction of net income and the increase in weighted average shares outstanding.

Changing the long-standing approach of diluted earnings per share will create confusion in the investment community. Adopting the IASB's proposal may lead analysts and investors to adopt a new measure which is not meaningful, reliable or comparable and can be highly variable in relation to a company's actual fundamental performance.

Valuation Tools

It is widely known that the Black-Scholes options pricing model was developed to value short term freely traded options and was not designed to value the unique features of employee stock options such as the inability to trade these options and vesting restrictions. Employee stock options are long term (usually a 10-20 year term) and are not freely traded options because they are nontransferable, subject to other restrictions on exercise (black-out periods) and forfeited upon employee termination. In addition, unlike traded options, employee stock options have a vesting period requirement before the options can be exercised. It is not surprising that many companies disclose in their financial statements the fact that the Black-Scholes methodology was not developed for employee stock options, that the assumptions used in the model are highly subjective, and that management believes that this model does not provide a reliable measure of the fair value of employee stock options. Yet, even with these known flaws in the reliability of the values generated by Black-Scholes, this is still the primary model used for valuing employee stock options under the mandatory expense proposal.

The assumptions used in Black-Scholes are highly subjective. For example, the expected volatility that management estimates for Black-Scholes purposes is based on historical volatility trends that are expected to be applied to stock options that vest in the future. As we all know, past performance does not necessarily provide a good indication of the future. Future stock price volatility can, among other things, be affected by political agendas, overall investor confidence in the capital markets, future earnings, and catastrophic events. Future stock volatility is difficult to predict. By example, Genentech's current historical volatility differs by as much as 20% depending on whether historically 250 days is used or 100 days. Furthermore, over the past 3 years, our historical volatility has changed by 76% partly due to some of the factors mentioned above. To use a constant volatility factor determined in this manner in a model reaching 10-20 years in the future is absurd. In addition, other assumptions used in the Black-Scholes model include expected option life, expected dividend yields and the expected risk-free rate of interest, all of which are highly subjective and subject to manipulation. From a consistency and comparability standpoint, there is genuine concern regarding the variability that will exist when one company uses a particular valuation model and another company uses a different model or assumptions... even when, for example, these companies are within the same industry. Because there is so much subjectivity in the valuation inputs, similar size companies and companies in both the same and in different industries can have significant valuation differences; therefore it would be difficult for analysts and investors to make any meaningful comparisons.

With this much variability and subjectivity in determining the proper valuation input to be used in the fair valuing of employee stock options, it is already difficult to rely on the Black-Scholes model even for footnote stock option disclosure purposes and would be compounded were the Black-Scholes valuation results included in the income statement. The Black-Scholes valuation model and related expense impact, as proposed, penalizes typical growth companies with high stock volatilities and benefits stable companies with lower stock volatilities. Mandatory expensing of stock options merely introduces a variable with significant potential to distort a company's performance.

Impact on Growth Companies

As a growth company, we believe that the IASB's proposal of mandatory expensing of stock options will have a significant impact on our company and other companies in the emerging technology area. As a means for recruiting and retaining highly qualified employees, we grant broad-based stock options to all eligible employees. In our yearly stock option grants, approximately 90% of the options granted are to employees other than executive officers. We believe that our broad-based stock option plan offers widespread employee ownership of our company and has been an effective tool to increase productivity, employee commitment, and innovation and align employee interest with those of shareholders.

Broad-based stock option plans produce more value for shareholders because all employees have a vested interest in the company and in the long run, value creation. The IASB proposal penalizes companies who have broad-based stock option plans because these stock options will need to be expensed. Companies that grant stock options to selected employees will not be impacted as much because there are fewer options granted than under broad-based stock option plans. If adopted, the IASB proposal would most likely eliminate broad-based stock option plans.

The elimination of broad-based stock option plans could have serious consequences at a time when economic recovery is critical. For small start-up companies with limited cash on hand, broad-based stock option plans allow these companies to hire and retain qualified employees. We have used broad-based stock options to instill a tremendous entrepreneurial spirit in our employees. This entrepreneurial spirit, in turn, adds significant value for our shareholders. Companies that have broad-based stock option plans have harnessed this entrepreneurial spirit to grow significantly over the years and become leading technology companies. Eliminating broad-based stock option plans will crush the entrepreneurial spirit of start-up companies that have had a large part in fostering America's economic growth.

Conclusion

We strongly believe that the FASB should retain the current standard under FAS 123 confirming any such unreliable measurement to footnote disclosure and not adopt the mandatory expensing of stock options proposed by the IASB. We believe that the key measure of performance used by analysts and investors, diluted earnings per share, includes the effects of the options most likely to be exercised and that stock option expensing would erroneously double count the income statement and the diluted shares impact. In addition, the Black-Scholes valuation tool was not developed to value employee stock options and is not a reliable measure of expense given the subjectivity of the inputs that go into the valuation model. The adoption of the IASB's proposal does not enhance a financial statement's transparency, reliability or comparability and therefore does not serve shareholders and investors. We believe that the best method to enhance the quality of financial statements is to provide additional disclosure of the potential dilutive effects of stock options granted and the details of their distribution to senior management and employees on a quarterly basis.

The American economy has grown historically from the innovation and entrepreneurial spirit which start-up technology companies have utilized by hiring and retaining qualified workers who have a vested financial interest and can share in the growth of their companies. Adopting rules that limit our ability to hire and retain qualified employees and discourage innovation hurts the economy and shareholders.

Again, thank you for the opportunity to provide feedback on the IASB's proposal on stock option expense.

Sincerely,

Louis J. Lavigne, Jr.
Executive Vice President and
Chief Financial Officer